

Memorandum 99-2

Uniform Principal and Income Act: Staff Draft Recommendation

Attached to this memorandum is a staff draft of a final recommendation proposing enactment of the modified Uniform Principal and Income Act (1997). The draft recommendation is mostly the same as the draft attached to Memorandum 98-75 at the last meeting, with the incorporation of a number of revisions discussed in the Staff Notes and in the First Supplement of Memorandum 98-75. In December, the Commission did not have sufficient membership present to approve a final recommendation.

In the interim, the Commission directed the staff to continue working with interested parties to resolve remaining issues. We have had some discussions with representatives of the California Bankers Association (CBA), but as yet no new ideas have surfaced that would result in a consensus bill. Jim Deeringer, liaison with the State Bar Estate Planning, Trust and Probate Law Section Executive Committee, reports that the Committee supports having the adjustment power in the statute (see Section 16336) and wants to see “some kind of a safe harbor built into” the statute. However, the Committee “is not prepared to commit itself at this time as to favoring any particular approach to the safe harbor” and “is willing to leave that decision up to the Commission.” The staff reads this as support for the protections and limitations built into the current draft, particularly the safe harbor effect of the notice of proposed action procedure in Section 16337. We have discussed other approaches at Commission meetings and in the working group, but we have not found a better way to balance the respective interests.

As noted in December, only the CBA responded to the requests for comments on the tentative recommendation. The CBA comments are considered in Staff Notes following the relevant sections. (See pp. 11, 20, 21, 24, 25, 31, 33, 34, 35, 38, 40, 42, 45, 47, 51, 59.) For the full text of the CBA letter, and other commentary on the uniform act, see the exhibits to Memorandum 98-75.

At the February meeting, the staff will discuss the more important comments, i.e., those on pages 21 (Section 16337), 31 (Section 16350), 38 (Section 16360), and

40 (Section 16361). Commissioners should raise any other issues as desired at the meeting. The disposition of other issues is indicated in the relevant notes.

Jim Deeringer has raised an issue concerning the 90-10 rule in Section 16361, as first noted in the First Supplement to Memorandum 98-75. We understand that the experts are still discussing the issues. If revision is called for, we can make any needed amendments to the bill after it is introduced.

The staff recommends approval of the draft recommendation, subject to any revisions approved at the February meeting.

Respectfully submitted,

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#L-649

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

STAFF DRAFT RECOMMENDATION

Uniform Principal and Income Act

February 1999

California Law Revision Commission
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SUMMARY OF DRAFT

The proposed law would replace the California Revised Uniform Principal and Income Act (Prob. Code §§ 16300-16315) (RUPIA) with a statute based on the new Uniform Principal and Income Act approved by the Uniform Law Commissioners in 1997. The proposed law makes a number of minor and technical revisions in the text of the uniform act.

The proposed law would modernize the law to take account of new estate planning practices and new financial instruments that have developed since RUPIA was promulgated in 1962.

The proposed law would also make needed revisions in principal and income rules for consistency with the prudent investor rule embodied in the Uniform Prudent Investor Act (Prob. Code §§ 16045-16054), which was enacted in California in 1995. Existing principal and income rules, which focus on trust accounting principles, can conflict with the overriding duty of a prudent investor to invest trust assets as a portfolio.

UNIFORM PRINCIPAL AND INCOME ACT

1 A new Uniform Principal and Income Act (UPAIA) was approved by the
2 National Conference of Commissioners on Uniform State Laws in 1997.¹ The Law
3 Revision Commission recommends enactment of the new uniform act, subject to a
4 number of revisions, to replace the existing law on this subject, which is largely
5 the same as the 1962 Revised Uniform Principal and Income Act (RUPIA).²

6 The Prefatory Note of the new Uniform Principal and Income Act summarizes
7 its scope and purposes as follows:³

8 UNIFORM ACT PREFATORY NOTE

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

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

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

20 Revision of the 1931 and 1962 Acts

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

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

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

1. The new UPAIA can be viewed online or downloaded from the Internet in several formats at
<<http://www.law.upenn.edu/library/ulc/upaia/upaia97.htm>> (visited Oct. 30, 1998).

2. See Prob. Code §§ 16300-16315. The existing law 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).

3. Cross-references to relevant sections in the proposed law, *infra*, are indicated in brackets.

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

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

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

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

10 (1) The application of the probate administration rules to revocable living trusts
11 after the settlor's death and to other terminating trusts. Articles 2 and 3. [See draft
12 Prob. Code §§ 16340-16347.]

13 (2) The payment of interest or some other amount on the delayed payment of an
14 outright pecuniary gift that is made pursuant to a trust agreement instead of a will
15 when the agreement or state law does not provide for such a payment. Section
16 201(3). [See draft Prob. Code § 16340(b).]

17 (3) The allocation of net income from partnership interests acquired by the trustee
18 other than from a decedent (the old Acts deal only with partnership interests
19 acquired from a decedent). Section 401. [See draft Prob. Code § 16350.]

20 (4) An "unincorporated entity" concept has been introduced to deal with
21 businesses operated by a trustee, including farming and livestock operations, and
22 investment activities in rental real estate, natural resources, timber, and derivatives.
23 Section 403. [See draft Prob. Code § 16352.]

24 (5) The allocation of receipts from discount obligations such as zero-coupon
25 bonds. Section 406(b). [See draft Prob. Code § 16357(b).]

26 (6) The allocation of net income from harvesting and selling timber between
27 principal and income. Section 412. [See draft Prob. Code § 16364.]

28 (7) The allocation between principal and income of receipts from derivatives,
29 options, and asset-backed securities. Sections 414 and 415. [See draft Prob. Code §§
30 16366-16367.]

31 (8) Disbursements made because of environmental laws. Section 502(a)(7). [See
32 draft Prob. Code § 16371(a)(7).]

33 (9) Income tax obligations resulting from the ownership of S corporation stock
34 and interests in partnerships. Section 505. [See draft Prob. Code § 16374.]

35 (10) The power to make adjustments between principal and income to correct
36 inequities caused by tax elections or peculiarities in the way the fiduciary income
37 tax rules apply. Section 506. [See draft Prob. Code § 16375.]

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

1 (1) An income beneficiary's estate will be entitled to receive only net income
2 actually received by a trust before the beneficiary's death and not items of accrued
3 income. Section 303. [See draft Prob. Code § 16347.]

4 (2) Income from a partnership is based on actual distributions from the
5 partnership, in the same manner as corporate distributions. Section 401. [See draft
6 Prob. Code § 16350.]

7 (3) Distributions from corporations and partnerships that exceed 20% of the
8 entity's gross assets will be principal whether or not intended by the entity to be a
9 partial liquidation. Section 401(d)(2). [See draft Prob. Code § 16350(d)(1)(B).]

10 (4) Deferred compensation is dealt with in greater detail in a separate section.
11 Section 409. [See draft Prob. Code § 16361.]

12 (5) The 1962 Act rule for "property subject to depletion," (patents, copyrights,
13 royalties, and the like), which provides that a trustee may allocate up to 5% of the
14 asset's inventory value to income and the balance to principal, has been replaced by
15 a rule that allocates 90% of the amounts received to principal and the balance to
16 income. Section 410. [See draft Prob. Code § 16362.]

17 (6) The percentage used to allocate amounts received from oil and gas has been
18 changed — 90% of those receipts are allocated to principal and the balance to
19 income. Section 411. [See draft Prob. Code § 16363.]

20 (7) The unproductive property rule has been eliminated for trusts other than
21 marital deduction trusts. Section 413. [See draft Prob. Code § 16365.]

22 (8) Charging depreciation against income is no longer mandatory, and is left to
23 the discretion of the trustee. Section 503. [See draft Prob. Code § 16372.]

