

Memorandum 98-64

Uniform Principal and Income Act: Staff Draft Tentative Recommendation

Attached to this memorandum is a staff draft of a tentative recommendation proposing enactment of a modified Uniform Principal and Income Act (1997). Before this draft can be distributed as a tentative recommendation, the Commission needs to review the draft in some detail, particularly the issues presented in the staff notes following several of the sections in the draft. We also anticipate persons attending the meeting will want the Commission to consider a number of issues.

The draft tentative recommendation incorporates a host of revisions and ideas generated by the “working group,” which consisted of Prof. Edward Halbach (a longtime Commission consultant, currently finishing work as Reporter on the Restatement (3d) of Trusts), Prof. David English (Commission consultant, and Reporter on the Uniform Trust Act project), Matthew “Sandy” Rae (Chair of the UPAIA Drafting Committee), James L. Deeringer (liaison with the State Bar Estate Planning, Trust and Probate Law Section Executive Committee), James P. Bessolo (Bank of America, California Bankers Association), David W. Lauer (Wells Fargo, CBA), Maurine Padden (CBA), and Stan Ulrich. The working group met on July 1 and August 13, and had a conference call on September 4, to consider technical details and broader issues in the uniform act. Numerous revisions have been made in the language of the uniform act as a result of the working group review and the draft incorporates these consensus changes. The staff has also made a number of other improvements, as is our practice when reviewing uniform acts, keeping in mind the benefits of uniformity.

Remaining Issues

A variety of technical issues remain to be resolved, and the newly drafted parts of the statute have not been reviewed by the working group to see if the staff has correctly interpreted the consensus. The proposals concerning the power to adjust (draft Section 16336), the safe harbor unitrust standard (draft Section 16337), and the notice of proposed action (draft Section 16338) have not been reviewed by the working group. The safe harbor and the notice of proposed

action ideas were mainly discussed in the abstract and were among a number of ideas and combinations of elements that arose in the working group discussions. In other words, the staff has no expectation that these proposals are in their final form. Some issues are raised in staff notes following relevant sections, and we expect more issues will arise at the meeting.

There are ongoing drafting issues in some of the more complicated sections, such as draft Sections 16335 (general fiduciary duties) and 16340 (determination and distribution of net income and principal). These sections have been redrafted several times, but the staff does not believe we necessarily have a consensus from the working group. In addition, the staff intends to review earlier comments of the state bar team and the New York advisory committee proposal in detail when time permits.

On the other hand, a large number of technical issues have been resolved one way or another. Some issues have been avoided by eliminating language. For example, the bank representatives have had problems with the definition of “terms of the trust,” as discussed at the July Commission meeting. Still, the uniform act frequently uses the phrase “terms of the trust or will” and the banks were concerned that this might mean something other than the trust instrument. The staff does not believe this is an issue inherent in the UPAIA, so we have been willing to remove “terms of the” throughout the act. The broader question of what constitutes the “trust” and how its “terms” are determined and interpreted may be worth clarifying some time in the future, such as when the National Conference approves a Uniform Trust Act, but need not be addressed now. There are other areas where the UPAIA, as a uniform act intended for consideration in a variety of state law contexts, provides an overly detailed rule that we can omit or narrow because the subject is covered elsewhere in California law.

Status of the Major Policy Issue — UPAIA Section 104 (Power To Adjust)

Section 104 of the UPAIA provides a discretionary power permitting the trustee to make adjustments between principal and income accounts to achieve the purposes of the trust and treat all beneficiaries fairly and reasonably. The problem inevitably arises, or will arise, when trustees understand and apply the California Uniform Prudent Investor Act to maximize return on the portfolio consistent with the trust purposes. Under prudent investor principles, trustees are no longer supposed to select investments just to produce a level of return in the form of trust accounting income for income beneficiaries. This traditional

approach ignores the benefit of investments in equities and the tax savings inherent in emphasizing capital gains. The tension between prudent investor principles and the traditional principal and income rules retained in the new uniform act is relieved by the power to adjust. This said, we need to remember that with all of the exceptions to the power to adjust (see draft Section 16336(b)), it is estimated that the statutory power would apply to only a small percentage of trusts — we've heard estimates as low as 5%.

Draft Section 16336 includes the discretionary power to make adjustments, but eliminates the list of mandatory considerations in UPAIA 104(b) that our experts agreed could become “litigation points.” To further address the concern over litigation instigated by disappointed beneficiaries, draft Section 16337 provides a “safe harbor” protecting adjustments to income accounts equivalent to a 4% unitrust amount. This idea was inspired, in part, by a report of the New York Legislative Advisory Committee that recommends a 4% per year unitrust as a default rule for trusts after the operative date. (The NY committee proposes adopting the Section 104 fiduciary power to adjust as the rule applicable to pre-operative date trusts — for background, see the “Memorandum in Support of the Proposed Legislation” prepared by the NY committee, in Memorandum 98-36, Exhibit pp. 3-14.)

Schedule

The Commission has been proceeding on the understanding that we would try to complete work on the UPAIA this year, with a view toward introducing legislation in the 1999 legislative session. The working group is still optimistic about wrapping this subject up and would prefer not to keep tinkering with it for another year before seeing it in bill form.

The staff believes we can still meet this schedule, but to do so may necessitate distributing a tentative recommendation that does not meet our usual standards. While we have benefited immeasurably from the detailed review by the working group, we still need to distribute the proposal to our wider community of interested persons for their review and comment. We cannot wait until after the December meeting to distribute a tentative recommendation and effectively meet the legislative schedule.

If the Commission is uneasy about distributing a “tentative recommendation” in the form of the attached draft (as revised to implement decisions at this meeting and to complete editorial work), then we could distribute a “discussion

draft” or “exposure draft” or some other lesser document so we can elicit comments in a timely fashion.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

UNIFORM PRINCIPAL AND INCOME ACT

A new Uniform Principal and Income Act was approved by the National Conference of Commissioners on Uniform State Laws in 1997. The Law Revision Commission recommends enactment of the new uniform act, subject to a number of revisions, to replace the existing law on this subject, which is largely the same as the 1962 Revised Uniform Principal and Income Act.¹

The Prefatory Note of the new Uniform Principal and Income Act summarizes its scope and purposes as follows:

UNIFORM ACT 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?

1. See Prob. Code §§ 16300-16315. This statute was enacted on Commission recommendation as part of the Trust Law. See *Recommendation Proposing the Trust Law*, 18 Cal. L. Revision Comm’n Reports 501 (1986); *Selected 1986 Trust and Probate Legislation*, 18 Cal. L. Revision Comm’n Reports 1201 (1986).

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

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

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

7 (2) The payment of interest or some other amount on the delayed payment of an
8 outright pecuniary gift that is made pursuant to a trust agreement instead of a will
9 when the agreement or state law does not provide for such a payment. Section
10 201(3).

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

14 (4) An "unincorporated entity" concept has been introduced to deal with
15 businesses operated by a trustee, including farming and livestock operations, and
16 investment activities in rental real estate, natural resources, timber, and derivatives.
17 Section 403.

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

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

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

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

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

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

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

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

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

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

41 (4) Deferred compensation is dealt with in greater detail in a separate section.
42 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.²

2. The Prefatory Note cites the following background:

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* (2d ed. 1998). 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).

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Trustee's Discretionary Power to Adjust

Other Substantive Revisions

Technical Revisions

3. Prob. Code §§ 16045-16054. This statute was enacted on Commission recommendation. See *Uniform Prudent Investor Act*, 25 Cal. L. Revision Comm'n Reports 543 (1995); *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).

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UNIFORM PRINCIPAL AND INCOME ACT

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Prob. Code §§ 16320-16375 (added). Uniform Principal and Income Act

SEC. _____. Chapter 3 (commencing with Section 16320) is added to Part 4 of Division 9 of the Probate Code, to read:

CHAPTER 3. UNIFORM PRINCIPAL AND INCOME ACT

Comment. This chapter contains the California version of the Uniform Principal and Income Act of 1997. It supersedes the California version of the Revised Uniform Principal and Income Act of 1962 (RUIA) in former Sections 16300-16315. Many provisions in this chapter are the same as or drawn from the Uniform Principal and Income Act of 1997. In Comments to sections in this chapter, a reference to the “Uniform Principal and Income Act (1997),” the “uniform act,” or “UPAIA” means the official text of the uniform act approved by the National Conference of Commissioners on Uniform State Law. Variations from the official text of the uniform act are noted in the Comments to sections in this chapter.

Article 1. Short Title and Definitions

§ 16320. Short title [UPAIA § 101]

16320. This chapter may be cited as the Uniform Principal and Income Act.

Comment. Section 16320 replaces former Section 16300 (short title of Revised Uniform Principal and Income Act of 1962). Some provisions included in the Uniform Principal and Income Act (1997) are generalized elsewhere in this code. See Sections 2(b) construction of provisions drawn from uniform acts) (*cf.* UPAIA § 601), 11 (severability) (*cf.* UPAIA § 602)

§ 16321. Application of definitions [UPAIA § 102]

16321. The definitions in this article govern the construction of this chapter.

Comment. Section 16321 continues the introductory clause of former Section 16301. For other definitions applicable to this chapter, see Part 2 (commencing with Section 20) of Division 1. Several definitions in the Uniform Principal and Income Act (1997) are not included in this chapter because they are provided in the general Probate Code definitions. See Sections 24 (“beneficiary” defined), 56 (“person” defined), 84 (“trustee” defined).

§ 16322. Accounting period [UPAIA § 102(2)]

16322. “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.

Comment. Section 16322 is the same as Section 102(2) of the Uniform Principal and Income Act (1997).

See also Sections 16323 (“fiduciary” defined), 16325 (“income interest” defined).

§ 16323. Fiduciary [UPAIA § 102(3)]

16323. “Fiduciary” means a personal representative or a trustee.

Comment. Section 16323 is the same in substance as Section 102(3) of the Uniform Principal and Income Act (1997). For the purposes of this chapter, the definition of fiduciary in this section is used instead of the general definition in Section 39. See also Sections 58 (“personal representative” defined), 84 (“trustee” defined). The second sentence of UPAIA Section 102(3) is omitted as surplus, since the definition of personal representative in Section 58 covers the same persons.

§ 16324. Income [UPAIA § 102(4)]

16324. “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 5.1 (commencing with Section 16350), 5.2 (commencing with Section 16355), or 5.3 (commencing with Section 16360).

Comment. Section 16324 is the same as Section 102(4) of the Uniform Principal and Income Act (1997).

See also Sections 62 (“property” defined), 16323 (“fiduciary” defined), 16329 (“principal” defined).

§ 16325. Income beneficiary [UPAIA § 102(5)]

16325. “Income beneficiary” means a person to whom net income of a trust is or may be payable.

Comment. Section 16325 supersedes former Section 16301(a) and is the same as Section 102(5) of the Uniform Principal and Income Act (1997).

See also Section 16328 (“net income” defined).

Background from Uniform Act:

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.

[Adapted from Unif. Principal and Income Act § 102(5) comment (1997).]

§ 16326. Income interest [UPAIA § 102(6)]

16326. “Income interest” means the right of an income beneficiary to receive all or part of net income, whether the trust requires it to be distributed or authorizes it to be distributed in the trustee’s discretion.

Comment. Section 16326 is the same as Section 102(6) of the Uniform Principal and Income Act (1997), except that “trust” is used in place of “terms of the trust.”

See also Sections 16325 (“income beneficiary” defined), 16328 (“net income” defined).

§ 16327. Mandatory income interest [UPAIA § 102(7)]

16327. “Mandatory income interest” means the right of an income beneficiary to receive net income that the trust requires the fiduciary to distribute.

Comment. Section 16327 is the same as Section 102(7) of the Uniform Principal and Income Act (1997), except that “trust” is used in place of “terms of the trust.”

See also Sections 16323 (“fiduciary” defined), 16325 (“income beneficiary” defined), 16328 (“net income” defined).

§ 16328. Net income [UPAIA § 102(8)]

16328. “Net income” means the total receipts allocated to income during an accounting period minus the disbursements made from income during the accounting period, plus or minus transfers under this chapter to or from income during the accounting period.

Comment. Section 16328 is the same as Section 102(8) of the Uniform Principal and Income Act (1997).

See also Section 16322 (“accounting period” defined), 16324 (“income” defined).

Background from Uniform Act:


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.
[Adapted from Unif. Principal and Income Act § 102(8) comment (1997).]

§ 16329. Principal [UPAIA § 102(10)]

16329. “Principal” means property held in trust eventually to be delivered to a remainder beneficiary.

Comment. Section 16329 is drawn from Section 102(10) of the Uniform Principal and Income Act (1997), but continues language from former Section 16303(b). The reference in the uniform act to distribution “when the trust terminates” has been omitted as overly restrictive, since principal distributions may occur before a trust terminates. This section provides only a general definition — the determination of what constitutes principal in particular circumstances depends on the application of the rules of this chapter.

See also Sections 62 (“property” defined).

 **Staff Note.** The working group did not see much value in this definition, particularly in its more restrictive uniform act language. It could be eliminated without loss. Even in this more benign form, based on existing Section 16303, it may be too limited within the broader context of the UPAIA, which applies to both trusts and estates.

The working group did agree that the definition of “remainder beneficiary” in UPAIA Section 102(11) (“a person entitled to receive principal when an income interest ends”) was not needed, particularly since it is only used in the definition of “principal” in this section.

Article 2. General Provisions and Fiduciary Duties

§ 16335. General fiduciary duties [UPAIA § 103]

16335. (a) In allocating receipts and disbursements to or between principal and income, and with respect to any other matter within the scope of this chapter, a fiduciary:

(1) Shall administer a trust or decedent’s estate in accordance with the trust or the will, even if there is a different provision in this chapter.

(2) May administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this chapter, and no inference that the fiduciary has improperly exercised the discretion arises from the fact that the fiduciary has made an allocation contrary to a provision of this chapter.

(3) Shall administer a trust or estate in accordance with this chapter if the trust or the will does not contain a different provision or do not give the fiduciary a discretionary power of administration.

(4) Shall add a receipt or charge a disbursement to principal to the extent that the trust or the will and this chapter 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 16336(a) or any other discretionary power of administration regarding a matter within the scope of this chapter, whether granted by a trust, a will, or this chapter, the fiduciary shall administer the trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the trust or the will clearly manifests an intention that the fiduciary shall or may favor one or more of the beneficiaries. The exercise of discretion in accordance with this chapter is presumed to be fair and reasonable to all beneficiaries.

Comment. Section 16335 supersedes former Section 16302 and is generally the same as Section 103 of the Uniform Principal and Income Act (1997), with a number of changes. The last clause in subdivision (a)(2) has been added to preserve and generalize the “no inference” rule in former Section 16302(b). “Trust” is used in place of “terms of the trust” throughout. As provided in the introductory clause of subdivision (a), its rules apply to allocation between principal and income (Sections 16350-16375), as under former Section 16302, but in addition, these rules apply to matters within the scope of Sections 16335-16341.

The rule in the first sentence of subdivision (b) is a special expression of the general fiduciary duty in Section 16003. The wording in the second sentence has been revised to make clear that the presumption applies to exercise of discretion under this chapter.

See also Sections 84 (“trust” defined), 16323 (“fiduciary” defined), 16324 (“income” defined), 16329 (“principal” defined).

Background from Uniform Act:

Prior Act. The rule in Section 2(a) of the 1962 Act [former Prob. Code § 16302] is restated in Section 103(a) [Prob. Code § 16335(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 [former Prob. Code § 16302] 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) [Prob. Code § 16335(a)] states that it also applies to matters within the scope of Articles [3 (commencing with Probate Code Section 16340)] and [4 (commencing with Probate Code Section 16345)]. Section 103(a)(2) [Prob. Code § 16335(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.

....

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) [Prob. Code § 16335(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) [Prob. Code § 16335(b)], after considering the return from the portfolio as a whole, the trustee may make an appropriate adjustment under Section 104(a) [Prob. Code § 16336(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). [See Prob. Code § 16003.] 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

1 the trustee from abusing it. *Id.* § 183, comment *a*. “The precise meaning of the trustee’s duty of
2 impartiality and the balancing of competing interests and objectives inevitably are matters of
3 judgment and interpretation. Thus, the duty and balancing are affected by the purposes, terms,
4 distribution requirements, and other circumstances of the trust, not only at the outset but as they
5 may change from time to time.” *Id.* § 232, comment *c*.

6 The terms of a trust may provide that the trustee, or an accountant engaged by the trustee, or a
7 committee of persons who may be family members or business associates, shall have the power to
8 determine what is income and what is principal. If the terms of a trust provide that this Act
9 specifically or principal and income legislation in general does not apply to the trust but fail to
10 provide a rule to deal with a matter provided for in this Act, the trustee has an implied grant of
11 discretion to decide the question. Section 103(b) [Prob. Code § 16335(b)] provides that the rule of
12 impartiality applies in the exercise of such a discretionary power to the extent that the terms of the
13 trust do not provide that one or more of the beneficiaries are to be favored. The fact that a person
14 is named an income beneficiary or a remainder beneficiary is not by itself an indication of
15 partiality for that beneficiary.

16 [Adapted from Unif. Principal and Income Act § 103 comment (1997).]

17  **Staff Note.** With respect to trustees, the duty of impartiality set forth in subdivision (b)
18 overlaps with the general duty in Section 16003 of the Trust Law. The working group was
19 concerned that this might create an opportunity for confusion or inconsistent interpretation,
20 although on the surface, the two rules appear consistent. However, the duty in subdivision (b) is
21 more detailed than the general duty, and drafted to cover administration of decedents’ estates. In
22 the context of this act, subdivision (b) provides more guidance than the general duty, and the staff
23 would prefer to keep it.

24 Existing Probate Code Section 16003 provides as follows:

25 16003. If a trust has two or more beneficiaries, the trustee has a duty to deal impartially
26 with them and shall act impartially in investing and managing the trust property, taking into
27 account any differing interests of the beneficiaries.

28 **§ 16336. Trustee’s power to adjust [see UPAIA § 104]**

29 16336. (a) Subject to subdivision (b), a trustee may make an adjustment between
30 principal and income to the extent the trustee considers necessary if all of the following
31 conditions are satisfied:

32 (1) The trustee invests and manages trust assets as a prudent investor, whether pursuant
33 to the Uniform Prudent Investor Act (Article 2.5 (commencing with Section 16045) of
34 Chapter 1) or express provisions in the trust.

35 (2) The trust describes the amount that may or must be distributed to a beneficiary by
36 referring to the trust’s income.

37 (3) The trustee determines that application of the rules in subdivision (a) of Section
38 16335 would not permit the trustee is to satisfy the standard provided in subdivision (b)
39 of Section 16335.

40 (b) A trustee may not make an adjustment between principal and income in any of the
41 following circumstances:

42 (1) Where it would diminish the income interest in a trust that requires all of the
43 income to be paid at least annually to a spouse and for which an estate tax or gift tax
44 marital deduction would be allowed, in whole or in part, if the trustee did not have the
45 power to make the adjustment.

46 (2) Where it would reduce the actuarial value of the income interest in a trust to which
47 a person transfers property with the intent to qualify for a gift tax exclusion.

1 (3) Where it would change the amount payable to a beneficiary as a fixed annuity or a
2 fixed fraction of the value of the trust assets.

3 (4) From any amount that is permanently set aside for charitable purposes under a will
4 or trust, unless both income and principal are so set aside.

5 (5) Where possessing or exercising the power to make an adjustment would cause an
6 individual to be treated as the owner of all or part of the trust for income tax purposes,
7 and the individual would not be treated as the owner if the trustee did not possess the
8 power to make an adjustment.

9 (6) Where possessing or exercising the power to make an adjustment would cause all or
10 part of the trust assets to be included for estate tax purposes in the estate of an individual
11 who has the power to remove a trustee or appoint a trustee, or both, and the assets would
12 not be included in the estate of the individual if the trustee did not possess the power to
13 make an adjustment.

14 (7) Where the trustee is a beneficiary of the trust.

15 [(8) Where the trustee is not a beneficiary, but the adjustment would benefit the trustee
16 directly or indirectly.]

17 (c) If paragraph (5), (6), (7), or (8) of subdivision (b) applies to a trustee and there is
18 more than one trustee, a cotrustee to whom the provision does not apply may make the
19 adjustment unless the exercise of the power by the remaining trustee or trustees is not
20 permitted by the trust.

21 (d) A trustee may release the entire power conferred by subsection (a) or may release
22 only the power to adjust from income to principal or the power to adjust from principal to
23 income in either of the following circumstances:

24 (1) If the trustee is uncertain about whether possessing or exercising the power will
25 cause a result described in paragraph (1) to (6), inclusive, or (8) of subdivision (b).

26 (2) If the trustee determines that possessing or exercising the power will or may deprive
27 the trust of a tax benefit or impose a tax burden not described in subsection (b).

28 (e) A release under subdivision (d) may be permanent or for a specified period,
29 including a period measured by the life of an individual.

30 (f) A trust that limits the power of a trustee to make an adjustment between principal
31 and income does not affect the application of this section unless it is clear from the trust
32 that it is intended to deny the trustee the power of adjustment provided by subsection (a).

33 **Comment.** Section 16336 is the same as parts of Section 104 of the Uniform Principal and
34 Income Act (1997). The purpose of this section is to provide a way to reconcile the tension
35 between the duties under the Uniform Prudent Investor Act (Section 16045 *et seq.*) and the
36 technical trust accounting rules governing allocations between principal and income provided in
37 other parts of this chapter, the Uniform Principal and Income Act. The power to adjust is a
38 discretionary power and is subject to rules governing exercise of discretionary powers, both under
39 the trust terms and the law of trusts. The trustee may exercise the power to adjust under the
40 authority of this section and related rules, or may prefer to seek the agreement of beneficiaries
41 before making the adjustment. Section 16337 provides a safe harbor for trustees who exercise the
42 power to adjust consistent with a 4% unitrust standard. The trustee may also seek court approval
43 under Section 17200(b)(5) of a decision to make an adjustment.

44 The trustee's determination of whether to make an adjustment under this section, and how to
45 implement the adjustment, are subject to the trustee's fiduciary duties. See Sections 16003,
46 16335(b). Unlike Section 104(b) of the Uniform Principal and Income Act (1997), this section
47 does not mandate consideration of particular factors, but the UPAIA factors provide useful
48 guidance. Thus, in deciding whether and to what extent to exercise the power to make

adjustments under subsection (a), the following factors are appropriate to consider: (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 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.

See also Sections 24 (“beneficiary” defined), 84 (“trustee” defined), 16324 (“income” defined), 16329 (“principal” defined),

Background from Uniform Act:

Purpose and Scope of Provision. The purpose of Section 104 [Prob. Code § 16336] 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) [Prob. Code § 16336(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) [Prob. Code § 16335(a)], that he is unable to comply with Section 103(b) [Prob. Code § 16335(b)].... [The] trustee may not make an adjustment in circumstances described in Section 104(c) [Prob. Code § 16336(b)].

Section 104 [Prob. Code § 16336] 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) [Prob. Code § 16336(a)] is the requirement in Section 103(b) [Prob. Code § 16335(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 [Prob. Code § 16336] 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

1 investor rule has been approved by the courts, or the terms of the trust require it. Even if a State's
2 legislature or courts have not formally adopted the rule, the Restatement establishes the prudent
3 investor rule as an authoritative interpretation of the common law prudent man rule, referring to
4 the prudent investor rule as a "modest reformulation of the Harvard College dictum and the basic
5 rule of prior Restatements." Restatement of Trusts 3d: Prudent Investor Rule, Introduction, at 5.
6 As a result, there is a basis for concluding that the first condition is satisfied in virtually all States
7 except those in which a trustee is permitted to invest only in assets set forth in a statutory "legal
8 list."

9 The second condition will be met when the terms of the trust require all of the "income" to be
10 distributed at regular intervals; or when the terms of the trust require a trustee to distribute all of
11 the income, but permit the trustee to decide how much to distribute to each member of a class of
12 beneficiaries; or when the terms of a trust provide that the beneficiary shall receive the greater of
13 the trust accounting income and a fixed dollar amount (an annuity), or of trust accounting income
14 and a fractional share of the value of the trust assets (a unitrust amount). If the trust authorizes the
15 trustee in its discretion to distribute the trust's income to the beneficiary or to accumulate some or
16 all of the income, the condition will be met because the terms of the trust do not permit the trustee
17 to distribute more than the trust accounting income.

18 To meet the third condition, the trustee must first meet the requirements of Section 103(a)
19 [Prob. Code § 16335(a)], i.e., she must apply the terms of the trust, decide whether to exercise the
20 discretionary powers given to the trustee under the terms of the trust, and must apply the
21 provisions of the Act if the terms of the trust do not contain a different provision or give the
22 trustee discretion. Second, the trustee must determine the extent to which the terms of the trust
23 clearly manifest an intention by the settlor that the trustee may or must favor one or more of the
24 beneficiaries. To the extent that the terms of the trust do not require partiality, the trustee must
25 conclude that she is unable to comply with the duty to administer the trust impartially. To the
26 extent that the terms of the trust do require or permit the trustee to favor the income beneficiary or
27 the remainder beneficiary, the trustee must conclude that she is unable to achieve the degree of
28 partiality required or permitted. If the trustee comes to either conclusion – that she is unable to
29 administer the trust impartially or that she is unable to achieve the degree of partiality required or
30 permitted – she may exercise the power to adjust under Section 104(a) [Prob. Code § 16336(a)].

31 *Impartiality and productivity of income.* The duty of impartiality between income and
32 remainder beneficiaries is linked to the trustee's duty to make the portfolio productive of trust
33 accounting income whenever the distribution requirements are expressed in terms of distributing
34 the trust's "income." The 1962 Act implies that the duty to produce income applies on an asset by
35 asset basis because the right of an income beneficiary to receive "delayed income" from the sale
36 proceeds of underproductive property under Section 12 of that Act arises if "any part of principal
37 ... has not produced an average net income of a least 1% per year of its inventory value for more
38 than a year" Under the prudent investor rule, "[t]o whatever extent a requirement of income
39 productivity exists, ... the requirement applies not investment by investment but to the portfolio as
40 a whole." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment *i*, at 34. [See Prob.
41 Code § 16047.] The power to adjust under Section 104(a) [Prob. Code § 16336(a)] is also to be
42 exercised by considering net income from the portfolio as a whole and not investment by
43 investment. Section 413(b) of this Act [Prob. Code § 16365(b)] eliminates the underproductive
44 property rule in all cases other than trusts for which a marital deduction is allowed; the rule
45 applies to a marital deduction trust if the trust's assets "consist substantially of property that does
46 not provide the spouse with sufficient income from or use of the trust assets ..." – in other words,
47 the section applies by reference to the portfolio as a whole.

48 While the purpose of the power to adjust in Section 104(a) [Prob. Code § 16336(a)] is to
49 eliminate the need for a trustee who operates under the prudent investor rule to be concerned
50 about the income component of the portfolio's total return, the trustee must still determine the
51 extent to which a distribution must be made to an income beneficiary and the adequacy of the
52 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*. [See Prob. Code §§ 16045-16052, California Uniform Prudent Investor Act.]

Factors to consider in exercising the power to adjust. Section 104(b) requires [not required in Prob. Code § 16336] 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 [see Prob. Code § 16047(c)] 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 [see Prob. Code § 16048] 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) [Prob. Code § 16336(b)(1)-(4)] is to preserve tax benefits that may have been an important purpose for creating the trust. Subsections (c)(5), (6), and (8) [Prob. Code § 16336(b)(5), (6), (8)] deny the power to adjust in the circumstances described in those subsections in order to prevent adverse tax consequences, and subsection (c)(7) [Prob. Code § 16336(b)(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) [Prob. Code § 16336(b)(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 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 spouse. Subsection (c)(1) [Prob. Code § 16336(b)(1)] applies to a trust that qualifies for the marital deduction because the 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) [Prob. Code § 16336(b)(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) [Prob. Code § 16336(b)(3)] applies to annuity trusts and unitrusts with no charitable beneficiaries as well as to trusts with charitable income or remainder beneficiaries; its

1 purpose is to make it clear that a beneficiary's right to receive a fixed annuity or a fixed fraction
2 of the value of a trust's assets is not subject to adjustment under Section 104(a) [Prob. Code §
3 16336(a)]. Subsection (c)(3) [Prob. Code § 16336(b)(3)] does not apply to any additional amount
4 to which the beneficiary may be entitled that is expressed in terms of a right to receive income
5 from the trust. For example, if a beneficiary is to receive a fixed annuity or the trust's income,
6 whichever is greater, subsection (c)(3) [Prob. Code § 16336(b)(3)] does not prevent a trustee from
7 making an adjustment under Section 104(a) [Prob. Code § 16336(a)] in determining the amount
8 of the trust's income.

9 If subsection (c)(5), (6), (7), or (8) [Prob. Code § 16336(b)(5), (6), (8)], prevents a trustee from
10 exercising the power to adjust, subsection (d) [Prob. Code § 16336(c)] permits a cotrustee who is
11 not subject to the provision to exercise the power unless the terms of the trust do not permit the
12 cotrustee to do so.

13 *Release of the power to adjust.* Section 104(e) [Prob. Code § 16336(d)-(e)] permits a trustee to
14 release all or part of the power to adjust in circumstances in which the possession or exercise of
15 the power might deprive the trust of a tax benefit or impose a tax burden. For example, if
16 possessing the power would diminish the actuarial value of the income interest in a trust for
17 which the income beneficiary's estate may be eligible to claim a credit for property previously
18 taxed if the beneficiary dies within ten years after the death of the person creating the trust, the
19 trustee is permitted under subsection (e) [Prob. Code § 16336(d)] to release just the power to
20 adjust from income to principal.

21 *Trust terms that limit a power to adjust.* Section 104(f) [Prob. Code § 16336(f)] applies to trust
22 provisions that limit a trustee's power to adjust. Since the power is intended to enable trustees to
23 employ the prudent investor rule without being constrained by traditional principal and income
24 rules, an instrument executed before the adoption of this Act whose terms describe the amount
25 that may or must be distributed to a beneficiary by referring to the trust's income or that prohibit
26 the invasion of principal or that prohibit equitable adjustments in general should not be construed
27 as forbidding the use of the power to adjust under Section 104(a) [Prob. Code § 16336(a)] if the
28 need for adjustment arises because the trustee is operating under the prudent investor rule.
29 Instruments containing such provisions that are executed after the adoption of this Act should
30 specifically refer to the power to adjust if the settlor intends to forbid its use. See generally, Joel
31 C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax
32 Planning, 66 Iowa L. Rev. 273 (1981).

33 *Examples.* The following examples illustrate the application of Section 104 [Prob. Code §
34 16336]:

35 *Example (1)* – T is the successor trustee of a trust that provides income to A for life, remainder
36 to B. T has received from the prior trustee a portfolio of financial assets invested 20% in stocks
37 and 80% in bonds. Following the prudent investor rule, T determines that a strategy of investing
38 the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably
39 suited to the trust, but T also determines that adopting this approach will cause the trust to receive
40 a smaller amount of dividend and interest income. After considering the [relevant] factors ..., T
41 may transfer cash from principal to income to the extent T considers it necessary to increase the
42 amount distributed to the income beneficiary.

43 *Example (2)* – T is the trustee of a trust that requires the income to be paid to the settlor's son C
44 for life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that
45 pay double-digit interest and determines that a portion of the interest, which is allocated to
46 income under Section 406 of this Act [Prob. Code § 16357], is a return of capital. In
47 consideration of the loss of value of principal due to inflation and other factors that T considers
48 relevant, T may transfer part of the interest to principal.

49 *Example (3)* – T is the trustee of a trust that requires the income to be paid to the settlor's sister
50 E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children.
51 E's income from her social security, pension, and savings exceeds the amount required to provide
52 for her accustomed standard of living. The terms of the trust permit T to invade principal to
53 provide for E's health and to support her in her accustomed manner of living, but do not
54 otherwise indicate that T should favor E or F. Applying the prudent investor rule, T determines

1 that the trust assets should be invested entirely in growth stocks that produce very little dividend
2 income. Even though it is not necessary to invade principal to maintain E's accustomed standard
3 of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally
4 accorded a person who is the sole income beneficiary of a trust, and T may transfer cash from
5 principal to income to provide her with that degree of enjoyment.