24 **Coordination with the Uniform Prudent Investor Act**

25 The law of trust investment has been modernized. See Uniform Prudent Investor
26 Act (1994); Restatement (Third) of Trusts: Prudent Investor Rule (1992)
27 (hereinafter Restatement of Trusts 3d: Prudent Investor Rule). Now it is time to
28 update the principal and income allocation rules so the two bodies of doctrine can
29 work well together. This revision deals conservatively with the tension between
30 modern investment theory and traditional income allocation. The starting point is to
31 use the traditional system. If prudent investing of all the assets in a trust viewed as a
32 portfolio and traditional allocation effectuate the intent of the settlor, then nothing
33 need be done. The Act, however, helps the trustee who has made a prudent, modern
34 portfolio-based investment decision that has the initial effect of skewing return from
35 all the assets under management, viewed as a portfolio, as between income and
36 principal beneficiaries. The Act gives that trustee a power to reallocate the portfolio
37 return suitably. To leave a trustee constrained by the traditional system would
38 inhibit the trustee's ability to fully implement modern portfolio theory.⁴

4. 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

CALIFORNIA VARIATIONS

The Commission has reviewed the new Uniform Principal and Income Act in light of California practice and with the advice and assistance of expert practitioners, trustees, and academic consultants. As a result of this review, the Commission proposes a number of minor substantive and technical revisions in the uniform act, particularly aimed at (1) clarifying doubtful areas in the uniform act, (2) coordinating it with other California statutes, such as the Uniform Prudent Investor Act⁵ and the rules governing interest and income during administration,⁶ and (3) eliminating or restricting elements in the uniform act that could unfairly expose trustees to liability for breach of trust.⁷

Trustee's Discretionary Power To Adjust

The most controversial feature of the uniform act has been the power to adjust between principal and income accounts. Institutional trustees are concerned that the standards for exercise of the discretion are too complicated and vague, resulting in exposure to litigation over whether the discretion to adjust should or should not have been exercised. The proposed law addresses this concern by removing the mandatory factors the trustee would have to consider before exercising the power to adjust⁸ and providing a streamlined procedure for giving notice of proposed action to beneficiaries before making the adjustment.⁹

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).

5. 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).

6. See Prob. Code §§ 12000-12007.

7. For example, proposed Probate Code Section 16360(c) makes clear that the authority to allocate certain insubstantial allocations to principal (UPAIA § 408) is in the discretion of the trustee and that the trustee has no duty to make this determination.

8. See UPAIA § 104(b). The factors are important, however, and are included as appropriate considerations in the Comment to proposed Probate Code Section 16336.

9. This procedure (proposed Prob. Code § 16337) is based, in part, on the notice of proposed action under the Independent Administration of Estates Act. See Prob. Code §§ 10400 *et seq.*, 10582, 10585-

General Fiduciary Duty

The uniform act is largely free-standing and is understandably drafted to fit into the law of any state. Consequently, the uniform act contains some statements of general fiduciary principles that would duplicate or overlap general provisions in the California Trust Law, or perhaps even result in substantive changes. For example, Section 103(b) of the uniform act provides:

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

As applied to trusts, this standard overlaps the duty of impartiality in the Trust Law¹⁰ and adds a “fair and reasonable” standard that is not explicitly provided in California statutory law. Having a convenient statement of the standard in the principal and income law is useful, particularly since it applies to both wills and trusts, but it needs to be consistent with the general Trust Law rule. Accordingly, the proposed law eliminates the “fair and reasonable” statement to avoid any implication that some special duty applies in principal and income matters.

Minor and Technical Revisions

A large number of technical and editorial revisions have been made to integrate the uniform act into California law, to conform to related terminology in California law governing trusts and estates, and to improve readability. These changes are indicated in the Comments to provisions in the proposed law.

10587. The Commission considered adopting a 4% unitrust standard as a safe harbor, but rejected the concept because the standard would tend to become a ceiling limiting appropriate adjustments, and would also act as a floor since income beneficiaries would expect at least the 4% level. Setting a statutory percentage would reduce the flexibility needed to respond to varying economic conditions.

10. Prob. Code § 16003.

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PROPOSED LEGISLATION

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 (UPAIA). 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 Laws. 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(1)]

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(1) of the Uniform Principal and Income Act (1997).

See also Sections 16323 (“fiduciary” defined), 16326 (“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). This chapter applies to wills and trusts, unlike the former principal and income law, which applied only to trusts. Compare Section 16335 (general fiduciary duties) with former Section 16302 (duty of trustee as to receipts and expenditures). See also Section 10531(a) (principal and income allocations and determinations by personal representative under the Independent Administration of Estates Act). 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). The definition of “principal” in the uniform act is not included in this chapter because it is not needed.

See also Sections 62 (“property” defined), 16323 (“fiduciary” 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). The definition of “remainder beneficiary” in the uniform act is not included in this chapter because it is not needed.

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 [Prob. Code §§ 16336(a), 16364(b), 16371(b), 16372(b), 16373(a) & 16375(a)].

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

 **Staff Note.** CBA comments: “The phrase beginning ‘plus or minus transfers’ should be eliminated since it is our position that the power to adjust should be eliminated from the statute.” (Exhibit p. 2, item 1.)

If the power to adjust is removed from the statute, we will remove all statutory and Comment references to it. Obviously, it is not a reason to object to the draft statute that it takes the power to adjust into account in other appropriate sections. We do not intend to discuss other places where the CBA objects to provisions that are dependent on the power to adjust.

However, in this case, the point is incorrect. As stated in the Background Comment to Section 16328, there are a number of provisions that are covered by the “plus or minus” language — Section 16336 is only one of them. Consequently, the section should remain unchanged.

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 decedent’s 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 decedent’s estate in accordance with this chapter if the trust or the will does not contain a different provision or does 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 a discretionary power of administration regarding a matter within the scope of this chapter, whether granted by a trust, a will, or this chapter, including the trustee's power to adjust under subdivision (a) of Section 16336, the fiduciary shall administer the trust or decedent's estate impartially, except to the extent that the trust or the will expresses 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 82 ("trust" defined), 16323 ("fiduciary" defined), 16324 ("income" 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 [former Prob. Code § 16302(b)] 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 the trustee from abusing it. *Id.* § 183, comment *a*. "The precise meaning of the trustee's duty of impartiality and the balancing of competing interests and objectives inevitably are matters of judgment and interpretation. Thus, the duty and balancing are affected by the purposes, terms, distribution requirements, and other circumstances of the trust, not only at the outset but as they may change from time to time." *Id.* § 232, comment *c*.

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

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

§ 16336. Trustee's power to adjust [see UPAIA § 104]

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

- (1) The trustee invests and manages trust assets under the prudent investor rule.
- (2) The trust describes the amount that shall or may be distributed to a beneficiary by referring to the trust's income.
- (3) The trustee determines, after applying the rules in subdivision (a) of Section 16335, that the trustee is unable to comply with subdivision (b) of Section 16335.

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

- (1) Where it would diminish the income interest in a trust that (A) requires all of the income to be paid at least annually to a spouse and (B) for which, if the trustee did not have the power to make the adjustment, an estate tax or gift tax marital deduction would be allowed, in whole or in part.
- (2) Where it would reduce the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion.

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

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

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

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

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

15 (c) Notwithstanding Section 15620, if paragraph (5), (6), or (7), of subdivision
16 (b) applies to a trustee and there is more than one trustee, a cotrustee to whom the
17 provision does not apply may make the adjustment unless the exercise of the
18 power by the remaining trustee or trustees is not permitted by the trust.

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

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

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

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

29 (f) A trust that limits the power of a trustee to make an adjustment between
30 principal and income does not affect the application of this section unless it is clear
31 from the trust that it is intended to deny the trustee the power of adjustment
32 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. A procedure for giving notice of proposed actions is provided in
42 Section 16337. The trustee may also seek court approval under Section 17200(b)(5) of a decision
43 to make an adjustment.

44 The condition expressed in subdivision (a)(1) — that the trustee invests and manages trust
45 assets under the prudent investor rule — will almost always be met. The Uniform Prudent

Investor Act (Sections 16045-16054) applies to all California trusts, except to the extent a trust provides otherwise. See Sections 16046(b) (control by trust instrument), 16054 (application of prudent investor rule to all trusts). Under Section 16046, even where the trust provides special rules, to the extent the rules can be classed as a prudent investor rule, the condition of subdivision (a)(1) is satisfied.

The trustee's determination of whether to make an adjustment under this section, and how to implement the adjustment, are subject to the trustee's fiduciary duties. See Sections 16003, 16335(b). Unlike Section 104(b) of the Uniform Principal and Income Act (1997), this section does not mandate consideration of particular factors, but the UPAIA factors provide useful 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 trust gives 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.