6 *Example (4)* – T is the trustee of a trust that is governed by the law of State X. The trust became
7 irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of
8 the income to be paid to G for life, remainder to H, and also give T the power to invade principal
9 for the benefit of G for “dire emergencies only.” The terms of the trust limit the aggregate amount
10 that T can distribute to G from principal during G's life to 6% of the trust's value at its inception.
11 The trust's portfolio is invested initially 50% in stocks and 50% in bonds, but after State X adopts
12 the prudent investor rule T determines that, to achieve suitable risk and return objectives for the
13 trust, the assets should be invested 90% in stocks and 10% in bonds. This change increases the
14 total return from the portfolio and decreases the dividend and interest income. Thereafter, even
15 though G does not experience a dire emergency, T may exercise the power to adjust under
16 Section 104(a) [Prob. Code § 16336(a)] to the extent that T determines that the adjustment is from
17 only the capital appreciation resulting from the change in the portfolio's asset allocation. If T is
18 unable to determine the extent to which capital appreciation resulted from the change in asset
19 allocation or is unable to maintain adequate records to determine the extent to which principal
20 distributions to G for dire emergencies do not exceed the 6% limitation, T may not exercise the
21 power to adjust. See Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in
22 Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

23 *Example (5)* – T is the trustee of a trust for the settlor's child. The trust owns a diversified
24 portfolio of marketable financial assets with a value of \$600,000, and is also the sole beneficiary
25 of the settlor's IRA, which holds a diversified portfolio of marketable financial assets with a
26 value of \$900,000. The trust receives a distribution from the IRA that is the minimum amount
27 required to be distributed under the Internal Revenue Code, and T allocates 10% of the
28 distribution to income under Section 409(c) of this Act [Prob. Code § 16361(c)]. The total return
29 on the IRA's assets exceeds the amount distributed to the trust, and the value of the IRA at the
30 end of the year is more than its value at the beginning of the year. Relevant factors that T may
31 consider in determining whether to exercise the power to adjust and the extent to which an
32 adjustment should be made to comply with Section 103(b) [Prob. Code § 16335(b)] include the
33 total return from all of the trust's assets, those owned directly as well as its interest in the IRA, the
34 extent to which the trust will be subject to income tax on the portion of the IRA distribution that
35 is allocated to principal, and the extent to which the income beneficiary will be subject to income
36 tax on the amount that T distributes to the income beneficiary.

37 *Example (6)* – T is the trustee of a trust whose portfolio includes a large parcel of undeveloped
38 real estate. T pays real property taxes on the undeveloped parcel from income each year pursuant
39 to Section 501(3) [Prob. Code § 16370(c)]. After considering the return from the trust's portfolio
40 as a whole and other relevant factors ..., T may exercise the power to adjust under Section 104(a)
41 [Prob. Code § 16336(a)] to transfer cash from principal to income in order to distribute to the
42 income beneficiary an amount that T considers necessary to comply with Section 103(b) [Prob.
43 Code § 16335(b)].

44 *Example (7)* – T is the trustee of a trust whose portfolio includes an interest in a mutual fund
45 that is sponsored by T. As the manager of the mutual fund, T charges the fund a management fee
46 that reduces the amount available to distribute to the trust by \$2,000. If the fee had been paid
47 directly by the trust, one-half of the fee would have been paid from income under Section 501(1)
48 [Prob. Code § 16370(a)] and the other one-half would have been paid from principal under
49 Section 502(a)(1) [Prob. Code § 16371(a)(1)]. After considering the total return from the portfolio
50 as a whole and other relevant factors ..., T may exercise its power to adjust under Section 104(a)
51 [Prob. Code § 16336(a)] by transferring \$1,000, or half of the trust's proportionate share of the
52 fee, from principal to income.

☞ **Staff Note.** As discussed in Memorandum 98-64 and earlier memorandums, the power to adjust has been the main source of controversy concerning the UPAIA. The working group devoted much of its third meeting to the concepts of a unitrust standard, a safe harbor based on a unitrust standard, how the power to adjust could be modified to provide further guidance, and other related issues. But the working group did not spend a lot of time going through the power to adjust itself, and no doubt a number of issues remain. In the absence of a consensus of the working group, however, the staff has not found the will to make many changes in the UPAIA section. The staff believes that it is essentially sound, and that the answer is to deal directly with the related concerns about uncertainty and liability with other rules that provide options for restraining the adjustment power or reducing exposure to liability. In the end, however, there must be some liability — but it doesn't arise from the power to adjust. It arises from the failure of the trustees to comply with the prudent investor rule.

A minor technical problem has not been resolved. Subdivision (b)(8) provides that the power to adjust can't be exercised if the trustee would benefit directly or indirectly. Both CBA and the State Bar commentators have noted that this would preclude an adjustment that affects the amount of principal where the trustee's compensation is a percentage of the value of trust property. As Prof. Dobris has pointed out, however, this raises an issue of conflict whenever the trustee makes decisions affecting the value of principal. The staff is inclined to omit subdivision (b)(8) and rely on general rules of conflict of interest. This avoids the technical argument and leaves the issue where it is now, which presumably lets trustees make decisions that technically involve some degree of conflict. An alternative would be to qualify the degree of conflict with an appropriate adjective to eliminate the hypertechnical quibbles.

§ 16337. Safe harbor for adjustments to unitrust standard

16337. (a) For the purposes of this section:

(1) The "unitrust amount" is equal to the unitrust standard multiplied by the valuation factor.

(2) The "unitrust standard" is four percent.

(3) The "valuation factor" is an average net fair market value of trust property over a three-year period, or a lesser period where the trust has not existed for three years. The valuation factor is determined by calculating the total of the net fair market value of all property held in the trust on the first business day of the fiscal year of the trust for which the unitrust amount is being determined and of each of the preceding two fiscal years of the trust, and dividing by three. In the case of a short fiscal year of the trust, the valuation factor shall be determined by prorating on a daily basis.

(b) A trustee acting in good faith is not liable to a beneficiary for making an adjustment under Section 16336 to permit a distribution to income beneficiaries that is equivalent to the unitrust amount under this section.

(c) This section does not create an inference that a trustee has violated any duty by the failure to make an adjustment or by making an adjustment that is greater or less than the unitrust standard in this section.

Comment. Section 16337 is new. It is intended to provide a safe harbor for adjustments from principal to income under Section 16336 which results in up to a 4% unitrust amount. This section is not intended to set a floor or a ceiling on appropriate adjustments under Section 16336. As made clear in subdivision (c), it is intended only to provide a safe harbor for adjustments under its terms, and no inferences or implications are to be drawn from fiduciary actions that differ from the 4% unitrust amount in this section or from inaction in circumstances where adjustment under the standard of this section would be possible.

See also Sections 62 ("property" defined), ("trustee" defined), 16325 ("income beneficiary" defined).

➡ **Staff Note.** The working group has attempted to devise rules that would avoid the potential for second guessing trustee determinations under the power to adjust between principal and income accounts proposed in UPAIA Section 104. The most popular or intriguing notion coming out of our three discussions has consistently been the idea of providing a safe harbor as proposed in draft Section 16337. This is new territory, and no doubt will need further refinement, but the central concept is presented above.

The New York EPTL-SCPA Legislative Advisory Committee, in its 5th Report, entitled “Proposed Changes to the Definition of Trust Accounting Income, To Redefine Appropriate Benefit Currently Distributable” (April 7, 1998) — which is the committee’s report on UPAIA — proposes a *default* 4% unitrust rule for trusts created after the operative date of their proposed legislation. That report has been influential in the working group’s thinking on this issue, although the group’s conclusion is different. The proposal inherent in draft Sections 16336 and 16337 is to reduce the potential for litigation, as noted in the staff note to Section 16336, and to provide the most significant benefits of the adjustment power by encouraging adjustment in the uniform act conception, where appropriate, subject to a safe harbor version of the New York default rule. In other words, the New York default rule would become an optional safe harbor standard that attempts to serve the goal of encouraging appropriate adjustments without exposing trustees to undue liability. This approach should encourage trustees to take advantage of the advances and benefits of the California Uniform Prudent Investor Act, by investing for total return taking into account the goals of the trust, while avoiding the liability exposure institutional trustees have detected in the UPAIA power to adjust.

For reference purposes, relevant parts of the NY proposal are set out below:

EPTL § 11-2.5. (a) Unless the terms of the trust provide otherwise, the net income of any trust to which this section applies shall mean the unitrust amount as determined hereunder.

(b) Unitrust amount.

(1) The “unitrust amount” for a fiscal year of the trust shall mean an amount equal to four percent multiplied by a fraction, the numerator of which shall be the sum of the net fair market values of all property held in the trust on the first business day of each valuation year of the trust and the denominator of which is the sum of such valuation years.

(2) The unitrust amount as computed in accordance with paragraph (b)(1) shall be proportionately reduced for any distributions, in whole or in part (other than distributions of the unitrust amount) and for any payments of expenses that the trustee determines to be material from the trust within a valuation year, and shall be proportionately increased for the receipt, other than a receipt that represents a return on investment, of any additional property into the trust within a valuation year.

(3) In the case of a short fiscal year, the trust shall prorate the unitrust amount on a daily basis.

(c) Other Definitions and Special Rules. As used in this section,

(1) A “current beneficiary” is a person to whom the income (within the meaning of this section or otherwise) of the trust is payable, or in the discretion of the trustee may be paid, in whole or in part, during the applicable valuation year.

(2) The term “valuation year” shall mean the fiscal year of the trust for which the unitrust amount is being determined and each of the immediately preceding two fiscal years of the trust (or such lesser number of years that the trust is in existence).

(3) [Definition of net fair market value to be added to indicate that it is the fair market value reduced by accrued liabilities]

(4) The “net fair market value of all property held in trust” for purposes of paragraph (b)(1) shall not include the fair market value of any residential property or any tangible personal property that, as of the first business day of the valuation year for which the unitrust amount is being determined, one or more current beneficiaries of the trust have or had the right to occupy, or have or had the right to possess or control (other than in his or her capacity as a trustee of the trust), and instead the right of occupancy or the right to possession or control shall be deemed to be the unitrust amount with respect to such residential property or such

tangible personal property, provided, however, that the unitrust amount shall be adjusted in accordance with paragraph (b)(2) for partial distributions from or receipt into the trust of such residential property or tangible personal property during a valuation year.

(5) In determining the net fair market value of all property held in the trust pursuant to paragraph (b)(1), the trust shall, not less often than annually, determine the fair market value of each asset of the trust that consists primarily of real property or other property that is not traded on a regular basis in an active market, and all such determinations shall, if made reasonably and in good faith, be conclusive on all persons interested in the trust.

(6) The term “trustee” includes a personal representative and a trustee.

(7) The term “trust” includes any fiduciary entity with property owned by a trustee, as defined in this section.

....

(e) Trusts to Which Section Applies

(1) This section shall apply to:

(A) Any trust created after _____ (including an estate of a decedent dying after _____); and

(B) Unless the instrument creating the trust provides otherwise, any trust created on or before _____ (including an estate of a decedent dying on or before _____), provided the trustee, on or before the last day of the second fiscal year of the trust beginning after _____, with the consent of all persons interested in the trust, elects to have this section apply. The election shall be made by an instrument, executed and acknowledged, and delivered to the creator of the trust, if he or she is then living, to all persons interested in the trust and to the court, if any, having jurisdiction over the trust. Where a person interested in the trust has the same interest as a person under a disability, it shall not be necessary to obtain the consent of or notify the person under a disability.

(2) Notwithstanding paragraph (d)(1)(A), unless the instrument creating the trust provides otherwise, the trustee, on or before the last day of the third fiscal year of the trust, with the consent of all persons interested in the trust, may elect to have section 11-2.4 apply to the trust, in which case this section shall not apply to the trust. The election shall be made by an instrument, executed and acknowledged, and delivered to the creator of the trust, if he or she is then living, to all persons interested in the trust and to the court, if any, having jurisdiction over the trust. Where a person interested in the trust has the same interest as a person under a disability, it shall not be necessary to obtain the consent of or notify the person under a disability.

(3) (A) The court having jurisdiction of a trust to which this section otherwise would apply pursuant to paragraph (d)(1)(A), upon the petition of the trustee and upon notice to all persons interested in the trust, may direct that section 11-2.4 shall apply to the trust, and that this section shall not apply to the trust; and

(B) The court having jurisdiction of a trust to which this section otherwise would not apply, upon the petition of the trustee or of any current beneficiary of the trust and upon notice to all persons interested in the trust, may direct that this section shall apply to the trust and that section 11-2.4 shall not apply to the trust.

(4) In the determination of whether section 11-2.4 or this section should apply to the trust, all of the factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant, shall be considered:

(i) the nature, purpose, and expected duration of the trust;

(ii) the intent of the creator of the trust;

(iii) the identity and circumstances of the beneficiaries;

(iv) the needs for liquidity, regularity of payment, and preservation and appreciation of capital;

(v) 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 creator of the trust.

(5) For purposes of determining the time period in which a trustee may elect under paragraph (d)(2), a trust which continues in the existence for the benefit of a new current beneficiary or class of current beneficiaries upon the termination of the interest of a prior current beneficiary or class of prior current beneficiaries shall be deemed to be a new trust, the first fiscal year of which commences on the date of the termination of such interest.

§ 16338. Notice of proposed action

16338. (a) A fiduciary acting in good faith is not liable to a beneficiary for an action taken (or a decision not to act) regarding a matter governed by this chapter if the fiduciary does not receive a written objection to the proposed action from the beneficiary within the applicable period and the other requirements of this section are satisfied.

(b) If the fiduciary chooses to use the notice of proposed action procedure, at least 60 days before the action is taken, the fiduciary shall give the beneficiary written notice of the proposed action. The notice of proposed action shall be mailed or personally delivered to each beneficiary whose interest would be affected by the proposed action.

(c) The notice of proposed action shall state that it is given pursuant to this section and shall state all of the following:

(1) The name and mailing address of the fiduciary.

(2) The name and telephone number of a person who may be contacted to get additional information.

(3) The action proposed to be taken, with a reasonably specific description of the action, sufficient to inform the beneficiary of the factual and legal reasons for the action, the facts on which the fiduciary relies, and an explanation of how the beneficiary will be affected by the action.

(4) The date on or after which the proposed action is to be taken.

(d) A beneficiary may object to the proposed action by mailing or delivering a written objection to the fiduciary at the address stated in the notice of proposed action within the time period applicable under subdivision (b).

(e) Notice of proposed action need not be given to any person who consents in writing to the proposed action. The consent may be executed at any time before or after the proposed action is taken.


(f) If the fiduciary receives a written objection within the applicable period, either the fiduciary or a beneficiary may petition the court having jurisdiction over the trust or estate to have the proposed action taken as proposed, taken with modifications, or denied. In the proceeding, a beneficiary objecting to the proposed action has the burden of proving that the fiduciary's proposed action should not be taken. A beneficiary who has not objected is not estopped from opposing the proposed action in the proceeding. If the fiduciary decides not to implement the proposed action, the fiduciary shall notify the beneficiaries of the decision not to take the action and the reasons for that decision. A beneficiary may petition the court to have the action taken, and has the burden of proving that it should be taken.

(g) The fiduciary's expenses incurred in formulating the proposed action and invoking the procedure provided in this section shall be allocated to principal and income pursuant to Sections 16340, 16370, and 16371. The court shall determine whether a beneficiary's expenses are to be charged to the estate or trust and, if so, whether to principal or income.

Comment. Section 16338 is new. This section provides a special notice of proposed action procedure applicable to determinations under this chapter, the Uniform Principal and Income Act.

1 It does not apply generally to trust or estate administration. Some features of this procedure are
2 drawn from the notice of proposed action procedure (see, e.g., Sections 10582, 10585-10587)
3 under the Independent Administration of Estates Act (Section 10400 *et seq.*).

4 The beneficiaries required to be given notice under this procedure, in the case of a trust, are
5 determined by Section 15804 (virtual representation under Trust Law). For judicial proceedings
6 concerning trusts, see, e.g., Section 17200.