The introductory clause in subdivision (c) recognizes that this subdivision is an exception to the default rule requiring trustees to act unanimously.

See also Sections 24 ("beneficiary" defined), 84 ("trustee" defined), 16324 ("income" 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 ..., 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

1 drafted to describe a beneficiary's distribution rights in terms that do not depend upon the amount
 2 of trust accounting income, but to the extent that drafters of trust documents continue to describe
 3 an income beneficiary's distribution rights by referring to trust accounting income, Section 104
 4 [Prob. Code § 16336] will be an important tool in trust administration.

5 *Three conditions to the exercise of the power to adjust.* The first of the three conditions [Prob.
 6 Code § 16336(a)(1)] that must be met before a trustee can exercise the power to adjust — that the
 7 trustee invest and manage trust assets as a prudent investor — is expressed in this Act by
 8 language derived from the Uniform Prudent Investor Act, but the condition will be met whether
 9 the prudent investor rule applies because the Uniform Act or other prudent investor legislation
 10 has been enacted, the prudent investor rule has been approved by the courts, or the terms of the
 11 trust require it. Even if a State's legislature or courts have not formally adopted the rule, the
 12 Restatement establishes the prudent investor rule as an authoritative interpretation of the common
 13 law prudent man rule, referring to the prudent investor rule as a "modest reformulation of the
 14 Harvard College dictum and the basic rule of prior Restatements." Restatement of Trusts 3d:
 15 Prudent Investor Rule, Introduction, at 5. As a result, there is a basis for concluding that the first
 16 condition is satisfied in virtually all States except those in which a trustee is permitted to invest
 17 only in assets set forth in a statutory "legal list."

18 The second condition [Prob. Code § 16336(a)(2)] will be met when the terms of the trust
 19 require all of the "income" to be distributed at regular intervals; or when the terms of the trust
 20 require a trustee to distribute all of the income, but permit the trustee to decide how much to
 21 distribute to each member of a class of beneficiaries; or when the terms of a trust provide that the
 22 beneficiary shall receive the greater of the trust accounting income and a fixed dollar amount (an
 23 annuity), or of trust accounting income and a fractional share of the value of the trust assets (a
 24 unitrust amount). If the trust authorizes the trustee in its discretion to distribute the trust's income
 25 to the beneficiary or to accumulate some or all of the income, the condition will be met because
 26 the terms of the trust do not permit the trustee to distribute more than the trust accounting income.

27 To meet the third condition [Prob. Code § 16336(a)(3)], the trustee must first meet the
 28 requirements of Section 103(a) [Prob. Code § 16335(a)], i.e., she must apply the terms of the
 29 trust, decide whether to exercise the discretionary powers given to the trustee under the terms of
 30 the trust, and must apply the provisions of the Act if the terms of the trust do not contain a
 31 different provision or give the trustee discretion. Second, the trustee must determine the extent to
 32 which the terms of the trust clearly manifest an intention by the settlor that the trustee may or
 33 must favor one or more of the beneficiaries. To the extent that the terms of the trust do not require
 34 partiality, the trustee must conclude that she is unable to comply with the duty to administer the
 35 trust impartially. To the extent that the terms of the trust do require or permit the trustee to favor
 36 the income beneficiary or the remainder beneficiary, the trustee must conclude that she is unable
 37 to achieve the degree of partiality required or permitted. If the trustee comes to either conclusion
 38 — that she is unable to administer the trust impartially or that she is unable to achieve the degree
 39 of partiality required or permitted — she may exercise the power to adjust under Section 104(a)
 40 [Prob. Code § 16336(a)].

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

1 applies to a marital deduction trust if the trust's assets "consist substantially of property that does
2 not provide the spouse with sufficient income from or use of the trust assets ..." — in other
3 words, the section applies by reference to the portfolio as a whole.

4 While the purpose of the power to adjust in Section 104(a) [Prob. Code § 16336(a)] is to
5 eliminate the need for a trustee who operates under the prudent investor rule to be concerned
6 about the income component of the portfolio's total return, the trustee must still determine the
7 extent to which a distribution must be made to an income beneficiary and the adequacy of the
8 portfolio's liquidity as a whole to make that distribution.

9 For a discussion of investment considerations involving specific investments and techniques
10 under the prudent investor rule, see Restatement of Trusts 3d: Prudent Investor Rule § 227,
11 Comments *k-p*. [See also Prob. Code §§ 16045-16052, California Uniform Prudent Investor Act.]

12 *Factors to consider in exercising the power to adjust.* Section 104(b) requires [not required in
13 Prob. Code § 16336 — factors are listed in the California Comment *supra* factors that are
14 "appropriate to consider"] a trustee to consider factors relevant to the trust and its beneficiaries in
15 deciding whether and to what extent the power to adjust should be exercised. Section 2(c) of the
16 Uniform Prudent Investor Act [see Prob. Code § 16047(c)] sets forth circumstances that a trustee
17 is to consider in investing and managing trust assets. The circumstances in Section 2(c) of the
18 Uniform Prudent Investor Act are the source of the factors in paragraphs (3) through (6) and (8)
19 of Section 104(b) (modified where necessary to adapt them to the purposes of this Act) so that, to
20 the extent possible, comparable factors will apply to investment decisions and decisions involving
21 the power to adjust. If a trustee who is operating under the prudent investor rule decides that the
22 portfolio should be composed of financial assets whose total return will result primarily from
23 capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same
24 time the extent to which an adjustment from principal to income may be necessary under Section
25 104. On the other hand, if a trustee decides that the risk and return objectives for the trust are best
26 achieved by a portfolio whose total return includes interest and dividend income that is sufficient
27 to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled
28 under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to
29 adjust.

30 *Assets received from the settlor.* Section 3 of the Uniform Prudent Investor Act provides that
31 "[a] trustee shall diversify the investments of the trust unless the trustee reasonably determines
32 that, because of special circumstances, the purposes of the trust are better served without
33 diversifying." [For a comparable rule, see Prob. Code § 16048.] The special circumstances may
34 include the wish to retain a family business, the benefit derived from deferring liquidation of the
35 asset in order to defer payment of income taxes, or the anticipated capital appreciation from
36 retaining an asset such as undeveloped real estate for a long period. To the extent the trustee
37 retains assets received from the settlor because of special circumstances that overcome the duty to
38 diversify, the trustee may take these circumstances into account in determining whether and to
39 what extent the power to adjust should be exercised to change the results produced by other
40 provisions of this Act that apply to the retained assets. See Section 104(b)(5) [omitted in
41 California]; Uniform Prudent Investor Act § 3, Comment, 7B U.L.A. 18, at 25-26 (Supp. 1997);
42 Restatement of Trusts 3d: Prudent Investor Rule § 229 and Comments *a-e*.

43 *Limitations on the power to adjust.* The purpose of subsections (c)(1) through (4) [Prob. Code §
44 16336(b)(1)-(4)] is to preserve tax benefits that may have been an important purpose for creating
45 the trust. Subsections (c)(5), (6), and (8) [Prob. Code § 16336(b)(5)-(6); UPAIA subsection (c)(8)
46 is omitted in California] deny the power to adjust in the circumstances described in those
47 subsections in order to prevent adverse tax consequences, and subsection (c)(7) [Prob. Code §
48 16336(b)(7)] denies the power to adjust to any beneficiary, whether or not possession of the
49 power may have adverse tax consequences.

50 Under subsection (c)(1) [Prob. Code § 16336(b)(1)], a trustee cannot make an adjustment that
51 diminishes the income interest in a trust that requires all of the income to be paid at least annually
52 to a spouse and for which an estate tax or gift tax marital deduction is allowed; but this subsection
53 does not prevent the trustee from making an adjustment that increases the amount of income paid
54 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 purpose is to make it clear that a beneficiary’s right to receive a fixed annuity or a fixed fraction of the value of a trust’s assets is not subject to adjustment under Section 104(a) [Prob. Code § 16336(a)]. Subsection (c)(3) [Prob. Code § 16336(b)(3)] does not apply to any additional amount to which the beneficiary may be entitled that is expressed in terms of a right to receive income from the trust. For example, if a beneficiary is to receive a fixed annuity or the trust’s income, whichever is greater, subsection (c)(3) [Prob. Code § 16336(b)(3)] does not prevent a trustee from making an adjustment under Section 104(a) [Prob. Code § 16336(a)] in determining the amount of the trust’s income.

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

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

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

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

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

Example (2) — *T* is the trustee of a trust that requires the income to be paid to the settlor’s son *C* for life, remainder to *C*’s daughter *D*. In a period of very high inflation, *T* purchases bonds that

1 pay double-digit interest and determines that a portion of the interest, which is allocated to
 2 income under Section 406 of this Act [Prob. Code § 16357], is a return of capital. In
 3 consideration of the loss of value of principal due to inflation and other factors that *T* considers
 4 relevant, *T* may transfer part of the interest to principal.

5 *Example (3)* — *T* is the trustee of a trust that requires the income to be paid to the settlor's sister
 6 *E* for life, remainder to charity *F*. *E* is a retired schoolteacher who is single and has no children.
 7 *E*'s income from her social security, pension, and savings exceeds the amount required to provide
 8 for her accustomed standard of living. The terms of the trust permit *T* to invade principal to
 9 provide for *E*'s health and to support her in her accustomed manner of living, but do not
 10 otherwise indicate that *T* should favor *E* or *F*. Applying the prudent investor rule, *T* determines
 11 that the trust assets should be invested entirely in growth stocks that produce very little dividend
 12 income. Even though it is not necessary to invade principal to maintain *E*'s accustomed standard
 13 of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally
 14 accorded a person who is the sole income beneficiary of a trust, and *T* may transfer cash from
 15 principal to income to provide her with that degree of enjoyment.


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

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

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

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

[Adapted from Unif. Principal and Income Act § 104 comment (1997).]

 **Staff Note.** The CBA comments on this section are discussed in Memorandum 98-75.

§ 16337. Notice of proposed action

16337. (a) A trustee may give a notice of proposed action regarding a matter governed by this chapter as provided in this section. For the purpose of this section, a proposed action includes a course of action and a decision not to take action.

(b) The trustee shall mail notice of the proposed action to all adult beneficiaries who are receiving or are entitled to receive income under the trust or to receive a distribution of principal if the trust were terminated at the time the notice is given.

(c) 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.

(d) 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 trustee.

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

(3) A description of the action proposed to be taken and an explanation of the reasons for the action.

(4) The time within which objections to the proposed action can be made, which shall be at least 30 days from the mailing of the notice of proposed action.

(5) The date on or after which the proposed action may be taken or is effective.

(e) A beneficiary may object to the proposed action by mailing a written objection to the trustee at the address stated in the notice of proposed action within the time period specified in the notice of proposed action.


(f) A trustee is not liable to a beneficiary for an action regarding a matter governed by this chapter if the trustee 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. If no beneficiary entitled to notice objects under this section, the trustee is not liable to any current or future beneficiary with respect to the proposed action.

(g) If the trustee receives a written objection within the applicable period, either the trustee or a beneficiary may petition the court 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 trustee'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 trustee decides not to implement the proposed action, the trustee shall notify the beneficiaries of the decision not to take the action and the reasons for the decision. A beneficiary may petition the court to have the action taken, and has the burden of proving that it should be taken.

Comment. Section 16337 is new. This section provides a special notice of proposed action procedure applicable to principal and income allocation matters governed by this chapter. This procedure does not apply generally to trust administration. Some features of this procedure are drawn from the notice of proposed action procedure (see, e.g., Sections 10582, 10585-10587) under the Independent Administration of Estates Act (Section 10400 *et seq.*). This section applies only to notice of proposed action given by trustees. Personal representatives with authority under the Independent Administration of Estates Act have the option of using the notice of proposed action procedure under that act. See Sections 10531(a) (principal and income allocations and determinations), 10580(b) (optional use of notice of proposed action procedure).

See also Section 1215 (manner of giving notice). For judicial proceedings concerning trusts, see, e.g., Section 17200.

 **Staff Note.** CBA comments (Exhibit p. 2, item 4):

4. In order to clarify that the trustee is protected as to all beneficiaries if no objections are received from them after notice is provided, Section 16337(f) should be amended to read as follows:

If the notice of proposed action is mailed in accordance with subdivision (b), and no written objection to the proposed action is received during the applicable period from a beneficiary to whom the notice of proposed action was sent, a trustee shall not be liable to a current or future beneficiary of the trust with respect to the proposed action, irrespective of whether the beneficiary received notice of the proposed action.

The staff has addressed the issue raised by the CBA comment by adding the following sentence to subdivision (f): "If no beneficiary entitled to notice objects under this section, the trustee is not liable to any current or future beneficiary with respect to the proposed action."

§ 16338. Application of chapter to existing trusts and estates [UPAIA § 605]

16338. This chapter applies to every trust or decedent's estate existing on January 1, 2000, except as otherwise expressly provided in the trust or will or in this chapter.

Comment. Section 16338 is the same in substance as Section 605 of the Uniform Principal and Income Act (1997).

See also Section 3 (general transitional provisions).

Article 3. Decedent's Estate or Terminating Income Interest

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

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

1 (a) If property is specifically given to a beneficiary, by will or trust, the fiduciary
2 of the estate or of the terminating income interest shall distribute the net income
3 and principal receipts to the beneficiary who is to receive the property, subject to
4 the following rules:

5 (1) The net income and principal receipts from the specifically given property
6 are determined by including all of the amounts the fiduciary receives or pays with
7 respect to the property, whether the amounts accrued or became due before, on, or
8 after the decedent's death or an income interest in a trust ends, and by making a
9 reasonable provision for amounts the fiduciary believes the estate or terminating
10 income interest may become obligated to pay after the property is distributed.

11 (2) The fiduciary may not reduce income and principal receipts from the
12 specifically given property on account of a payment described in Section 16370 or
13 16371, to the extent that the will, the trust, or Section 12002 requires payment
14 from other property or to the extent that the fiduciary recovers the payment from a
15 third person.

16 (b) The fiduciary shall distribute to a beneficiary who receives a pecuniary
17 amount, whether outright or in trust, the interest or any other amount provided by
18 the will, the trust, or Chapter 8 (commencing with Section 12000) of Part 10 of
19 Division 7, from the remaining net income determined under subdivision (c) or
20 from principal to the extent that net income is insufficient.

21 (c) The fiduciary shall determine the remaining net income of the decedent's
22 estate or terminating income interest as provided in this chapter and by doing the
23 following:

24 (1) Including in net income all income from property used to discharge
25 liabilities.

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

32 (3) Paying from principal all other disbursements made or incurred in connection
33 with the settlement of a decedent's estate or the winding up of a terminating
34 income interest, including debts, funeral expenses, disposition of remains, family
35 allowances, and death taxes and related penalties that are apportioned to the estate
36 or terminating income interest by the will, the trust, or Division 10 (commencing
37 with Section 20100).

38 (d) After distributions required by subdivision (b), the fiduciary shall distribute
39 the remaining net income determined under subdivision (c) in the manner provided
40 in Section 16341 to all other beneficiaries.

41 (e) For purposes of this section, a reference in Chapter 8 (commencing with
42 Section 12000) of Part 10 of Division 7 to the date of the testator's death means

the date of the settlor's death or of the occurrence of some other event on which the distributee's right to receive the gift depends.

Comment. Section 16340 is drawn from Section 201 of the Uniform Principal and Income Act (1997), with a number of modifications to conform with the California rule on specific gifts and to improve readability. The revised language is intended to set out the rules in logical order, the order in which the fiduciary would make determinations and allocations. This section supersedes former Sections 16305 and 16314.

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

Subdivision (a) is drawn from UPAIA Section 201(1) and (5). The introductory clause is drawn from UPAIA Section 201(1). Subdivision (a)(1) is the same in substance as the second sentence of UPAIA Section 201(5). Subdivision (a)(2) is the same in substance as the first sentence of UPAIA Section 201(5).

Subdivisions (a) and (b) continue former Section 16314(a) without substantive change. This rule substitutes for UPAIA Section 201(3).

Subdivision (c) is the same in substance as UPAIA Section 201(2).