7  **Staff Note.** This section is drawn from a proposal considered by the UPAIA drafting
8 committee, as set out in the October 1995 UPAIA draft. (Much additional detail has been added
9 based on the existing notice of proposed action procedure in the Independent Administration of
10 Estates Act.) The uniform act reporter's notes on this draft section read as follows:

11 This new provision is predicated on the notion that the real contest in a principal and
12 income dispute should be between the income and remainder beneficiaries rather than
13 between a beneficiary and the fiduciary (absent bad faith, an intentional wrong or gross
14 negligence) and that a fiduciary should be encouraged to make principal and income
15 decisions based on what is fair and reasonable without having to worry about being
16 surcharged. The fiduciary's proposal is presumptively correct.

17 No fiduciary is required to proceed under this section, and it applies only if the fiduciary
18 gives a notice stating that it is pursuant to this section. A beneficiary would have the same
19 remedies that he now has if a fiduciary takes an action or makes a decision without using the
20 procedure in this section and a beneficiary feels the fiduciary took the wrong action, made the
21 wrong decision, or failed to act when the beneficiary believes an action or decision was
22 required.

23 **§ 16339. Application of chapter to existing trusts and estates [UPAIA § 605]**

24 16339. This chapter applies to every trust or decedent's estate existing on January 1,
25 2000, except as otherwise expressly provided in the trust or will or in this chapter.

26 **Comment.** Section 16339 is the same in substance as Section 605 of the Uniform Principal and
27 Income Act (1997).

28 See also Section 3 (general transitional provisions).

29 Article 3. Decedent's Estate or Terminating Income Interest

30 **§ 16340. Determination and distribution of net income and principal [UPAIA § 201]**

31 16340. After the decedent's death, in the case of a decedent's estate, or after an income
32 interest in a trust ends, the following rules apply:

33 (a) If property is specifically given to a beneficiary, by will or trust, the fiduciary of the
34 estate or of the terminating income interest shall perform the following duties:

35 (1) Determine the net income and principal receipts from the property as provided in
36 this chapter. The net income and principal receipts from the property are determined by
37 including all of the amounts the fiduciary receives or pays with respect to the property,
38 whether the amounts accrued or became due before, on, or after the decedent's death or
39 an income interest in a trust ends, and by making a reasonable provision for amounts the
40 fiduciary believes the estate or terminating income interest may become obligated to pay
41 after the property is distributed.

42 (2) Reduce income and principal receipts on account of a payment described in Section
43 16370 or 16371, except to the extent that the will, the trust, or Section 12002 requires
44 payment from other property or to the extent that the fiduciary recovers [or expects to
45 recover] the payment from a third person.

1 (3) Distribute the net income and principal receipts to the beneficiary who is to receive
2 the property.

3 (b) A fiduciary shall distribute to a beneficiary who receives a pecuniary amount,
4 whether outright or in trust, the interest or any other amount provided by the will, the
5 trust, or Chapter 8 (commencing with Section 12000) of Part 10 or Division 7, from net
6 income determined under subdivision (a) or from principal to the extent that net income
7 is insufficient. For purposes of this subdivision, a reference in Chapter 8 (commencing
8 with Section 12000) of Part 10 of Division 7 to the date of the testator's death means the
9 date of the settlor's death or of the occurrence of some other event on which the
10 distributee's right to receive the gift depends.

11 (c) After complying with subdivisions (a) and (b), the fiduciary shall determine the
12 remaining net income of the decedent's estate or terminating income interest as provided
13 in this chapter and by performing the following duties:

14 (1) Include in net income all income from property used to discharge liabilities.

15 (2) Pay from income or principal, in the fiduciary's discretion, fees of attorneys,
16 accountants, and fiduciaries, court costs and other expenses of administration, and interest
17 on death taxes, except that the fiduciary may pay these expenses from income of property
18 passing to a trust for which the fiduciary claims an estate tax marital or charitable
19 deduction only to the extent that the payment of these expenses from income will not
20 cause the reduction or loss of the deduction.

21 (3) Pay from principal all other disbursements made or incurred in connection with the
22 settlement of a decedent's estate or the winding up of a terminating income interest,
23 including debts, funeral expenses, disposition of remains, family allowances, and death
24 taxes and related penalties that are apportioned to the estate or terminating income
25 interest by the will, the trust, or Chapter 8 (commencing with Section 12000) of Part 10
26 of Division 7.

27 (4) Distribute the remaining net income in the manner provided in Section 16341 to all
28 other beneficiaries, including a beneficiary who receives a pecuniary amount in trust,
29 even if the beneficiary holds an unqualified power to withdraw assets from the trust or
30 other presently exercisable general power of appointment over the trust.

31 **Comment.** Section 16340 is drawn from Section 201 of the Uniform Principal and Income Act
32 (1997), with a number of modifications to conform with the California rule on specific gifts and
33 to improve readability. The revised language is intended to set out the rules in logical order, the
34 order in which the fiduciary would make determinations and allocations. This section supersedes
35 former Section 16305.

36 This section invokes rules provided elsewhere in this chapter that apply to trustees. In places,
37 the uniform act refers specifically to rules "which apply to trustees." See UPAIA Section 201(1)-
38 (2). This language has been omitted to simplify this section, but the concept is the same: the rules
39 applicable to trustees (and fiduciaries generally) in this chapter are to be applied both in cases of
40 decedent's estates and terminating income interests in trusts under this section.

41 Subdivision (a) is drawn from UPAIA Section 201(1) and (5). Subdivision (a)(1) combines the
42 first sentence of UPAIA Section 201(1) and the second sentence of UPAIA Section 201(5).
43 Subdivision (a)(2) is the same in substance as the first sentence of UPAIA Section 201(5).
44 Subdivision (a)(3) is the same in substance as the second sentence of UPAIA Section 201(1).

45 Subdivision (b) continues former Section 16314 without substantive change. This rule
46 substitutes for UPAIA Section 201(3).

47 Subdivision (c)(1)-(3) is the same in substance as UPAIA Section 201(2). Subdivision (c)(4) is
48 the same in substance as UPAIA Section 201(4).

1 See also Sections 62 (“property” defined), 16323 (“fiduciary” defined), 16324 (“income”
2 defined), 16326 (“income interest” defined), 16328 (“net income” defined), 16329 (“principal”
3 defined).

4 **Background from Uniform Act:**

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

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

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

30 *Gift of a pecuniary amount.* Section 201(3) and (4) [Prob. Code § 16340(b) & (c)(4)] provide
31 different rules for an outright gift of a pecuniary amount and a gift in trust of a pecuniary amount;
32 this is the same approach used in Section 5(b)(2) of the 1962 Act [see former Prob. Code §
33 16305].

34 *Interest on pecuniary amounts.* Section 201(3) [superseded by Prob. Code § 16340(b)] provides
35 that the beneficiary of an outright pecuniary amount is to receive the interest or other amount
36 provided by applicable law if there is no provision in the will or the terms of the trust. Many
37 States have no applicable law that provides for interest or some other amount to be paid on an
38 outright pecuniary gift under an inter vivos trust; this section provides that in such a case the
39 interest or other amount to be paid shall be the same as the interest or other amount required to be
40 paid on testamentary pecuniary gifts. This provision is intended to accord gifts under inter vivos
41 instruments the same treatment as testamentary gifts. The various state authorities that provide for
42 the amount that a beneficiary of an outright pecuniary amount is entitled to receive are collected
43 in Richard B. Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula*
44 *Provisions*, App. B (4th ed. 1997).

45 *Administration expenses and interest on death taxes.* Under Section 201(2)(B) [Prob. Code §
46 16340(c)(2)] a fiduciary may pay administration expenses and interest on death taxes from either
47 income or principal. An advantage of permitting the fiduciary to choose the source of the
48 payment is that, if the fiduciary’s decision is consistent with the decision to deduct these expenses
49 for income tax purposes or estate tax purposes, it eliminates the need to adjust between principal
50 and income that may arise when, for example, an expense that is paid from principal is deducted
51 for income tax purposes or an expense that is paid from income is deducted for estate tax
52 purposes.

1 The United States Supreme Court has considered the question of whether an estate tax marital
2 deduction or charitable deduction should be reduced when administration expenses are paid from
3 income produced by property passing in trust for a surviving spouse or for charity and deducted
4 for income tax purposes. The Court rejected the IRS position that administration expenses
5 properly paid from income under the terms of the trust or state law must reduce the amount of a
6 marital or charitable transfer, and held that the value of the transferred property is not reduced for
7 estate tax purposes unless the administration expenses are material in light of the income the trust
8 corpus could have been expected to generate. *Commissioner v. Estate of Otis C. Hubert*, 117 S.
9 Ct. 1124 (1997). The provision in Section 201(2)(B) [Prob. Code § 16340(c)(2)] permits a
10 fiduciary to pay and deduct administration expenses from income only to the extent that it will
11 not cause the reduction or loss of an estate tax marital or charitable contributions deduction,
12 which means that the limit on the amount payable from income will be established eventually by
13 Treasury Regulations.

14 *Interest on estate taxes.* The IRS agrees that interest on estate and inheritance taxes may be
15 deducted for income tax purposes without having to reduce the estate tax deduction for amounts
16 passing to a charity or surviving spouse, whether the interest is paid from principal or income.
17 Rev. Rul. 93-48, 93-2 C.B. 270. For estates of persons who died before 1998, a fiduciary may not
18 want to deduct for income tax purposes interest on estate tax that is deferred under Section 6166
19 or 6163 because deducting that interest for estate tax purposes may produce more beneficial
20 results, especially if the estate has little or no income or the income tax bracket is significantly
21 lower than the estate tax bracket. For estates of persons who die after 1997, no estate tax or
22 income tax deduction will be allowed for interest paid on estate tax that is deferred under Section
23 6166. However, interest on estate tax deferred under Section 6163 will continue to be deductible
24 for both purposes, and interest on estate tax deficiencies will continue to be deductible for estate
25 tax purposes if an election under Section 6166 is not in effect.

26 Under the 1962 Act, Section 13(c)(5) charges interest on estate and inheritance taxes to
27 principal. The 1931 Act has no provision. Section 501(3) of this Act [Prob. Code § 16370(c)]
28 provides that, except to the extent provided in Section 201(2)(B) or (C) [Prob. Code §
29 16340(c)(2) or (c)(3)], all interest must be paid from income.

30 [Adapted from Unif. Principal and Income Act § 201 comment (1997).]

31 ➡ **Staff Note.** The working group has continued to review UPAIA Section 201, and the job is
32 probably not complete. The intent is to preserve California's special rules on distribution of
33 interest and income during administration. Additional work needs to be done to make sure that
34 these rules have been effectively integrated into the uniform act and that all inconsistent rules
35 have been identified and removed.

36 The rule in subdivision (b), as noted in the Comment, preserves existing Section 16314. This
37 language replaces UPAIA Section 201(3):

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

46 **§ 16341. Distribution to residuary and remainder beneficiaries [UPAIA § 202]**

47 16341. (a) Each beneficiary described in paragraph (4) of subdivision (c) of Section
48 16340 is entitled to receive a portion of the net income equal to the beneficiary's
49 fractional interest in undistributed principal assets, using values as of the appropriate
50 distribution dates and without reducing the values by any unpaid principal obligations.

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

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

7 **Comment.** Section 16341 is drawn from parts of Section 202 of the Uniform Principal and
8 Income Act (1997). This section retains the basic rules of the UPAIA section, but omits some
9 unnecessary detail. This section supersedes parts of former Section 16304.

10 Subdivision (a) is the same in substance as the first sentence of UPAIA Section 202(a), and
11 includes the “unpaid principal obligation” rule from UPAIA Section 202(b)(3). The second
12 sentence of Section 202(a) is not needed because it simply reaffirms that the rule in the first
13 sentence is to be applied when there are more than one distributions:

14 If a fiduciary makes more than one distribution of assets to beneficiaries to whom this section
15 applies, each beneficiary, including one who does not receive part of the distribution, is
16 entitled, as of each distribution date, to the net income the fiduciary has received after the
17 date of death or terminating event or earlier distribution date but has not distributed as of the
18 current distribution date. [UPAIA § 202(a) 2d sent.]

19 Subdivision (b) is the same as UPAIA Section 202(c), except that the reference to “person” in
20 the uniform act has been changed to “beneficiary.”

21 Subdivision (c) is the same as UPAIA Section 202(b)(4).

22 The following UPAIA rules are not included in Section 16341 because they are already stated
23 in the general rule as set out in subdivision (a):

24 The beneficiary is entitled to receive a portion of the net income equal to the beneficiary’s
25 fractional interest in the undistributed principal assets immediately before the distribution
26 date, including assets that later may be sold to meet principal obligations. [UPAIA §
27 202(b)(1).]

28 The beneficiary’s fractional interest in the undistributed principal assets must be calculated
29 on the basis of the aggregate value of those assets as of the distribution date without reducing
30 the value by any unpaid principal obligation. [UPAIA § 202(b)(3).]

31 Subdivisions (b)(2) and (d) of UPAIA Section 202 are omitted as unnecessary in view of
32 the special California rules on interest and income accruing during administration. See
33 Sections 12000-12006, 16305. The uniform act provision was added to fill a gap noted by
34 several commentators (see UPAIA § 202 comment) — a gap that had been filled by earlier
35 California legislation, which is unaffected by enactment of this chapter. See, e.g., Section
36 16340(c) (continuing former Section 16314). For background on former law, see
37 *Recommendation Relating to Interest and Income During Administration*, 19 Cal. L. Revision
38 Comm’n Reports 1019 (1988).

39 **Background from Uniform Act:**

40 *Relationship to prior Acts.* Section 202 [Prob. Code § 16341] retains the concept in Section
41 5(b)(2) of the 1962 Act [see former Prob. Code § 16305] that the residuary legatees of estates are
42 to receive net income earned during the period of administration on the basis of their
43 proportionate interests in the undistributed assets when distributions are made. It changes the
44 basis for determining their proportionate interests by using asset values as of a date reasonably
45 near the time of distribution instead of inventory values....

46 [Adapted from Unif. Principal and Income Act § 202 comment (1997).]

Article 4. Apportionment at Beginning and End of Income Interest

§ 16345. When right to income begins and ends [UPAIA § 301]

16345. (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 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 at the following times:

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

(2) 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, on the date of the testator's death.

(3) In the case of an asset that is transferred to a fiduciary by a third party because of the individual's death, on the date 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 subdivision (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. Section 16345 is the same in substance as Section 301 of the Uniform Principal and Income Act (1997). This section supersedes parts of former Section 16304.

See also Sections 24 ("beneficiary" defined), 84 ("trustee" defined), 16324 ("income" defined), 16325 ("income beneficiary" defined), 16326 ("income interest" defined), 16328 ("net income" defined), 16329 ("principal" defined).

Background from Uniform Act:

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 [Prob. Code §§ 16346-16347] apply accordingly if the terms of the trust do not contain different provisions.

[Adapted from Unif. Principal and Income Act § 301 comment (1997).]

§ 16346. Apportionment of receipts and disbursements when decedent dies or income interest begins [UPAIA § 302]

16346. (a) A trustee shall allocate an income receipt or disbursement other than one to which Section [16340(a)] 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 shall 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 shall be allocated to principal and the balance shall 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 chapter. Distributions to shareholders or other owners from an entity to which Section 16350 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. Section 16346 is the same in substance as Section 302 of the Uniform Principal and Income Act (1997). This section supersedes parts of former Section 16304.

See also Sections 84 (“trustee” defined), 16324 (“income” defined), 16326 (“income interest” defined), 16329 (“principal” defined).

Background from Uniform Act. 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 [Prob. Code § 16346] 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 [Prob. Code § 16346], 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) [Prob. Code § 16346(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) [Prob. Code § 16340(a)] 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 [Prob. Code § 16357].

[Adapted from Unif. Principal and Income Act § 302 comment (1997).]

§ 16347. Apportionment when income interest ends [UPAIA § 303]

16347. (a) For the purposes of 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 by the trust.

(b) Except as provided in subdivision (c), on the date when a mandatory income interest ends, the trustee shall pay to a mandatory income beneficiary who survives that date, or to 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 trust.