Subdivision (d) is the same in substance as UPAIA Section 201(4).

Subdivision (e) continues former Section 16314(b).

See also Sections 62 ("property" defined), 16323 ("fiduciary" defined), 16324 ("income" defined), 16326 ("income interest" defined), 16328 ("net income" defined).

Background from Uniform Act:

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

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

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

....

Administration expenses and interest on death taxes. Under Section 201(2)(B) [Prob. Code § 16340(c)(2)] a fiduciary may pay administration expenses and interest on death taxes from either

income or principal. An advantage of permitting the fiduciary to choose the source of the payment is that, if the fiduciary's decision is consistent with the decision to deduct these expenses for income tax purposes or estate tax purposes, it eliminates the need to adjust between principal and income that may arise when, for example, an expense that is paid from principal is deducted for income tax purposes or an expense that is paid from income is deducted for estate tax purposes.

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

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

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

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

Staff Note. CBA comments: "Section 16340(a)(2) and Section 16340(c)(2) must be clarified. The meaning of these sections is unclear." (Exhibit p. 3, item 5.)

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

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

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

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

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

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

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

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

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

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

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

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

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

Background from Uniform Act:

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

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

Staff Note. CBA comments: “Section 16341 should be amended to eliminate the word ‘appropriate’ as it is used to modify ‘distribution.’” (Exhibit p. 3, item 6)
This word was in subdivision (a) and was added as a result of the working group’s review. However, it is not crucial, and has been removed in response to the CBA objection.

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

1 in the trust or, if no date is specified, on the date an asset becomes subject to a trust
2 or successive income interest.

3 (b) An asset becomes subject to a trust at the following times:

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

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

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

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

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

18 **Comment.** Section 16345 is the same in substance as Section 301 of the Uniform Principal and
19 Income Act (1997). This section supersedes parts of former Section 16304.

20 See also Sections 24 ("beneficiary" defined), 84 ("trustee" defined), 16324 ("income" defined),
21 16325 ("income beneficiary" defined), 16326 ("income interest" defined), 16328 ("net income"
22 defined).

23 **Background from Uniform Act:**

24 *Period during which there is no beneficiary.* The purpose of the second part of subsection (d) is
25 to provide that, at the end of a period during which there is no beneficiary to whom a trustee may
26 distribute income, the trustee must apply the same apportionment rules that apply when a
27 mandatory income interest ends. This provision would apply, for example, if a settlor creates a
28 trust for grandchildren before any grandchildren are born. When the first grandchild is born, the
29 period preceding the date of birth is treated as having ended, followed by a successive income
30 interest, and the apportionment rules in Sections 302 and 303 [Prob. Code §§ 16346-16347] apply
31 accordingly if the terms of the trust do not contain different provisions.

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

33 **§ 16346. Apportionment of receipts and disbursements when decedent dies or income**
34 **interest begins [UPAIA § 302]**

35 16346. (a) A trustee shall allocate an income receipt or disbursement other than
36 one to which Section 16340(a) applies to principal if its due date occurs before a
37 decedent dies in the case of an estate or before an income interest begins in the
38 case of a trust or successive income interest.

39 (b) A trustee shall allocate an income receipt or disbursement to income if its
40 due date occurs on or after the date on which a decedent dies or an income interest
41 begins and it is a periodic due date. An income receipt or disbursement shall be
42 treated as accruing from day to day if its due date is not periodic or it has no due
43 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).

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).

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 (d)(1)(A)], 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) [subdivision (d)(1)(B)] whether or not the entity describes it as a partial liquidation. In determining whether a distribution is greater than 20% of the gross assets, the portion of the distribution that does not exceed the amount of income tax that the trustee or a beneficiary must pay on the entity's taxable income is ignored.

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

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

Staff Note. CBA comments: "The inclusion of the 20 percent amount in Section 16350(d)(1) appears arbitrary and too high and could possibly result in an inequitable allocation of a distribution from an entity." (Exhibit p. 3, item 7.)

The 20% figure is set in the uniform act. The staff has no way of judging whether it is correct or not, but we are inclined to defer to the expertise of the drafters. Our materials do not indicate how the number was chosen; perhaps we can get further background from the drafting committee or the reporter. The 20% figure has been accepted by the New York Legislative Advisory Committee. Perhaps, however, the CBA representatives can suggest a better figure.

Keep in mind that the UPAIA provides default rules. At least for post-operative date trusts, if the rule is a problem in a particular kind of trust, the drafter of the trust can provide a different rule.

It should be understood that almost any statutory figure or amount is "arbitrary" to some degree. If we were to abolish all arbitrary numbers in the statutes, we wouldn't have statutes of limitations, sentencing guidelines, taxes, child support guidelines, terms of office, an age of majority, and countless other rules that employ fixed time periods, ages, amounts, percentages, and so forth. In this case, a certain, reasonable rule (even if technically "arbitrary") should be acceptable, even if it does not dispense perfect justice in all cases.

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

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

1 allocate to principal an amount received as a distribution of principal from the trust
2 or estate.

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

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

8 **Background from Uniform Act:**

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

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

25 [Adapted from Unif. Principal and Income Act § 402 comment (1997).]

26 **§ 16352. Business and other activities conducted by trustee [UPAIA § 403]**

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

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

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

44 (1) Retail, manufacturing, service, and other traditional business activities.

45 (2) Farming.

46 (3) Raising and selling livestock and other animals.

- (4) Managing rental properties.
- (5) Extracting minerals and other natural resources.
- (6) Timber operations.
- (7) Activities to which Section 16366 applies.

Comment. Section 16352 is the same in substance as Section 403 of the Uniform Principal and Income Act (1997), with some minor technical revisions. This section supersedes parts of former Section 16308.

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

Background from Uniform Act:

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

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

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

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

[Adapted from Unif. Principal and Income Act § 403 comment (1997).]

Staff Note. CBA comments: “The provisions of Section 16352(b) are unnecessary because the Act should define the proper allocation of receipts and not leave that allocation to the trustee’s discretion.” (Exhibit p. 3, item 8.)

The staff does not know how to evaluate this point. We understand that CBA would prefer to eliminate any role for discretion in the UPAIA or in the Trust Law as a whole. But we do not think this is possible or desirable as a general proposition. Here again, we defer to the uniform act drafting committee. The provision seems to provide desirable flexibility that would be beneficial in operation of a business. There are some situations where it is impossible for a statute to provide specific rules for every variation in the details that may be encountered in practice. This looks like

one of those situations. It should also be noted that the member of the State Bar review team who reported on this section thought the section was “acceptable.”

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

§ 16355. Principal receipts [UPAIA § 404]

16355. A trustee shall allocate to principal:

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

(b) Subject to any contrary rules in Articles 5.1 (commencing with Section 16350), 5.2 (commencing with Section 16355), and 5.3 (commencing with Section 16360), money or other property received from the sale, exchange, liquidation, or change in form of a 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 in substance as Section 404 of the Uniform Principal and Income Act (1997), with some minor 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).

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.

[Adapted from Unif. Principal and Income Act § 404 comment (1997).]

 **Staff Note.** CBA comments: “The phrase ‘or for other reasons to the extent not based on the loss of income’ in Section 16355(c) must be clarified.” (Exhibit p. 3, item 9.)

The staff does not understand the objection and we don’t know how to clarify the language. It seems plain on its face that this language is a catch-all provision stating the obvious: the trustee is to allocate to principal amounts recovered from third parties as a reimbursement other than a reimbursement based on loss of income. In other words, a reimbursement of principal recovered from a third party is principal. The State Bar reviewer had no problem with this language. The New York Advisory Committee did not revise this rule.

§ 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 in substance 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).

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.]

[Adapted from Unif. Principal and Income Act § 405 comment (1997).]

Staff Note. CBA comments: "Consistent with our comment 8 above, the phrase [in Section 16356] referencing Section 16352 should be eliminated." (Exhibit p. 3, item 10.)

This is simply a conforming revision that depends on the disposition of Section 16352. Note that there are other references to Section 16352 that CBA has not mentioned in this connection. See, e.g., Section 16358(b).

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

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

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

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

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

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

Background from Uniform Act:

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

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

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

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

[Adapted from Unif. Principal and Income Act § 406 comment (1997).]

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

16358. (a) Except as otherwise provided in subdivision (b), a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or its trustee is named as beneficiary, including a contract that insures the trust or its trustee against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall allocate dividends on an insurance policy to income if the premiums on the policy are paid from income, and to principal if the premiums are paid from principal.

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

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

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

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

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

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

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

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

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

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

(c) Nothing in this section imposes a duty on the trustee to make an allocation under this section, and the trustee is not liable for failure to make an allocation under this section.

Comment. Subdivisions (a) and (b) of Section 16360 are drawn from Section 408 of the Uniform Principal and Income Act (1997). Subdivision (c) is added to make clear that exercise of the power under this section is wholly discretionary with the trustee.

See also Sections 84 ("trustee" defined), 16322 ("accounting period" defined), 16324 ("income" defined).

Background from Uniform Act:

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

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

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

[Adapted from Unif. Principal and Income Act § 408 comment (1997).]

☞ **Staff Note.** CBA comments: “Section 16360 should be eliminated. There is no need for the trustee to make a determination of what is ‘insubstantial.’” (Exhibit p. 3, item 11.)

The CBA representatives argued this point at the working group sessions, but others thought it would be useful. The agreed solution was to include the exoneration provision in subdivision (b). The staff does not understand why the section has again become an issue, and why the exoneration rule is not sufficient protection for whatever worries CBA may have about liability for allocating or not allocating *insubstantial* amounts to principal.

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

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

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

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

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

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

Comment. Section 16361 is the same as Section 409 of the Uniform Principal and Income Act (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).

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

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 409(c) [Prob. Code § 16361(c)], which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the amount received is allocated to

income and the balance is allocated to principal. All other payments are allocated to principal because they represent a change in the form of a principal asset; Section 409 [Prob. Code § 16361] follows the rule in Section 404(2) [Prob. Code § 16355(b)], which provides that money or property received from a change in the form of a principal asset be allocated to principal.

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

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

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

[Adapted from Unif. Principal and Income Act § 409 comment (1997).]

Staff Note. CBA comments (Exhibit p. 3, item 12):

Does Section 16361 cover real estate installment notes? We believe that Section 16355(b) would cover this type of asset, but this Section could also be interpreted to cover this type of asset. In addition, the second sentence of Section 16361(c) appears to be in conflict with the first sentence to the extent that a "payment is required to be made". Clarification is necessary.

The staff does not see that this section would apply to real estate installment notes. However, if it is a problem, we can add a sentence to the Comment stating that the section does not apply to real estate installment notes, if appropriate.

Nor do we see a conflict between the first and second sentences of subdivision (c). The first sentence applies where all or part of the payment is required to be paid; the second sentence applies where no part of the payment is required to be made.

§ 16362. Liquidating asset [UPAIA § 410]

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

1 16367, or any asset for which the trustee establishes a reserve for depreciation
2 under Section 16372.

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

5 **Comment.** Section 16362 is the same as Section 410 of the Uniform Principal and Income Act
6 (1997), except that the limitation on rights to receive payments “during a period of more than one
7 year” is omitted. This section supersedes part of former Section 16310.

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

9 **Background from Uniform Act:**

10 *Prior Acts.* Section 11 of the 1962 Act [former Prob. Code § 16310] allocates receipts from
11 “property subject to depletion” to income in an amount “not in excess of 5%” of the asset’s
12 inventory value. The 1931 Act has a similar 5% rule that applies when the trustee is under a duty
13 to change the form of the investment. The 5% rule imposes on a trust the obligation to pay a fixed
14 annuity to the income beneficiary until the asset is exhausted. Under both the 1931 and 1962 Acts
15 the balance of each year’s receipts is added to principal. A fixed payment can produce unfair
16 results. The remainder beneficiary receives all of the receipts from unexpected growth in the
17 asset, e.g., if royalties on a patent or copyright increase significantly. Conversely, if the receipts
18 diminish more rapidly than expected, most of the amount received by the trust will be allocated to
19 income and little to principal. Moreover, if the annual payments remain the same for the life of
20 the asset, the amount allocated to principal will usually be less than the original inventory value.
21 For these reasons, Section 410 [Prob. Code § 16362] abandons the annuity approach under the
22 5% rule.

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

27 [Adapted from Unif. Principal and Income Act § 410 comment (1997).]

28 **§ 16363. Minerals, water, and other natural resources [UPAIA § 411]**

29 16363. (a) To the extent that a trustee accounts for receipts from an interest in
30 minerals or other natural resources pursuant to this section, the trustee shall
31 allocate them as follows:

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

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

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

40 (4) If an amount is received from a working interest or any other interest in
41 mineral or other natural resources not described in paragraph (1), (2), or (3), 90
42 percent of the net amount received shall be allocated to principal and the balance
43 to income.

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

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

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

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

[Adapted from Unif. Principal and Income Act § 411 comment (1997).]

Staff Note. CBA comments: “The phrase ‘is more than nominal’ should be eliminated from Section 16363(a)(3). In Section 16363(a)(4), the phrase ‘in mineral or other natural resources’ should be added to modify the phrase ‘any other interest.’” (Exhibit p. 3, item 13.)

The staff does not see why the first change should be made. We have made the second change as an editorial improvement in subdivision (a)(4).

§ 16364. Timber [UPAIA § 412]

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

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

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

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

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

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

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

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

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

Background from Uniform Act:

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

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

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

[Adapted from Unif. Principal and Income Act § 412 comment (1997).]

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

16365. (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 16336 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 it into productive property[, as provided by subdivision (c) of Section 21524,] or exercise the power under subdivision (a) of Section 16336 within a reasonable time. The trustee may decide which action or combination of actions to take.

(b) In cases not governed by subdivision (a), 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 as Section 413 of the Uniform Principal and Income Act (1997), with the incorporation of the substantive addition of the reasonable time standard drawn from the former version of Section 21524(c). This section continues the former rule provided in Section 21524(c). This section supersedes part of former Section 16311 (underproductive property).

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

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. [See Prob. Code § 21524(c).] The trustee should also consider the application of Section 104 of this Act [Prob. Code § 16336] 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 [Prob. Code § 16336] describes a situation involving the payment from income of carrying charges on unproductive real estate in which Section 104 [Prob. Code § 16336] 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) [Prob. Code § 16336(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) [Prob. Code § 16336(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).

[Adapted from Unif. Principal and Income Act § 413 comment (1997).]

Staff Note. CBA comments: “Section 16365 appears to be unnecessary in light of the provision of Section 21524(c).” (Exhibit p. 3, item 14.)

This section is broader than Section 21524(c). The two provisions overlap, in that some language in Section 16365 repeats language in Section 21524, which it also incorporates. This is a compromise that was intended to preserve the structure of the marital deduction gifts statute (Sections 21520-21526) and the UPAIA. However, providing the same rule in two places can be confusing.

The better solution to resolve any problems arising from inconsistent interpretations would be to remove the cross-reference to Section 21524(c) in this section and amend Section 21524(c) as follows:

(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~~ take action under subdivision (a) of Section 16365.

§ 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).

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.

[Adapted from Unif. Principal and Income Act § 414 comment (1997).]

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

16367. (a) In this section, “asset-backed security” means an asset whose value is based upon the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for the security. The term includes an asset that gives the owner the right to receive from the collateral financial assets only the interest or other current return or only the proceeds other than interest or current return. The term does not include an asset to which Section 16350 or 16361 applies.

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

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


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

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

Background from Uniform Act:

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

[Adapted from Unif. Principal and Income Act § 415 comment (1997).]

 **Staff Note.** CBA comments: “The Uniform Act sections are referenced in Section 16367(a) rather than the appropriate California version.” (Exhibit p. 3, item 15.)

This technical error has been corrected above.

Article 6. Allocation of Disbursements During Administration of Trust

§ 16370. Disbursements from income [UPAIA § 501]

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

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

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.

[Adapted from Unif. Principal and Income Act § 501 comment (1997).]

§ 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).

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)(5)], 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

1 include the cost of environmental consultants, administrative proceedings and burdens of every
2 kind imposed as the result of an administrative or judicial proceeding, even though the burden is
3 not formally characterized as a penalty.