(c) If immediately before the income interest ends, the beneficiary under subdivision (b) has an unqualified power to revoke more than five percent of the trust, the undistributed income from the portion of the trust that may be revoked shall be added to principal.

(d) 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.

Comment. Section 16347 is the same in substance as Section 303 of the Uniform Principal and Income Act (1997). This section supersedes parts of former Section 16304.

Subdivision (a) is the same as UPAIA Section 303(a).

Subdivisions (b) and (c) are the same in substance as UPAIA Section 303(b). The provision has been restructured for clarity and some minor wording changes have been made. The “unless” clause in the uniform act provision is stated as an exception in subdivision (c), as recognized in the introductory clause of subdivision (b).

Subdivision (d) is the same as the first part of UPAIA Section 303(c). The last clause of UPAIA Section 303(c) (“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”) is omitted as being repetitive of general principles.

See also Sections 84 (“trustee” defined), 16324 (“income” defined), 16325 (“income beneficiary” defined), 16326 (“income interest” defined), 16327 (“mandatory income interest” defined), 16328 (“net income” defined), 16329 (“principal” defined).

Background from Uniform Act:

Prior Acts. Both the 1931 Act (Section 4) and the 1962 Act (Section 4(d) [see former Prob. Code § 16304]) 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 [Prob. Code §§ 16346 & 16347] 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) [Prob. Code § 16346(a)], the July 20 payment is added to the principal of the successive income interest when received. Under Section 302(b) [Prob. Code § 16346(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 [Prob. Code § 16347], 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.

[Adapted from Unif. Principal and Income Act § 303 comment (1997).]

Article 5.1. Allocation of Receipts During Administration of Trust: Receipts from Entities

§ 16350. Character of receipts [UPAIA § 401]

16350. (a) For the purposes of 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 decedent's estate to which Section 16351 applies, a business or activity to which Section 16352 applies, or an asset-backed security to which Section 16367 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 to principal the following receipts from an entity:

(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.

(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) For purposes of paragraph (3) of subdivision (c):

(1) Money is received in partial liquidation (A) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation, or (B) 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.

(2) Money is not received in partial liquidation, nor may it be taken into account under clause (B) of paragraph (1), to the extent that it does not exceed the amount of income tax that a trustee or beneficiary is required to pay on taxable income of the entity that distributes the money.

(e) A trustee may rely on 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. Section 16350 is the same in substance as Section 401 of the Uniform Principal and Income Act (1997), with several minor changes. Some minor wording changes have also been made. This section supersedes former law concerning corporate distributions (former Section 16306) and business and partnership distributions (former Section 16308).

Subdivision (d) combines the substance of subdivisions (d) and (e) of the uniform act and makes clear that the rules relate to partial liquidations covered by subdivision (c)(3). In subdivision (e), the uniform act limitation that the statement must be made "at or near the time of distribution" has been omitted. This is consistent with the rule under former Section 16306(e).

See also Sections 24 ("beneficiary" defined), 62 ("property" defined), 84 ("trustee" defined),

Background from Uniform Act:

Entities to which Section 401 [Prob. Code § 16350] applies. The reference to partnerships in Section 401(a) [Prob. Code § 16350(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. Making or continuing such an election would be equivalent to deciding under Section 104 [Prob. Code § 16336] to transfer income to principal in order to comply with Section 103(b) [Prob. Code § 16335(b)]. However, if the trustee makes or continues the election for a reason other than to comply with Section 103(b) [Prob. Code § 16335(b)], e.g., to make an investment without incurring brokerage commissions, the trustee should transfer cash from principal to income in an amount equal to the reinvested dividends.

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 [Prob. Code § 16350] embraces all of the items enumerated in Section 6 of the 1962 Act [former Prob. Code § 16306] as well as any other form of nonmonetary distribution not specifically mentioned in that Act.

Partial liquidations. Under subsection (d)(1) [subdivision], 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.

1 *Other large distributions.* A cash distribution may be quite large (for example, more than 10%
2 but not more than 20% of the entity's gross assets) and have characteristics that suggest it should
3 be treated as principal rather than income. For example, an entity may have received cash from a
4 source other than the conduct of its normal business operations because it sold an investment
5 asset; or because it sold a business asset other than one held for sale to customers in the normal
6 course of its business and did not replace it; or it borrowed a large sum of money and secured the
7 repayment of the loan with a substantial asset; or a principal source of its cash was from assets
8 such as mineral interests, 90% of which would have been allocated to principal if the trust had
9 owned the assets directly. In such a case the trustee, after considering the total return from the
10 portfolio as a whole and the income component of that return, may decide to exercise the power
11 under Section 104(a) [Prob. Code § 16336(a)] to make an adjustment between income and
12 principal, subject to the limitations in Section 104(c) [Prob. Code § 16336(b)].

13 [Adapted from Unif. Principal and Income Act § 401 comment (1997).]

14 ☞ **Staff Note.** The working group spent a fair amount of time discussing Section 401 and the
15 limited number of changes made in the redraft in Section 16350 are aimed at clarifying some of
16 the confusion. However, the staff has not answered the suggestion that the list of types of entities
17 in subdivision (a) could be made more exhaustive — any suggestions along these lines would be
18 appreciated.

19 A minor issue that we have not resolved is whether subdivision (a) should refer to “regulated
20 investment companies” (as in the UPAIA) or “registered investment companies. A preliminary
21 check on federal law shows nearly 50 sections using the first term, and 30 sections using the
22 second. “Regulated investment company” is used mostly in Title 26, the Internal Revenue Code.
23 “Registered investment company” is used mostly in Title 15 on commerce and trade, where
24 investment companies and advisors are regulated. “Registered investment company” is never
25 used in Title 26, and “regulated investment company” is used in Title 15 only once (§ 687). It
26 may be that “regulated investment company” is a more general term and that using “registered
27 investment company” might lead to some technical omissions. For now, the staff is inclined to
28 keep the UPAIA usage unless it is shown to be erroneous.

29 **§ 16351. Distribution from trust or estate [UPAIA § 402]**

30 16351. A trustee shall allocate to income an amount received as a distribution of
31 income from a trust or a decedent's estate (other than an interest in an investment entity)
32 in which the trust has an interest other than a purchased interest, and shall allocate to
33 principal an amount received as a distribution of principal from the trust or estate.

34 **Comment.** Section 16351 is drawn from the first sentence of Section 402 of the Uniform
35 Principal and Income Act (1997). This section applies to interests that have not been purchased
36 — if the trustee purchases an interest in a trust that is an investment entity, or a decedent or donor
37 transfers an interest in such a trust to a trustee, Section 16350 applies to a receipt from the trust.

38 See also Sections 84 (“trustee” defined), 16324 (“income” defined), 16329 (“principal”
39 defined).

40 **Background from Uniform Act:**

41 *Terms of the distributing trust or estate.* Under Section 103(a) [Prob. Code § 16335(a)], a
42 trustee is to allocate receipts in accordance with the terms of the recipient trust or, if there is no
43 provision, in accordance with this Act. However, in determining whether a distribution from
44 another trust or an estate is income or principal, the trustee should also determine what the terms
45 of the distributing trust or estate say about the distribution — for example, whether they direct
46 that the distribution, even though made from the income of the distributing trust or estate, is to be
47 added to principal of the recipient trust. Such a provision should override the terms of this Act,
48 but if the terms of the recipient trust contain a provision requiring such a distribution to be
49 allocated to income, the trustee may have to obtain a judicial resolution of the conflict between
50 the terms of the two documents.

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

7 ☞ **Staff Note.** The New York proposal (Section 11-2.4(d)(1)(B)) bases the rule of this section on
8 federal tax treatment:

9 Subject to the terms of a recipient trust, an amount received as a distribution of income from a
10 trust or an estate in which the trust has an interest other than a purchased interest must be
11 allocated to income if it is a distribution of ordinary income for federal income tax purposes.
12 Any other amounts received from such a trust or estate must be allocated to principal. If a
13 trustee purchases an interest in a trust that is an investment entity, or a decedent or donor
14 transfers an interest in such a trust to a trustee, [Section 401] applies to a receipt from the
15 trust.

16 The staff does not know whether this is a better approach. The working group was split on the
17 issue. Sandy Rae, chair of the uniform act drafting committee, did not think we would want to tie
18 this rule to taxation.

19 The language in the second sentence of the Comment is, in effect, the second sentence of
20 UPAIA Section 402. The working group spent some time trying to understand the relationship of
21 Section 401, 402, and other sections cross-referenced within them. The staff has come to the
22 conclusion that the second sentence serves only as a cross-reference, and should probably not be
23 included in the statutory language.

24 **§ 16352. Business and other activities conducted by trustee [UPAIA § 403]**

25 16352. (a) If a trustee who conducts a business or other activity determines that it is in
26 the best interest of all the beneficiaries to account separately for the business or other
27 activity instead of accounting for it as part of the trust's general accounting records, the
28 trustee may maintain separate accounting records for its transactions, whether or not its
29 assets are segregated from other trust assets.

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

39 (c) Businesses and other activities for which a trustee may maintain separate accounting
40 records include the following:

- 41 (1) Retail, manufacturing, service, and other traditional business activities.
- 42 (2) Farming.
- 43 (3) Raising and selling livestock and other animals.
- 44 (4) Managing rental properties.
- 45 (5) Extracting minerals and other natural resources.
- 46 (6) Timber operations.
- 47 (7) Activities to which Section 16366 applies.

1 **Comment.** Section 16352 is the same as Section 403 of the Uniform Principal and Income Act
2 (1997), with some technical revisions for stylistic purposes. This section supersedes parts of
3 former Section 16308.

4 See also Sections 24 (“beneficiary” defined), 84 (“trustee” defined), 16324 (“income” defined),
5 16329 (“principal” defined).

6 **Background from Uniform Act:**

7 *Purpose and scope.* The provisions in Section 403 [Prob. Code § 16352] are intended to give
8 greater flexibility to a trustee who operates a business or other activity in proprietorship form
9 rather than in a wholly-owned corporation (or, where permitted by state law, a single-member
10 limited liability company), and to facilitate the trustee’s ability to decide the extent to which the
11 net receipts from the activity should be allocated to income, just as the board of directors of a
12 corporation owned entirely by the trust would decide the amount of the annual dividend to be
13 paid to the trust. It permits a trustee to account for farming or livestock operations, rental
14 properties, oil and gas properties, timber operations, and activities in derivatives and options as
15 though they were held by a separate entity. It is not intended, however, to permit a trustee to
16 account separately for a traditional securities portfolio to avoid the provisions of this Act that
17 apply to such securities.

18 Section 403 [Prob. Code § 16352] permits the trustee to account separately for each business or
19 activity for which the trustee determines separate accounting is appropriate. A trustee with a
20 computerized accounting system may account for these activities in a “subtrust”; an individual
21 trustee may continue to use the business and record-keeping methods employed by the decedent
22 or transferor who may have conducted the business under an assumed name. The intent of this
23 section is to give the trustee broad authority to select business record-keeping methods that best
24 suit the activity in which the trustee is engaged.

25 If a fiduciary liquidates a sole proprietorship or other activity to which Section 403 [Prob. Code
26 § 16352] applies, the proceeds would be added to principal, even though derived from the
27 liquidation of accounts receivable, because the proceeds would no longer be needed in the
28 conduct of the business. If the liquidation occurs during probate or during an income interest’s
29 winding up period, none of the proceeds would be income for purposes of Section 201 [Prob.
30 Code § 16340].

31 *Separate accounts.* A trustee may or may not maintain separate bank accounts for business
32 activities that are accounted for under Section 403 [Prob. Code § 16352]. A professional trustee
33 may decide not to maintain separate bank accounts, but an individual trustee, especially one who
34 has continued a decedent’s business practices, may continue the same banking arrangements that
35 were used during the decedent’s lifetime. In either case, the trustee is authorized to decide to what
36 extent cash is to be retained as part of the business assets and to what extent it is to be transferred
37 to the trust’s general accounts, either as income or principal.

38 Article 5.2. Allocation of Receipts During Administration
39 of Trust: Receipts Not Normally Apportioned

40 **§ 16355. Principal receipts [UPAIA § 404]**

41 16355. A trustee shall allocate to principal:

42 (a) To the extent not allocated to income under this chapter, assets received from a
43 transferor during the transferor’s lifetime, a decedent’s estate, a trust with a terminating
44 income interest, or a payer under a contract naming the trust or its trustee as beneficiary.

45 (b) Subject to any contrary rules in Articles 5.1 (commencing with Section 16350), 5.2
46 (commencing with Section 16355), and 5.3 (commencing with Section 16360), money or
47 other property received from the sale, exchange, liquidation, or change in form of a
48 principal asset, including realized profit.

(c) Amounts recovered from third parties to reimburse the trust because of disbursements described in paragraph (7) of subdivision (a) of Section 16371 or for other reasons to the extent not based on the loss of income.

(d) 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.

(e) Net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income.

(f) Other receipts allocated to principal as provided in Article 5.3 (commencing with Section 16360).

Comment. Section 16355 is the same as Section 404 of the Uniform Principal and Income Act (1997), with a number of editorial changes. This section supersedes parts of former Section 16303(b) (inclusions in principal). Subdivision (b) makes clear that the general rule allocating receipts from the sale, exchange, liquidation, or change in form of principal assets is subject to special rules in other sections. See, e.g., Section 16362 (liquidating assets).

See also Sections 62 (“property” defined), 84 (“trustee” defined), 16322 (“accounting period” defined), 16324 (“income” defined), 16325 (“income beneficiary” defined), 16329 (“principal” defined).

Background from Uniform Act:

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.

§ 16356. Rental property [UPAIA § 405]

16356. Unless the trustee accounts for receipts from rental property pursuant to Section 16352, 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, shall 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. Section 16356 is the same as Section 405 of the Uniform Principal and Income Act (1997), with some technical changes in the introductory clause to clarify the relation of this section to Section 16352.

See also Sections 62 (“property” defined), 84 (“trustee” defined), 16329 (“principal” defined).

Background from Uniform Act:

Application of Section 403 [Prob. Code § 16352]. This section applies to the extent that the trustee does not account separately under Section 403 [Prob. Code § 16352] 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 [Prob. Code § 16356], a transfer from income to reimburse principal may be appropriate under Section 504 [Prob. Code § 16373] 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) [see Prob. Code § 16336 & Comment] in deciding whether and to what extent to make an adjustment between principal and income under Section 104(a) [Prob. Code § 16336(a)] after considering the return from the portfolio as a whole.]

1 **§ 16357. Obligation to pay money [UPAIA § 406]**

2 16357. (a) An amount received as interest, whether determined at a fixed, variable, or
3 floating rate, on an obligation to pay money to the trustee, including an amount received
4 as consideration for prepaying principal, shall be allocated to income without any
5 provision for amortization of premium.

6 (b) An amount received from the sale, redemption, or other disposition of an obligation
7 to pay money to the trustee more than one year after it is purchased or acquired by the
8 trustee, including an obligation whose purchase price (or its value when it is otherwise
9 acquired) is less than its value at maturity, shall be allocated to principal. If the obligation
10 matures within one year after it is purchased or acquired by the trustee, an amount
11 received in excess of its purchase price (or its value when it is otherwise acquired) shall
12 be allocated to income.

13 (c) This section does not apply to an obligation to which Section 16361, 16362, 16363,
14 16364, 16366, or 16367 applies.

15 **Comment.** Section 16357 is the same as Section 406 of the Uniform Principal and Income Act
16 (1997), with some minor editorial revisions. Subdivision (b) has been redrafted for clarity and
17 parallelism with subdivision (a). This section supersedes former Section 16307.

18 See also Sections 84 (“trustee” defined), 16324 (“income” defined), 16329 (“principal”
19 defined).

20 **Background from Uniform Act:**

21 *Variable or floating interest rates.* The reference in subsection (a) to variable or floating
22 interest rate obligations is intended to clarify that, even though an obligation’s interest rate may
23 change from time to time based upon changes in an index or other market indicator, an obligation
24 to pay money containing a variable or floating rate provision is subject to this section and is not to
25 be treated as a derivative financial instrument under Section 414 [Prob. Code § 16366].

26 *Discount obligations.* Subsection (b) applies to all obligations acquired at a discount, including
27 short-term obligations such as U.S. Treasury Bills, long-term obligations such as U.S. Savings
28 Bonds, zero-coupon bonds, and discount bonds that pay interest during part, but not all, of the
29 period before maturity. Under subsection (b), the entire increase in value of these obligations is
30 principal when the trustee receives the proceeds from the disposition unless the obligation, when
31 acquired, has a maturity of less than one year. In order to have one rule that applies to all discount
32 obligations, the Act eliminates the provision in the 1962 Act for the payment from principal of an
33 amount equal to the increase in the value of U.S. Series E bonds. The provision for bonds that
34 mature within one year after acquisition by the trustee is derived from the Illinois act. 760 ILCS
35 15/8 (1996).

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

40 *Effect of Section 104 [Prob. Code § 16336].* In deciding whether and to what extent to exercise
41 the power to adjust between principal and income granted by Section 104(a) [Prob. Code §
42 16336(a)], a relevant factor for the trustee to consider is the effect on the portfolio as a whole of
43 having a portion of the assets invested in bonds that do not pay interest currently.

44 **§ 16358. Insurance policies and similar contracts [UPAIA § 407]**

45 16358. (a) Except as otherwise provided in subdivision (b), a trustee shall allocate to
46 principal the proceeds of a life insurance policy or other contract in which the trust or its
47 trustee is named as beneficiary, including a contract that insures the trust or its trustee
48 against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall

1 allocate dividends on an insurance policy to income if the premiums on the policy are
2 paid from income, and to principal if the premiums are paid from principal.

3 (b) A trustee shall allocate to income proceeds of a contract that insures the trustee
4 against loss of occupancy or other use by an income beneficiary, loss of income, or,
5 subject to Section 16352, loss of profits from a business.

6 (c) This section does not apply to a contract to which Section 16361 applies.

7 **Comment.** Section 16358 is the same as Section 407 of the Uniform Principal and Income Act
8 (1997). This section supersedes former Section 16303(b)(3) (insurance proceeds on property).
9 Life insurance was not covered by prior law.

10 See also Sections 24 (“beneficiary” defined), 84 (“trustee” defined), 16324 (“income” defined),
11 16329 (“principal” defined).

12 Article 5.3. Allocation of Receipts During Administration 13 of Trust: Receipts Normally Apportioned

14 **§ 16360. Insubstantial allocations not required [UPAIA § 408]**

15 16360. (a) If a trustee determines that an allocation between principal and income
16 required by Section 16361, 16362, 16363, 16364, or 16367 is insubstantial, the trustee
17 may allocate the entire amount to principal unless one of the circumstances described in
18 subdivision (b) of Section 16336 applies to the allocation. This power may be exercised
19 by a cotrustee in the circumstances described in subdivision (c) of Section 16336 and
20 may be released for the reasons and in the manner provided in subdivisions (d) and (e) of
21 Section 16336.

22 (b) An allocation is presumed to be insubstantial in either of the following cases:

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

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

28 **Comment.** Section 16360 is drawn from Section 408 of the Uniform Principal and Income Act
29 (1997).

30 See also Sections 84 (“trustee” defined), 16322 (“accounting period” defined), 16324
31 (“income” defined), 16329 (“principal” defined),


32 **Background from Uniform Act:**

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

35 For example, assume that a trust’s assets, which include a working interest in an oil well, have
36 a value of \$1,000,000; the net income from the assets other than the working interest is \$40,000;
37 and the net receipts from the working interest are \$400. The trustee may allocate all of the net
38 receipts from the working interest to principal instead of allocating 10%, or \$40, to income under
39 Section 411 [Prob. Code § 16363]. If the net receipts from the working interest are \$35,000, so
40 that the amount allocated to income under Section 411 [Prob. Code § 16363] would be \$3,500,
41 the trustee may decide that this amount is sufficiently significant to the income beneficiary that
42 the allocation provided for by Section 411 [Prob. Code § 16363] should be made, even though the
43 trustee is still permitted under Section 408 [Prob. Code § 16360] to allocate all of the net receipts
44 to principal because the \$3,500 would increase the net income of \$40,000, as determined before
45 making an allocation under Section 411 [Prob. Code § 16363], by less than 10%. Section 408

1 [Prob. Code § 16360] will also relieve a trustee from having to allocate net receipts from the sale
2 of trees in a small woodlot between principal and income.

3 While the allocation to principal of small amounts under this section should not be a cause for
4 concern for tax purposes, allocations are not permitted under this section in circumstances
5 described in Section 104(c) [Prob. Code § 16336(b)] to eliminate claims that the power in this
6 section has adverse tax consequences.

7  **Staff Note.** When the working group reviewed this section, CBA representatives expressed
8 the concern that this type of rule might imply a duty, even though it is phrased in discretionary
9 terms (“the trustee may allocate”), and they did not like the incorporation of the factors in Section
10 104(c). However, it is not clear how the section would work without the limitations in Section
11 104(c), and there would be the danger that the existence of the power could have adverse tax
12 consequences, as noted in the italicized paragraph in the UPAIA background comment. If these
13 issues can’t be resolved, it may be best to delete this section. There is no such rule in the 1962
14 RUPIA or in the California version.

15 To deal with some of the concerns raised by this section, it was suggested that we include an
16 exoneration rule in this section, patterned after Probate Code Section 2585 in the guardianship-
17 conservatorship law:

18 2585. Nothing in this article imposes any duty on the conservator to propose any action
19 under this article, and the conservator is not liable for failure to propose any action under this
20 article.

21 **§ 16361. Deferred compensation, annuities, and similar payments [UPAIA § 409]**

22 16361. (a) In this section, “payment” means a payment that a trustee may receive over a
23 fixed number of years or during the life of one or more individuals because of services
24 rendered or property transferred to the payer in exchange for future payments. The term
25 includes a payment made in money or property from the payer’s general assets or from a
26 separate fund created by the payer, including a private or commercial annuity, an
27 individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-
28 ownership plan.

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

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

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

45 (e) This section does not apply to payments to which Section 16362 applies.

46 **Comment.** Section 16361 is the same as Section 409 of the Uniform Principal and Income Act
47 (1997). This section supersedes part of former Section 16310.

See also Sections 62 (“property” defined), 84 (“trustee” defined), 16322 (“accounting period” defined), 16324 (“income” defined), 16329 (“principal” defined),

Background from Uniform Act:

Scope. Section 409 [Prob. Code § 16361] 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 [Prob. Code § 16362] (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 [Prob. Code § 16361] because of their special characteristics.

Section 409 [Prob. Code § 16361] 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)).

....

Allocations Under Section 409(b) [Prob. Code § 16361(b)]. Section 409(b) [Prob. Code § 16361(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) [Prob. Code § 16361(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) [Prob. Code § 16361(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) [Prob. Code § 16361(c)].

Allocations Under Section 409(c) [Prob. Code § 16361(c)]. The focus of Section 409 [Prob. Code § 16361], 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) [Prob. Code § 16361(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

1 persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to
2 receive particular items that are paid to the IRA, but is instead the right to receive an amount
3 determined by dividing the value of the IRA by the remaining number of years in the payment
4 period. This payment right is similar to the right to receive a unitrust amount, which is normally
5 expressed as an amount equal to a percentage of the value of the unitrust assets without regard to
6 dividends or interest that may be received by the unitrust.

7 An amount received from an IRA or a plan with a payment provision similar to that of an IRA
8 is allocated under Section 409(c) [Prob. Code § 16361(c)], which differentiates between
9 payments that are required to be made and all other payments. To the extent that a payment is
10 required to be made (either under federal income tax rules or, in the case of a plan that is not
11 subject to those rules, under the terms of the plan), 10% of the amount received is allocated to
12 income and the balance is allocated to principal. All other payments are allocated to principal
13 because they represent a change in the form of a principal asset; Section 409 [Prob. Code §
14 16361] follows the rule in Section 404(2) [Prob. Code § 16355(b)], which provides that money or
15 property received from a change in the form of a principal asset be allocated to principal.

16 Section 409(c) [Prob. Code § 16361(c)] produces an allocation to income that is similar to the
17 allocation under the 1962 Act formula if the annual payments are the same throughout the
18 payment period, and it is simpler to administer. The amount allocated to income under Section
19 409 [Prob. Code § 16361] is not dependent upon the interest rate that is used for valuation
20 purposes when the decedent dies, and if the payments received by the trust increase or decrease
21 from year to year because the fund from which the payment is made increases or decreases in
22 value, the amount allocated to income will also increase or decrease.

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

36 *Application of Section 104.* Section 104(a) of this Act [Prob. Code § 16336(a)] gives a trustee
37 who is acting under the prudent investor rule the power to adjust from principal to income if,
38 considering the portfolio as a whole and not just receipts from deferred compensation, the trustee
39 determines that an adjustment is necessary. See Example (5) in the Comment following Section
40 104 [Prob. Code § 16336].

41 **§ 16362. Liquidating asset [UPAIA § 410]**

42 16362. (a) In this section, "liquidating asset" means an asset whose value will diminish
43 or terminate because the asset is expected to produce receipts for a period of limited
44 duration. The term includes a leasehold, patent, copyright, royalty right, and right to
45 receive payments under an arrangement that does not provide for the payment of interest
46 on the unpaid balance. The term does not include a payment subject to Section 16361,
47 resources subject to Section 16363, timber subject to Section 16364, an activity subject to
48 Section 16366, an asset subject to Section 16367, or any asset for which the trustee
49 establishes a reserve for depreciation under Section 16372.

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

1 **Comment.** Section 16362 is the same as Section 410 of the Uniform Principal and Income Act
2 (1997), except that the limitation on rights to receive payments “during a period of more than one
3 year” is omitted. This section supersedes part of former Section 16310.

4 See also Sections 84 (“trustee” defined), 16324 (“income” defined), 16329 (“principal”
5 defined).

6 **Background from Uniform Act:**

7 *Prior Acts.* Section 11 of the 1962 Act [former Prob. Code § 16310] allocates receipts from
8 “property subject to depletion” to income in an amount “not in excess of 5%” of the asset’s
9 inventory value. The 1931 Act has a similar 5% rule that applies when the trustee is under a duty
10 to change the form of the investment. The 5% rule imposes on a trust the obligation to pay a fixed
11 annuity to the income beneficiary until the asset is exhausted. Under both the 1931 and 1962 Acts
12 the balance of each year’s receipts is added to principal. A fixed payment can produce unfair
13 results. The remainder beneficiary receives all of the receipts from unexpected growth in the
14 asset, e.g., if royalties on a patent or copyright increase significantly. Conversely, if the receipts
15 diminish more rapidly than expected, most of the amount received by the trust will be allocated to
16 income and little to principal. Moreover, if the annual payments remain the same for the life of
17 the asset, the amount allocated to principal will usually be less than the original inventory value.
18 For these reasons, Section 410 [Prob. Code § 16362] abandons the annuity approach under the
19 5% rule.

20 *Lottery payments.* The reference in subsection (a) to rights to receive payments under an
21 arrangement that does not provide for the payment of interest includes state lottery prizes and
22 similar fixed amounts payable over time that are not deferred compensation arrangements covered
23 by Section 409 [Prob. Code § 16361].

24 **§ 16363. Minerals, water, and other natural resources [UPAIA § 411]**

25 16363. (a) To the extent that a trustee accounts for receipts from an interest in minerals
26 or other natural resources pursuant to this section, the trustee shall allocate them as
27 follows:

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

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

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

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

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

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

44 **Comment.** Section 16363 is the same as Section 411(a)-(c) of the Uniform Principal and
45 Income Act (1997), with the addition of the reference to “nominal bonus” in subdivision (a)(1).
46 This section supersedes parts of former Section 16309.


47 See also Sections 84 (“trustee” defined), 16324 (“income” defined), 16329 (“principal”
48 defined).

Background from Uniform Act:

... Section 411 [Prob. Code § 16363] 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 [Prob. Code § 16352] and 408 [Prob. Code § 16360]. 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 [Prob. Code § 16360].

Open mine doctrine. The purpose of Section 411(c) [Prob. Code § 16363(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).

 **Staff Note.** The working group did not think we need the special transitional rule in subdivision (d) of this section (and in the next section), which relate to constitutional concerns expressed in an Oklahoma case. The subdivision reads:

(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].

The relevant discussion from the uniform act comment reads:

Effective date provision [omitted from Prob. Code § 16363]. Section 9(b) of the 1962 Act [see former Prob. Code § 16309] 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).

1 **§ 16364. Timber [UPAIA § 412]**

2 16364. (a) To the extent that a trustee accounts for receipts from the sale of timber and
3 related products pursuant to this section, the trustee shall allocate the net receipts as
4 follows:

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

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

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

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

16 (b) In determining net receipts to be allocated under subdivision (a), a trustee shall
17 deduct and transfer to principal a reasonable amount for depletion.

18 (c) This chapter applies whether or not a decedent or transferor was harvesting timber
19 from the property before it became subject to the trust.

20 **Comment.** Section 16364 is the same as Section 412(a)-(c) of the Uniform Principal and
21 Income Act (1997), with some minor editorial revisions. This section supersedes former Section
22 16310 to the extent it applied to timber.

23 See also Sections 84 (“trustee” defined), 16322 (“accounting period” defined), 16324
24 (“income” defined), 16329 (“principal” defined),

25 **Background from Uniform Act:**

26 *Scope of section.* The rules in Section 412 [Prob. Code § 16364] are intended to apply to net
27 receipts from the sale of trees and by-products from harvesting and processing trees without
28 regard to the kind of trees that are cut or whether the trees are cut before or after a particular
29 number of years of growth. The rules apply to the sale of trees that are expected to produce
30 lumber for building purposes, trees sold as pulpwood, and Christmas and other ornamental trees.
31 Subsection (a) applies to net receipts from property owned by the trustee and property leased by
32 the trustee. The Act is not intended to prevent a tenant in possession of the property from using
33 wood that he cuts on the property for personal, noncommercial purposes, such as a Christmas
34 tree, firewood, mending old fences or building new fences, or making repairs to structures on the
35 property.

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

40 *Application of Sections 403 and 408 [Prob. Code §§ 16352 & 16360].* This section applies to
41 the extent that the trustee does not account separately for net receipts from the sale of timber and
42 related products under Section 403 [Prob. Code § 16352] or allocate all of the receipts to principal
43 under Section 408 [Prob. Code § 16360]. The option to account for net receipts separately under
44 Section 403 [Prob. Code § 16352] takes into consideration the possibility that timber harvesting
45 operations may have been conducted before the timber property became subject to the trust, and
46 that it may make sense to continue using accounting methods previously established for the
47 property. It also permits a trustee to use customary accounting practices for timber operations
48 even if no harvesting occurred on the property before it became subject to the trust.

§ 16365. Property not productive of income [UPAIA § 413(b)]

16365. In cases not governed by subdivision (c) of Section 21524, proceeds from the sale or other disposition of a trust asset are principal without regard to the amount of income the asset produces during any accounting period.

Comment. Section 16365 is the same in substance as Section 413(b) of the Uniform Principal and Income Act (1997). This section supersedes part of former Section 16311 (underproductive property). For the rule applicable to unproductive property in marital deduction trusts, see Section 21524(c).

See also Sections 16322 (“accounting period” defined), 16324 (“income” defined), 16329 (“principal” defined).


Background from Uniform Act:

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” [See Prob. Code § 16047(b).] The underproductive property provisions in Section 12 of the 1962 Act [former Prob. Code § 16311] 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 [Prob. Code § 16047(b)]. 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....

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

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.

....

 **Staff Note.** The part of the uniform act provision already covered by Section 21524(c) reads as follows:

413. (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 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[,] [or] 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.

Background from Uniform Act.... Marital deduction trusts. Subsection (a) draws on language in Reg. § 20.2056(b)-5(f)(4) and (5) to enable a trust for a spouse to qualify for a marital deduction if applicable state law is unclear about the 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 [Prob. Code § 16365], the power under Section 104(a) would be exercised to transfer principal to income and not to transfer income to principal.

Section 413 [Prob. Code § 16365] 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).

If the Commission decides to recommend a power to adjust, then the features of the uniform act relating to Section 104 would need to be included in this section, or in Section 21524(c).