4 *Title proceedings.* Disbursements that are made to protect a trust's property, referred to in
5 Section 502(a)(4) [Prob. Code § 16371(a)(4)], include an "action to assure title" that is mentioned
6 in Section 13(c)(2) of the 1962 Act [former Prob. Code § 16312(d)(2)].

7 *Insurance premiums.* Insurance premiums referred to in Section 502(a)(5) [Prob. Code §
8 16371(a)(5)] include title insurance premiums. They also include premiums on life insurance
9 policies owned by the trust, which represent the trust's periodic investment in the insurance
10 policy. There is no provision in the 1962 Act for life insurance premiums.

11 *Taxes.* Generation-skipping transfer taxes are payable from principal under subsection (a)(6).
12 [Adapted from Unif. Principal and Income Act § 502 comment (1997).]

13 **§ 16372. Transfers from income to principal for depreciation [UPAIA § 503]**

14 16372. (a) For purposes of this section, "depreciation" means a reduction in
15 value due to wear, tear, decay, corrosion, or gradual obsolescence of a fixed asset
16 having a useful life of more than one year.

17 (b) A trustee may transfer from income to principal a reasonable amount of the
18 net cash receipts from a principal asset that is subject to depreciation, under
19 generally accepted accounting principles, but may not transfer any amount for
20 depreciation under this section in any of the following circumstances:

21 (1) As to the portion of real property used or available for use by a beneficiary as
22 a residence or of tangible personal property held or made available for the personal
23 use or enjoyment of a beneficiary.

24 (2) During the administration of a decedent's estate.

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

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

29 **Comment.** Section 16372 is the same as Section 503 of the Uniform Principal and Income Act
30 (1997), with some clarifying language, and the addition of the generally accepted accounting
31 principles standard in subdivision (b). This addition continues the substance of former Section
32 16312(b)(2). Section 16372 also supersedes the last part of former Section 16312(d)(3).


33 See also Sections 84 ("trustee" defined), 16324 ("income" defined).

34 **Background from Uniform Act:**

35 *Prior Acts.* The 1931 Act has no provision for depreciation. Section 13(a)(2) of the 1962 Act
36 [former Prob. Code § 16312(b)(2)] provides that a charge shall be made against income for "... a
37 reasonable allowance for depreciation on property subject to depreciation under generally
38 accepted accounting principles" That provision has been resisted by many trustees, who do
39 not provide for any depreciation for a variety of reasons. One reason relied upon is that a charge
40 for depreciation is not needed to protect the remainder beneficiaries if the value of the land is
41 increasing; another is that generally accepted accounting principles may not require depreciation
42 to be taken if the property is not part of a business. The Drafting Committee concluded that the
43 decision to provide for depreciation should be discretionary with the trustee. The power to
44 transfer funds from income to principal that is granted by this section is a discretionary power of
45 administration referred to in Section 103(b) [Prob. Code § 16335(b)], and in exercising the power
46 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.

[Adapted from Unif. Principal and Income Act § 503 comment (1997).]

 **Staff Note.** CBA comments: “Section 16372(b)(3) should be eliminated if trustee discretion is removed. Please see comment 8 above.” (Exhibit p. 3, item 16.)

This depends on the disposition of the CBA comment on Section 16352.

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

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

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

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

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

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

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

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

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

See also Sections 62 (“property” defined), 84 (“trustee” defined), 16322 (“accounting period” defined), 16324 (“income” defined), 16326 (“income interest” defined).

Background from Uniform Act:

Prior Acts. The sources of Section 504 [Prob. Code § 16373] are Section 13(b) of the 1962 Act [former Prob. Code § 16312(c)], which permits a trustee to “regularize distributions,” if charges against income are unusually large, by using “reserves or other reasonable means” to withhold sums from income distributions; Section 13(c)(3) of the 1962 Act [former Prob. Code § 16312(d)(3)], which authorizes a trustee to establish an allowance for depreciation out of income if principal is used for extraordinary repairs, capital improvements and special assessments; and Section 12(3) of the 1931 Act, which permits the trustee to spread income expenses of unusual

1 amount “throughout a series of years.” Section 504 [Prob. Code § 16373] contains a more
2 detailed enumeration of the circumstances in which this authority may be used, and includes in
3 subsection (b)(4) the express authority to use income to make principal payments on a mortgage
4 if the depreciation charge against income is less than the principal payments on the mortgage.

5 [Adapted from Unif. Principal and Income Act § 504 comment (1997).]

6 **§ 16374. Income taxes [UPAIA § 505]**

7 16374. (a) A tax required to be paid by a trustee based on receipts allocated to
8 income shall be paid from income.

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

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

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

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

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

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

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

23 **Comment.** Section 16374 is the same as Section 505 of the Uniform Principal and Income Act
24 (1997), with some minor editorial changes.

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

26 **Background from Uniform Act:**

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

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

41 [Adapted from Unif. Principal and Income Act § 505 comment (1997).]

42 **§ 16375. Adjustments between principal and income because of taxes [UPAIA § 506]**

43 16375. (a) A fiduciary may make adjustments between principal and income to
44 offset the shifting of economic interests or tax benefits between income
45 beneficiaries and remainder beneficiaries that arise from any of the following:

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

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

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

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

22 **Comment.** Section 16375 is the same as Section 506 of the Uniform Principal and Income Act
23 (1997), with some minor editorial changes.

24 See also Sections 16323 ("fiduciary" defined), 16324 ("income" defined), 16325 ("income
25 beneficiary" defined).

26 **Background from Uniform Act:**

27 *Discretionary adjustments.* Section 506(a) [Prob. Code § 16375(a)] permits the fiduciary to
28 make adjustments between income and principal because of tax law provisions. It would permit
29 discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration
30 expenses that are paid from principal on an income tax return instead of on the estate tax return;
31 (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of
32 an estate or trust to be carried out to the distributee and relieves the persons who receive the
33 income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain
34 on the sale of a principal asset and pays a large state income tax on the gain, but under applicable
35 federal income tax rules the trustee may not deduct the state income tax payment from the capital
36 gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the
37 benefit of the deduction for state income tax paid on the capital gain. See generally Joel C.
38 Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax*
39 *Planning*, 66 Iowa L. Rev. 273 (1981).

40 Section 506(a)(3) [Prob. Code § 16375(a)(3)] applies to a qualified Subchapter S trust (QSST)
41 whose income beneficiary is required to include a pro rata share of the S corporation's taxable
42 income in his return. If the QSST does not receive a cash distribution from the corporation that is
43 large enough to cover the income beneficiary's tax liability, the trustee may distribute additional
44 cash from principal to the income beneficiary. In this case the retention of cash by the corporation
45 benefits the trust principal. This situation could occur if the corporation's taxable income includes
46 capital gain from the sale of a business asset and the sale proceeds are reinvested in the business
47 instead of being distributed to shareholders.

1 *Mandatory adjustment.* Subsection (b) provides for a mandatory adjustment from income to
2 principal to the extent needed to preserve an estate tax marital deduction or charitable
3 contributions deduction. It is derived from New York’s EPTL § 11-1.2(A), which requires
4 principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration
5 expenses on an income tax return instead of the estate tax return. Unlike the New York provision,
6 subsection (b) limits a mandatory reimbursement to cases in which a marital deduction or a
7 charitable contributions deduction is reduced by the payment of additional estate taxes because of
8 the fiduciary’s income tax election. It is intended to preserve the result reached in *Estate of*
9 *Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the Tax Court held that a
10 reimbursement required by the predecessor of EPTL § 11-1.2(A) resulted in the estate receiving
11 the same charitable contributions deduction it would have received if the administration expenses
12 had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary
13 will elect to deduct administration expenses for income tax purposes only when the income tax
14 reduction exceeds the estate tax reduction, the effect of this adjustment is that the principal is
15 placed in the same position it would have occupied if the fiduciary had deducted the expenses for
16 estate tax purposes, but the income beneficiaries receive an additional benefit. For example, if the
17 income tax benefit from the deduction is \$30,000 and the estate tax benefit would have been
18 \$20,000, principal will be reimbursed \$20,000 and the net benefit to the income beneficiaries will
19 be \$10,000.