§ 16366. Derivatives and options [UPAIA § 414]

16366. (a) In this section, “derivative” means a contract or financial instrument or a combination of contracts and financial instruments that 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 16352 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 shall be allocated to principal. An amount paid to acquire the option shall 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, shall be allocated to principal.

Comment. Section 16366 is the same as Section 414 of the Uniform Principal and Income Act (1997). The subject of this section was not covered by the former principal and income act.

See also Sections 62 (“property” defined), 84 (“trustee” defined), 16329 (“principal” defined).

Background from Uniform Act:

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 [Prob. Code § 16350] and not Section 414 [Prob. Code § 16366]. 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 [Prob. Code § 16352]; if a trustee chooses not to account under Section 403 [Prob. Code § 16352], Section 414(b) [Prob. Code § 16366(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) [Prob. Code § 16366(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 [Prob. Code § 16352]. 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) [Prob. Code § 16355(b)].

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.

1 **§ 16367. Asset-backed securities [UPAIA § 415]**

2 16367. (a) In this section, “asset-backed security” means an asset whose value is based
3 upon the right it gives the owner to receive distributions from the proceeds of financial
4 assets that provide collateral for the security. The term includes an asset that gives the
5 owner the right to receive from the collateral financial assets only the interest or other
6 current return or only the proceeds other than interest or current return. The term does not
7 include an asset to which Section 401 or 409 applies.

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

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

17 **Comment.** Section 16367 is the same as Section 415 of the Uniform Principal and Income Act
18 (1997).

19 See also Sections 84 (“trustee” defined), 16322 (“accounting period” defined), 16324
20 (“income” defined), 16329 (“principal” defined).

21 **Background from Uniform Act:**

22 *Scope of section.* Typical asset-backed securities include arrangements in which debt
23 obligations such as real estate mortgages, credit card receivables and auto loans are acquired by
24 an investment trust and interests in the trust are sold to investors. The source for payments to an
25 investor is the money received from principal and interest payments on the underlying debt. An
26 asset-backed security includes an “interest only” or a “principal only” security that permits the
27 investor to receive only the interest payments received from the bonds, mortgages or other assets
28 that are the collateral for the asset-backed security, or only the principal payments made on those
29 collateral assets. An asset-backed security also includes a security that permits the investor to
30 participate in either the capital appreciation of an underlying security or in the interest or dividend
31 return from such a security, such as the “Primes” and “Scores” issued by Americus Trust. An
32 asset-backed security does not include an interest in a corporation, partnership, or an investment
33 trust described in the Comment to Section 402 [Prob. Code § 16351], whose assets consist
34 significantly or entirely of investment assets. Receipts from an instrument that do not come within
35 the scope of this section or any other section of the Act would be allocated entirely to principal
36 under the rule in Section 103(a)(4) [Prob. Code § 16335(a)(4)], and the trustee may then consider
37 whether and to what extent to exercise the power to adjust in Section 104 [Prob. Code § 16336],
38 taking into account the return from the portfolio as whole and other relevant factors.

39 **Article 6. Allocation of Disbursements During Administration of Trust**

40 **§ 16370. Disbursements from income [UPAIA § 501]**

41 16370. A trustee shall make the following disbursements from income to the extent that
42 they are not disbursements to which paragraph (2) or (3) of subdivision (c) of Section
43 16340 applies:

44 (a) Except as otherwise ordered by the court, one-half of the regular compensation of
45 the trustee and of any person providing investment advisory or custodial services to the
46 trustee.

(b) Except as otherwise ordered by the court, one-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests.

(c) 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.

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

Comment. Section 16370 is the same as Section 501 of the Uniform Principal and Income Act (1997), with the addition of the recognition of court orders in subdivisions (a) and (b).

See also Sections 62 (“property” defined), 84 (“trustee” defined), 16324 (“income” defined), 16326 (“income interest” defined), 16330 (“remainder beneficiary” defined), 16329 (“principal” defined),

Background from Uniform Act:

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 [subdivision (d)] 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) [Prob. Code § 16371(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.

§ 16371. Disbursements from principal [UPAIA § 502]

16371. (a) A trustee shall make the following disbursements from principal:

(1) Except as otherwise ordered by the court, the remaining one-half of the disbursements described in subdivisions (a) and (b) of Section 16370.

(2) Except as otherwise ordered by the court, 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 subdivision (d) of Section 16370 of which the trust is the owner and beneficiary.

(6) Estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust.

(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. Section 16371 is the same as Section 502 of the Uniform Principal and Income Act (1997), with the addition of the recognition of court orders in subdivisions (a)(1) and (a)(2).

See also Sections 62 (“property” defined), 84 (“trustee” defined), 16324 (“income” defined), 16329 (“principal” defined),

Background from Uniform Act:

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 [Prob. Code § 16373]. 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) [Prob. Code § 16371(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 [Prob. Code § 16352]. 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) [Prob. Code § 16373(a) & (b)], a trustee who makes or expects to make a principal disbursement for an environmental expense described in Section 502(a)(7) [Prob. Code § 16371(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) [Prob. Code § 16371(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) [Prob. Code § 16371(a)(4)], include an “action to assure title” that is mentioned in Section 13(c)(2) of the 1962 Act [former Prob. Code § 16312(d)(2)].

Insurance premiums. Insurance premiums referred to in Section 502(a)(5) [Prob. Code § 16371(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).

§ 16372. Transfers from income to principal for depreciation [UPAIA § 503]

16372. (a) For purposes of 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 from income to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, under generally accepted accounting principles, but may not transfer any amount for depreciation under this section in any of the following circumstances:

(1) As to the 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.

(3) If the trustee is accounting under Section 16352 for the business or activity in which the asset is used.

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

Comment. Section 16372 is the same as Section 503 of the Uniform Principal and Income Act (1997), with some clarifying language, and the addition of the generally accepted accounting principles standard in subdivision (b). This addition continues the substance of former Section 16312(b)(2). Section 16372 also supersedes the last part of former Section 16312(d)(3).

See also Sections 84 (“trustee” defined), 16324 (“income” defined), 16329 (“principal” defined).

Background from Uniform Act:

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) [Prob. Code § 16335(b)], and in exercising the power a trustee must comply with Section 103(b) [Prob. Code § 16335(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) [Prob. Code § 16373(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.

☞ **Staff Note.** The preservation of the generally accepted accounting principles standard in subdivision (b) was recommended by the State Bar Estate Planning, Trust and Probate Law Section committee that reviewed the UPAIA. See Second Supplement to Memorandum 98-19, Exhibit pp. 22-23. The bar commentator also suggested placing a “reasonable period of time” limitation on the exception in subdivision (b)(2). The working group did not consider this suggestion.

§ 16373. Transfers from income to reimburse principal [UPAIA § 504]

16373. (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

1 one or more accounting periods to reimburse principal or to provide a reserve for future
2 principal disbursements.

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

6 (1) An amount chargeable to income but paid from principal because it is unusually
7 large, including extraordinary repairs.

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

10 (3) Disbursements made to prepare property for rental, including tenant allowances,
11 leasehold improvements, and broker's commissions.

12 (4) Periodic payments on an obligation secured by a principal asset to the extent that
13 the amount transferred from income to principal for depreciation is less than the periodic
14 payments.

15 (5) Disbursements described in paragraph (7) of subdivision (a) of Section 16371.

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

19 **Comment.** Section 16373 is the same as Section 504 of the Uniform Principal and Income Act
20 (1997), with some minor editorial changes. This section supersedes the first part of former
21 Section 16312(d)(3).

22 See also Sections 62 ("property" defined), 84 ("trustee" defined), 16322 ("accounting period"
23 defined), 16324 ("income" defined), 16326 ("income interest" defined), 16329 ("principal"
24 defined).

25 **Background from Uniform Act:**

26 *Prior Acts.* The sources of Section 504 [Prob. Code § 16373] are Section 13(b) of the 1962 Act
27 [former Prob. Code § 16312(c)], which permits a trustee to "regularize distributions," if charges
28 against income are unusually large, by using "reserves or other reasonable means" to withhold
29 sums from income distributions; Section 13(c)(3) of the 1962 Act [former Prob. Code §
30 16312(d)(3)], which authorizes a trustee to establish an allowance for depreciation out of income
31 if principal is used for extraordinary repairs, capital improvements and special assessments; and
32 Section 12(3) of the 1931 Act, which permits the trustee to spread income expenses of unusual
33 amount "throughout a series of years." Section 504 [Prob. Code § 16373] contains a more
34 detailed enumeration of the circumstances in which this authority may be used, and includes in
35 subsection (b)(4) the express authority to use income to make principal payments on a mortgage
36 if the depreciation charge against income is less than the principal payments on the mortgage.

37 **§ 16374. Income taxes [UPAIA § 505]**

38 16374. (a) A tax required to be paid by a trustee based on receipts allocated to income
39 shall be paid from income.

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

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

44 (1) From income to the extent that receipts from the entity are allocated to income.

45 (2) From principal to the extent that both of the following apply:

46 (A) Receipts from the entity are allocated to principal.

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

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

6 **Comment.** Section 16374 is the same as Section 505 of the Uniform Principal and Income Act
7 (1997), with some minor editorial changes.

8 See also Sections 84 ("trustee" defined), 16324 ("income" defined), 16329 ("principal"
9 defined).

10 **Background from Uniform Act:**

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

18 A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection
19 (d) takes into account the possibility that an ESBT may not receive a deduction for trust
20 accounting income that is distributed to the beneficiaries. Only limited guidance has been issued
21 by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that
22 may arise, but the powers granted to a trustee in Sections 506 [Prob. Code § 16375] and 104
23 [Prob. Code § 16336] to make adjustments are probably sufficient to enable a trustee to correct
24 inequities that may arise because of technical problems.

25 **§ 16375. Adjustments between principal and income because of taxes [UPAIA § 506]**

26 16375. (a) A fiduciary may make adjustments between principal and income to offset
27 the shifting of economic interests or tax benefits between income beneficiaries and
28 remainder beneficiaries that arise from any of the following:

29 (1) Elections and decisions, other than those described in subdivision (b), that the
30 fiduciary makes from time to time regarding tax matters.

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

33 (3) The ownership by a decedent's estate or trust of an interest in an entity whose
34 taxable income, whether or not distributed, is includable in the taxable income of the
35 estate, trust, or a beneficiary.

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

Comment. Section 16375 is the same as Section 506 of the Uniform Principal and Income Act (1997), with some minor editorial changes.

See also Sections 16323 (“fiduciary” defined), 16324 (“income” defined), 16325 (“income beneficiary” defined), 16329 (“principal” defined), 16330 (“remainder beneficiary” defined),

Background from Uniform Act:

Discretionary adjustments. Section 506(a) [Prob. Code § 16375(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) [Prob. Code § 16375(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

1 result is intended. Settlers who intend this tax result rarely state it as an objective in the terms of
2 the trust, but instead rely on the operation of the tax law to produce the desired result. As a result
3 it may not be possible to determine from the terms of the trust if the result was intentional or
4 unintentional. If the drafter of such a trust wants the trustee to have the authority to distribute
5 principal or income to the settlor to reimburse the settlor for taxes paid on the trust's income or
6 capital gains, such a provision should be placed in the terms of the trust. In some situations the
7 Internal Revenue Service may require that such a provision be placed in the terms of the trust as a
8 condition to issuing a private letter ruling.
9

1 C O N F O R M I N G R E V I S I O N S A N D R E P E A L S

2 **Corp. Code § 10251 (amended). Common trust funds**

3 SEC. _____. Section 10251 of the Corporations Code is amended to read:

4 10251. (a) “Educational institution,” as used in this section, means any nonprofit
5 corporation organized under Chapter 4 (commencing with Section 94400) or Chapter 7
6 (commencing with Section 94700) of Part 59 of the Education Code or organized under
7 Part 1 (commencing with Section 9000) of this division in effect on December 31, 1979,
8 and designated on or after January 1, 1980, as a nonprofit public benefit corporation, or
9 organized for charitable or eleemosynary purposes under Part 2 (commencing with
10 Section 5110) of this division, or Part 3 (commencing with Section 10200) of this
11 division in effect on December 31, 1979, and designated on or after January 1, 1980, as a
12 nonprofit public benefit corporation for the purpose of establishing, conducting or
13 maintaining an institution offering courses beyond high school and issuing or conferring
14 a diploma or for the purpose of offering or conducting private school instruction on the
15 high school or elementary school level and any charitable trust organized for such
16 purpose or purposes. “Educational institution,” as used in this section, also means the
17 University of California, the California State University, the California Community
18 Colleges, and any auxiliary organization, as defined in Section 89901 of the Education
19 Code, established for the purpose of receiving gifts, property and funds to be used for the
20 benefit of a state college.

21 (b) It shall be lawful for any educational institution to become a member of a nonprofit
22 corporation incorporated under the laws of any state for the purpose of maintaining a
23 common trust fund or similar common fund in which nonprofit organizations may
24 commingle their funds and property for investment and to invest any and all of its funds,
25 whenever and however acquired, in the common fund or funds; provided that, in the case
26 of funds or property held as fiduciary, the investment is not prohibited by the wording of
27 the will, deed, or other instrument creating the fiduciary relationship.

28 (c) An educational institution electing to invest in a common fund or funds under this
29 section may elect to receive distributions from each fund in an amount not to exceed for
30 each fiscal year the greater of the income, as ~~defined in Section 16303~~ determined under
31 Uniform Principal and Income Act, Chapter 3 (commencing with Section 16320) of Part
32 4 of Division 9 of the Probate Code, accrued on its interest in the fund or 10 percent of
33 the value of its interest in the fund as of the last day of its next preceding fiscal year. The
34 educational institution may expend the distribution or distributions for any lawful purpose
35 notwithstanding any general or special law characterizing the distribution, or any part
36 thereof, as principal or income; provided that, in the case of funds or property invested as
37 fiduciary, the expenditure is not prohibited by the wording of the will, deed, or other
38 instrument creating the fiduciary relationship. No such prohibition of expenditure shall be
39 deemed to exist solely because a will, deed, or other instrument, whether executed or in
40 effect before or after the effective date of this section, directs or authorizes the use of only
41 the “income,” or “interest,” or “dividends” or “rents, issues or profits,” or contains words
42 of similar import.

(d) The Corporate Securities Law of 1968 shall not apply to the creation, administration, or termination of common trust funds authorized under this section, or to participation therein.

(e) This section shall become operative on January 1, 1997.

Comment. Subdivision (c) of Section 10251 is amended to revise a cross-reference. Former Probate Code Section 16303 contained a broad definition of income relying on cross-references to all other provisions in the former Revised Uniform Principal and Income Act (Prob. Code §§ 16300-16315) that affected determination of income. The new Uniform Principal and Income Act (Prob. Code §§ 16320-16375) does not include a catalog provision like former Section 16303. The basic principle invoked by the cross-reference is the same — the meaning of “income” in subdivision (c) is determined under general principal and income rules applicable to trusts. The details of determining income, however, have changed in a number of respects. See Prob. Code §§ 16320-16375.

Prob. Code § 1063 (amended). Additional schedule of market value, etc.

SEC. _____. Section 1063 of the Probate Code is amended to read:

1063. (a) In all accounts, there shall be an additional schedule showing the estimated market value of the assets on hand as of the end of the accounting period, and a schedule of the estimated market value of the assets on hand as of the beginning of the accounting period for all accounts subsequent to the initial account. The requirement of an estimated value of real estate, a closely held business, or other assets without a ready market, may be satisfied by a good faith estimate by the fiduciary.

(b) If there were purchases or other changes in the form of assets occurring during the period of the account, there shall be a schedule showing these transactions. However, no reporting is required for transfers between cash or accounts in a financial institution or money market mutual funds as defined in subdivision (d) of Section 8901.

(c) If an estate of a decedent or a trust will be distributed to an income beneficiary, there shall be a schedule showing an allocation of receipts and disbursements between principal and income.

(d) If there is specifically devised property, there shall be an additional schedule accounting for income, disbursements, and proceeds of sale pursuant to ~~Sections~~ Section 12002 and 16314 subdivision (d) of Section 16304.

(e) If any interest has been paid or is to be paid under Section 12003, 12004, or 12005, ~~or 16314 subdivision (d) of Section 16304,~~ there shall be a schedule showing the calculation of the interest.

(f) If the accounting contemplates a proposed distribution, there shall be a schedule setting forth the proposed distribution, including the allocation of income required under Section 12006. If the distribution requires an allocation between trusts, the allocation shall be set forth on the schedule, unless the allocation is to be made by a trustee after receipt of the assets. If the distribution requires valuation of assets as of the date of distribution, the schedule shall set forth the fair market value of those assets.

(g) If, at the end of the accounting period, there are liabilities of the estate or trust, except current or future periodic payments, including rent, salaries, utilities, or other recurring expenses, there shall be a schedule showing all of the following:

(1) All liabilities which are a lien on estate or trust assets.

(2) Taxes due but unpaid as shown on filed returns or assessments received subsequent to filing of returns.

(3) All notes payable.

(4) Any judgments for which the estate or trust is liable.

(5) Any other material liability.

Comment. Subdivisions (d) and (e) of Section 1063 are amended to revise cross-references to former Section 16314. See Section 16304 Comment.

Prob. Code § 17351 (amended). Removal of trust from continuing jurisdiction

SEC. _____. Section 17351 of the Probate Code is amended to read:

17351. (a) If any of the trustees of a trust described in Section 17350 is a trust company, the trust shall be removed from continuing court jurisdiction as provided in this section. Within six months after the initial funding of the trust, the trustee shall give a notice of removal of the trust from continuing court jurisdiction to each beneficiary. Notice of removal shall be sent by registered or certified mail or by first-class mail, but notice sent by first-class mail is effective only if an acknowledgment of receipt of notice is signed by the beneficiary and returned to the trustee.

(b) The notice of removal of the trust from continuing court jurisdiction shall contain the following:

(1) A statement that as of January 1, 1983, the law was changed to remove the necessity for continuing court jurisdiction over the trust.

(2) A statement that Section 17200 of the Probate Code gives any beneficiary the right to petition a court to determine important matters relating to the administration of the trust.

(3) A copy of the text of Sections 17200 and 17201.

(4) A statement that each income beneficiary, as defined in ~~subdivision (a) of Section 16301~~ Section 16325, is entitled to an annual statement of the principal and income receipts and disbursements of the trust and that any other beneficiary is entitled to such information upon written request to the trustee.

(5) The name and location of the court in the county in which it is appropriate to file a petition pursuant to Section 17200, the name and location of the court that had jurisdiction over the administration of the decedent's estate, and a statement that it is appropriate to file a petition pursuant to Section 17200 with either court.

(c) The trustee shall file with the court that had jurisdiction over the administration of the decedent's estate proof of giving notice under this section within seven months after the initial funding of the trust.

Comment. Subdivision (b)(4) of Section 17351 is amended to correct a cross-reference. The definition in former Section 16301(a) is superseded by Section 16325. This is a technical, nonsubstantive change.

Prob. Code § 21524 (amended). Marital deduction trusts

SEC. _____. Section 21524 of the Probate Code is amended to read:

21524. If a marital deduction gift is made in trust, in addition to the other provisions of this chapter, each of the following provisions also applies to the marital deduction trust:

(a) The transferor's spouse is the only beneficiary of income or principal of the marital deduction property as long as the spouse is alive. Nothing in this subdivision precludes exercise by the transferor's spouse of a power of appointment included in a trust that qualifies as a general power of appointment marital deduction trust.

(b) Subject to subdivision (d), the transferor's spouse is entitled to all of the income of the marital deduction property not less frequently than annually, as long as the spouse is alive.

(c) The transferor's spouse has the right to require that the trustee of the trust make unproductive marital deduction property productive or to convert it into productive property within a reasonable time.

(d) Notwithstanding subdivision (d) of Section 16304 _____, in the case of qualified terminable interest property under Section 2056(b)(7) or Section 2523(f) of the Internal Revenue Code, on termination of the interest of the transferor's spouse in the trust all of the remaining accrued or undistributed income shall pass to the estate of the transferor's spouse, unless the instrument provides a different disposition that qualifies for the marital deduction.

Comment. Subdivision (d) of Section 21524 _____.

☞ **Staff Note.** The full text of the existing California RUPIA (Prob. Code §§ 16300-16315) is set out below for reference purposes. The sections are not shown in strikeout to preserve readability. Comments to repealed sections are incomplete; they will be completed when the text of the proposed new statute is completed.

Prob. Code §§ 16300-16315 (repealed). Revised Uniform Principal and Income Act

SEC. _____. Chapter 3 (commencing with Section 16300) of Part 4 of Division 9 of the Probate Code is repealed.

CHAPTER 3. REVISED UNIFORM PRINCIPAL AND INCOME ACT

Comment. The California version of the Revised Uniform Principal and Income Act of 1962 is superseded by the new Uniform Principal and Income of 1997, set out in Sections 16320-16375.

§ 16300 (repealed). Short title

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

Comment. Former Section 16300 is superseded by Section 16320 (short title of Uniform Principal and Income Act).

§ 16301 (repealed). 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. The substance of the introductory clause of former Section 16301 is continued in Section 16321 (application of definitions).

Subdivision (a) is superseded by Section 16325.

Subdivision (b) is not continued. See the “Background from Uniform Act” comment below.

Subdivision (c) is not continued.

Background from Uniform Act:

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).

[Adapted from Unif. Principal and Income Act § 102 comment (1997).]

§ 16302 (repealed). Duty of trustee as to 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. Former Section 16302 is superseded by Section 16335.

§ 16303 (repealed). Income and 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.

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

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

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

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

10 (4) Receipts allocated to principal as provided in Section 16304.

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

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

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

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

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

20 (10) Receipts from disposition of underproductive property as provided in Section
21 16311.

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

24 **Comment.** Former Section 16303 is superseded by Section ____.

25 **§ 16304 (repealed). When right to income arises; apportionment of income**

26 16304. (a) An income beneficiary is entitled to income from the date specified in the
27 trust instrument or, if none is specified, from the date an item of property becomes
28 subject to the trust. In the case of an item of property becoming subject to a trust by
29 reason of a person's death, it becomes subject to the trust as of the date of the death of the
30 person even though there is an intervening period of administration of the person's estate,
31 except that income on the property during the period of administration is governed by
32 Chapter 8 (commencing with Section 12000) of Part 10 of Division 7, and becomes
33 subject to the trust as it accrues.

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

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

36 (2) Receipts in the form of periodic payments (other than corporate distributions to
37 stockholders), including rent, interest, or annuities, not due at the date of the death of the
38 person shall be treated as accruing from day to day. That portion of the receipt accruing
39 before the date of death is principal and the balance is income.

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

43 (d) If an income beneficiary's right to income terminates by death or in any other
44 manner, income paid to the income beneficiary or received by the trustee before the
45 termination belongs to the income beneficiary or his or her personal representative. All

1 income received by the trustee after such termination shall be paid to the person next
2 entitled to income by the terms of the trust. This subdivision is subject to subdivision (d)
3 of Section 21524 and does not apply to income received by a trustee under subdivision
4 (b) of Section 16305.

5 (e) Corporate distributions to stockholders shall be treated as due on the day fixed by
6 the corporation for determination of stockholders of record entitled to distribution or, if
7 no date is fixed, on the date of declaration of the distribution by the corporation.

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

10 **Comment.** Former Section 16304 is superseded by Sections 16340-16341 and 16345-16347.

11 **§ 16305 (repealed). Income earned during administration of decedent's estate**

12 16305. (a) Unless the will otherwise provides, income from the property of a
13 decedent's estate after the death of the testator and before distribution, including income
14 from property used to discharge liabilities, shall be distributed in the manner set forth in
15 Chapter 8 (commencing with Section 12000) of Part 10 of Division 7. Income received
16 by a trustee under this subdivision shall be treated as income of the trust.

17 (b) If an income beneficiary's right to income, including interest payable under Section
18 12003, terminates by death or in any other manner during the period of probate
19 administration, income attributable to the period of probate administration, when
20 subsequently received by the trustee, shall be equitably prorated between the beneficiary
21 (or his or her personal representative) and the person next entitled to income by the terms
22 of the trust instrument.

23 **Comment.** Former Section 16305 is superseded by Section 16340.

24 **§ 16306 (repealed). Corporate distributions**

25 16306. (a) Corporate distributions of shares of the distributing corporation, including
26 distributions in the form of a stock split or stock dividend, are principal. A right to
27 subscribe to shares or other securities issued by the distributing corporation accruing to
28 stockholders on account of their stock ownership and the proceeds of any sale of the right
29 are principal.

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

34 (1) A call of shares.

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

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

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

43 (1) Distributions made from ordinary income are income.

1 (2) All other distributions, including distributions from capital gains, depreciation, or
2 depletion, whether made in the form of cash, an option to take new stock or cash, or an
3 option to purchase additional shares, are principal.

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

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

13 **Comment.** Former Section 16306 is superseded by Section 16350.

14 **§ 16307 (repealed). Bonds and other obligations for payment of money**

15 16307. (a) Bonds or other obligations for the payment of money are principal at their
16 inventory value, except as provided in subdivision (b) for discount bonds. No provision
17 shall be made for amortization of bond premiums or for accumulation for discount. The
18 proceeds of sale, redemption, or other disposition of the bonds or obligations are
19 principal.

20 (b) The increment in value of a bond or other obligation for the payment of money
21 payable at a future time in accordance with a fixed schedule of appreciation in excess of
22 the price at which it was issued is distributable as income. The increment in value is
23 distributable to the beneficiary who was the income beneficiary at the time of increment
24 from the first principal cash available or, if none is available, when realized by sale,
25 redemption, or other disposition. Whenever unrealized increment is distributed as income
26 but out of principal, the principal shall be reimbursed for the increment when realized.

27 **Comment.** Former Section 16307 is superseded by Section 16357.

28 **§ 16308 (repealed). Business and farming operations**

29 16308. (a) If a trustee uses any part of the principal in the operation of a business,
30 including an agricultural or farming operation, of which the settlor was a sole proprietor
31 or a partner, the net profits and losses of the business shall be computed in accordance
32 with recognized methods of accounting for a comparable business. Net profits from a
33 business are income. Net losses from a business do not reduce other trust income for the
34 fiscal or calendar year during which they occur but shall be carried into subsequent fiscal
35 or calendar years and reduce the net profits of the business for those years.

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

39 **Comment.** Former Section 16308 is superseded by Section 16350 and 16352.

40 **§ 16309 (repealed). Natural resources**

41 16309. (a) If any part of the principal consists of a right to receive royalties, overriding
42 or limited royalties, working interests, production payments, net profit interests, or other

1 interests in minerals or other natural resources in, on, or under land, the receipts from
2 taking the natural resources from the land shall be allocated as follows:

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

5 (2) If received from a production payment, the receipts are income to the extent of any
6 factor for interest or its equivalent provided in the governing instrument. There shall be
7 allocated to principal the fraction of the balance of the receipts which the unrecovered
8 cost of the production payment bears to the balance owed on the production payment,
9 exclusive of any factor for interest or its equivalent. The receipts not allocated to
10 principal are income.

11 (3) If received as a royalty, overriding or limited royalty, or bonus, or from a working,
12 net profit, or any other interest in minerals or other natural resources, receipts not
13 provided for in paragraphs (1) and (2) shall be apportioned on a yearly basis in
14 accordance with this paragraph whether or not any natural resource was being taken from
15 the land at the time the trust was established. The receipts shall be allocated entirely to
16 income or apportioned between income and principal as the trustee in its discretion may
17 determine, but the amount added to principal as an allowance for depletion may not
18 exceed the lesser of (A) the percentage of gross receipts allowed as a deduction for
19 depletion in computing taxable income for federal income tax purposes or (B) 50 percent
20 of the net receipts remaining after payment of expenses, direct and indirect, computed
21 without allowance for depletion.

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

23 **Comment.** Former Section 16309 is superseded by Sections 16363 (minerals, water, and other
24 natural resources) and 16364 (timber).

25 **§ 16310 (repealed). Other property subject to depletion**

26 16310. If the principal consists of property subject to depletion, other than property
27 subject to Section 16309, including land from which merchantable timber may be
28 removed and, when subject to depletion or amortization, leaseholds, patents, copyrights,
29 royalty rights, and rights to receive payments on a contract for deferred compensation,
30 receipts from the property shall be allocated entirely to income or apportioned between
31 income and principal as the trustee in its discretion may determine, but in no event shall
32 the amount allocated to principal exceed a reasonable allowance for depletion or
33 amortization.

34 **Comment.** Former Section 16310 is superseded by Sections 16361 (deferred compensation,
35 annuities, and similar payments), 16362 (liquidating assets), and 16364 (timber).

36 **§ 16311 (repealed). Underproductive property**

37 16311. (a) Except as otherwise provided in this section, a portion of the net proceeds of
38 sale of any part of principal which has not produced an average net income of at least 1
39 percent per year of its inventory value for more than a year, including as income the value
40 of any beneficial use of the property by the income beneficiary, shall be treated as
41 delayed income to which the income beneficiary is entitled as provided in this section.
42 The net proceeds of sale are the gross proceeds received, including the value of any
43 property received in substitution for the property disposed of, less the expenses, including

1 capital gains tax, if any, incurred in disposition and less any carrying charges paid while
2 the property was underproductive.

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

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

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

20 **Comment.** Former Section 16311 is not continued. See Section 16365

21 **§ 16312 (repealed). Charges against income and principal**

22 16312. (a) After determining income and principal in accordance with the terms of the
23 trust instrument or with this chapter, the trustee shall charge to income or principal
24 expenses and other charges as provided in this section.

25 (b) The following charges shall be made against income:

26 (1) Ordinary expenses incurred in connection with the administration, management, or
27 preservation of the trust property, including regularly recurring taxes assessed against any
28 portion of the principal, water rates, premiums on insurance taken upon the interests of
29 the income beneficiary, remainder beneficiary, or trustee, interest paid by the trustee, and
30 ordinary repairs.

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

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

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

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

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

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

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

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

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

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

16 (3) Extraordinary repairs or expenses incurred in making a capital improvement to
17 principal, including special assessments, but a trustee may establish an allowance for
18 depreciation out of income to the extent permitted by paragraph (2) of subdivision (b) and
19 by Section 16308.

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

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

26 **Comment.** Former Section 16312 is superseded by Sections 16373 and ____.

27 **§ 16313 (repealed). Reserve or allowance for depreciation or depletion;**

28 16313. The trustee is not required to set aside a reserve or allowance from trust income
29 for depreciation or depletion of, or to amortize, any trust property unless the trust
30 instrument expressly requires a reserve or allowance. Nothing in this chapter prevents a
31 trustee in its discretion from establishing a reserve or allowance, or from continuing any
32 previous practice of maintaining a reserve or allowance.

33 **Comment.** Former Section 16313 is superseded by Section 16372.

34 **§ 16314 (repealed). Income and interest on trust distributions**

35 16314. (a) A specific gift, a general pecuniary gift, an annuity, or a gift for maintenance
36 distributable under a trust carries with it income and bears interest in the same manner as
37 a specific devise, a general pecuniary devise, an annuity, or a devise for maintenance
38 under a will set forth in Chapter 8 (commencing with Section 12000) of Part 10 of
39 Division 7.


40 (b) For the purpose of this section, a reference in Chapter 8 (commencing with Section
41 12000) of Part 10 of Division 7 to the date of the testator's death means the date of the
42 settlor's death or other event upon which the distributee's right to receive the gift occurs.

43 **Comment.** Former Section 16314 is continued in Section 16350(c) without substantive change.
44 See Section 16350 Comment.

1 **§ 16315 (repealed). Application to trusts created before July 1, 1989**

2 16315. The changes made in Sections 16304 and 16305, and the addition of Section
3 16314, by Chapter 1199 of the Statutes of 1988 apply to a trust created before July 1,
4 1989, but the changes and addition apply to the trust as if created on that date and do not
5 affect any aspect of the trust administration that occurred, or rights of beneficiaries that
6 existed, before that date.

7 **Comment.** Former Section 16315 is not continued.

8  **Staff Note.** This section will need further analysis to determine whether it needs to be
9 continued in the new law.