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

36 [Adapted from Unif. Principal and Income Act § 506 comment (1997).]

CONFORMING REVISIONS AND REPEALS

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

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

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

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

(c) An educational institution electing to invest in a common fund or funds under this section may elect to receive distributions from each fund in an amount not to exceed for each fiscal year the greater of the income, as defined in ~~Section 16303~~ determined under the Uniform Principal and Income Act, Chapter 3 (commencing with Section 16320) of Part 4 of Division 9 of the Probate Code, accrued on its interest in the fund or 10 percent of the value of its interest in the fund as of the last day of its next preceding fiscal year. The educational institution may expend the distribution or distributions for any lawful purpose notwithstanding any general or special law characterizing the distribution, or any part thereof, as principal or income; provided that, in the case of funds or property invested as fiduciary, the expenditure is not prohibited by the wording of the will, deed, or other instrument creating the fiduciary relationship. No such prohibition of

1 expenditure shall be deemed to exist solely because a will, deed, or other
2 instrument, whether executed or in effect before or after the effective date of this
3 section, directs or authorizes the use of only the “income,” or “interest,” or
4 “dividends” or “rents, issues or profits,” or contains words of similar import.

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

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

9 **Comment.** Subdivision (c) of Section 10251 is amended to revise a cross-reference. Former
10 Probate Code Section 16303 contained a broad definition of income relying on cross-references to
11 all other provisions in the former Revised Uniform Principal and Income Act (Prob. Code §§
12 16300-16315) that affected determination of income. The new Uniform Principal and Income Act
13 (Prob. Code §§ 16320-16375) does not include a catalog provision like former Section 16303.
14 The basic principle invoked by the cross-reference is the same — the meaning of “income” in
15 subdivision (c) is determined under general principal and income rules applicable to trusts. The
16 details of determining income, however, have changed in a number of respects. See Prob. Code
17 §§ 16320-16375.

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

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

20 1063. (a) In all accounts, there shall be an additional schedule showing the
21 estimated market value of the assets on hand as of the end of the accounting
22 period, and a schedule of the estimated market value of the assets on hand as of the
23 beginning of the accounting period for all accounts subsequent to the initial
24 account. The requirement of an estimated value of real estate, a closely held
25 business, or other assets without a ready market, may be satisfied by a good faith
26 estimate by the fiduciary.

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

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

35 (d) If there is specifically devised property, there shall be an additional schedule
36 accounting for income, disbursements, and proceeds of sale pursuant to ~~Sections~~
37 Section 12002 and 16314 subdivision (b) of Section 16340.

38 (e) If any interest has been paid or is to be paid under Section 12003, 12004, or
39 12005, or 16314 subdivision (b) of Section 16340, there shall be a schedule
40 showing the calculation of the interest.

41 (f) If the accounting contemplates a proposed distribution, there shall be a
42 schedule setting forth the proposed distribution, including the allocation of income
43 required under Section 12006. If the distribution requires an allocation between

1 trusts, the allocation shall be set forth on the schedule, unless the allocation is to be
2 made by a trustee after receipt of the assets. If the distribution requires valuation of
3 assets as of the date of distribution, the schedule shall set forth the fair market
4 value of those assets.

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

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

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

11 (3) All notes payable.

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

13 (5) Any other material liability.

14 **Comment.** Subdivisions (d) and (e) of Section 1063 are amended to revise cross-references to
15 former Section 16314. See Section 16340 Comment.

16 **Prob. Code § 10531 (amended). Management and control of property under Independent**
17 **Administration of Estates Act**

18 SEC. _____. Section 10531 of the Probate Code is amended to read:

19 10531. (a) The personal representative has the power to manage and control
20 property of the estate, including making allocations and determinations under the
21 Uniform Principal and Income Act, Chapter 3 (commencing with Section 16320)
22 of Part 4 of Division 9. Except as provided in subdivision (b), the personal
23 representative may exercise this power without giving notice of proposed action
24 under Chapter 4 (commencing with Section 10580).

25 (b) The personal representative shall comply with the requirements of Chapter 4
26 (commencing with Section 10580) in any case where a provision of Chapter 3
27 (commencing with Section 10500) governing the exercise of a specific power so
28 requires.

29 **Comment.** Subdivision (a) of Section 10531 is amended to make clear that decisions made by
30 a personal representative under the Uniform Principal and Income Act are in the general category
31 of management and control of estate property. Unlike the former Revised Uniform Principal and
32 Income Act (former Sections 16300-16315), the new Uniform Principal and Income Act applies
33 to both trusts and decedents' estates. See, e.g., Sections 16323 ("fiduciary" defined), 16335
34 (general fiduciary duties).

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

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

37 17351. (a) If any of the trustees of a trust described in Section 17350 is a trust
38 company, the trust shall be removed from continuing court jurisdiction as provided
39 in this section. Within six months after the initial funding of the trust, the trustee
40 shall give a notice of removal of the trust from continuing court jurisdiction to
41 each beneficiary. Notice of removal shall be sent by registered or certified mail or
42 by first-class mail, but notice sent by first-class mail is effective only if an

1 acknowledgment of receipt of notice is signed by the beneficiary and returned to
2 the trustee.

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

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

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

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

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

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

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

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

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

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

27 21524. If a marital deduction gift is made in trust, in addition to the other
28 provisions of this chapter, each of the following provisions also applies to the
29 marital deduction trust:

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


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

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

41 (d) Notwithstanding ~~subdivision (d) of Section 16304~~ Section 16347, in the case
42 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 is amended to revise a cross-reference, in light of the replacement of the former Revised Uniform Principal and Income Act (Sections 16300-16315) by a new Uniform Principal and Income Act (Sections 16320-16375).

 **Staff Note.** See the Staff Note following Section 16365 *supra*.

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

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

§ 16301 (repealed). Definitions

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 ("income beneficiary" defined).

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

Comment. Former Section 16302 is superseded by Section 16335 (general fiduciary duties).

§ 16303 (repealed). Income and principal

Comment. Former Section 16303 is not continued. The new Uniform Principal and Income Act (Prob. Code §§ 16320-16375) does not include a catalog provision like former Section 16303. What is included in income and principal is determined by application of all relevant rules. See also Section 16324 ("income" defined).

1 **§ 16304 (repealed). When right to income arises; apportionment of income**

2 **Comment.** Former Section 16304 is superseded by Sections 16340-16341 (decedent's estate or
3 terminating income interest) and 16345-16347 (apportionment at beginning and end of income
4 interest).

5 **§ 16305 (repealed). Income earned during administration of decedent's estate**

6 **Comment.** Former Section 16305 is superseded by Section 16340 (determination and
7 distribution of net income and principal).

8 **§ 16306 (repealed). Corporate distributions**

9 **Comment.** Former Section 16306 is superseded by Section 16350 (character of receipts).

10 **§ 16307 (repealed). Bonds and other obligations for payment of money**

11 **Comment.** Former Section 16307 is superseded by Section 16357 (obligation to pay money).

12 **§ 16308 (repealed). Business and farming operations**

13 **Comment.** Former Section 16308 is superseded by Section 16350 (character of receipts) and
14 16352 (business and other activities conducted by trustee).

15 **§ 16309 (repealed). Natural resources**

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

18 **§ 16310 (repealed). Other property subject to depletion**

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

21 **§ 16311 (repealed). Underproductive property**

22 **Comment.** Former Section 16311 is not continued. See Section 16365 (property not productive
23 of income).

24 **§ 16312 (repealed). Charges against income and principal**

25 **Comment.** Former Section 16312 is superseded by Sections 16371 (disbursements from
26 principal, 16372 (transfers from income to principal for depreciation), and 16373 (transfers from
27 income to reimburse principal).

28 **§ 16313 (repealed). Reserve or allowance for depreciation or depletion**

29 **Comment.** Former Section 16313 is superseded by Section 16372 (transfers from income to
30 principal for depreciation).

31 **§ 16314 (repealed). Income and interest on trust distributions**

32 **Comment.** The substance of former Section 16314 is continued in Section 16340. See Section
33 16340 Comment.

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

2 **Comment.** Former Section 16315 is not continued. See Section 16338 (application of chapter
3 to existing trusts and estates).
