

TEXT OF COMMENTS TO SECTIONS AFFECTED BY
1999 COMMISSION RECOMMENDATIONS

PART A

CLRC Staff Note. This document sets out the text of all Official Comments to two Commission sponsored bills enacted in the 1999 legislative session — AB 846 (Ch. 145) and SB 210 (Ch. 344). The source for each Comment is given in the accompanying Table of “Sections Affected by 1999 Commission Legislation— Part A.”

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BUSINESS AND PROFESSIONS CODE

Bus. & Prof. Code § 6301.1 (amended). Board of law library trustees in San Diego County

Comment. Section 6301.1 is amended to accommodate unification of the municipal and superior courts in San Diego County. Cal. Const. art. VI, § 5(e).

CODE OF CIVIL PROCEDURE

Code Civ. Proc. § 77 (amended). Appellate division

Comment. Subdivision (h) of Section 77 is amended to refer more precisely to the appellate division. See Cal. Const. art. VI, § 4.

Code Civ. Proc. § 87 (added). Small claims case

Comment. Section 87 is added to clarify the appropriate treatment of a small claims case. The provision is declarative of existing law. Because a small claims case is a limited civil case, a provision that applies to a case other than a limited civil case (e.g., Sections 564, 1283.05) does not apply to a small claims case. Where, however, there is a conflict between a provision applicable to a limited civil case and a provision applicable to a small claims case, the provision applicable to a small claims case prevails over the more general provision in a small claims case. For example, Section 904.2 governs an appeal in a limited civil case. It is inapplicable to a small claims case because Section 904.5 specifies different procedures for an appeal from the small claims division. This is comparable to the situation that existed before the Constitution was amended to permit unification of the municipal and superior courts in a county: In a small claims case, a provision applicable to a small claims case prevailed over a general provision for a municipal court case. See, e.g., former Sections 904.2 (appeal from municipal or justice court), 904.5 (appeal from small claims division of municipal or justice court).

See Sections 85 (limited civil cases) & Comment, 116.220 (jurisdiction of the small claims division).

Code Civ. Proc. § 88 (added). “Unlimited civil case” defined

Comment. Section 88 is added to provide a convenient means of referring to a civil case other than a limited civil case. The new term (“unlimited civil case”) reflects the broad jurisdiction of the superior court. Cal. Const. art. VI, § 10. A small claims case is a type of limited civil case, not an unlimited civil case. See Sections 85 & 87 & Comments.

Code Civ. Proc. § 116.950 (amended). Small claims advisory committee

Comment. Subdivision (d) of Section 116.950 is amended to broaden the range of judicial officers eligible to serve on the Small Claims Advisory Committee.

Code Civ. Proc. § 395.9 (repealed). Reclassification as limited civil case or otherwise

Comment. Section 395.9 is repealed and recodified for organizational clarity. The first and third sentences of subdivision (a) are continued without substantive change in Section 403.040(a) (motion for reclassification). The second sentence of subdivision (a) is continued without substantive change in Section 403.070(b) (reclassified action or proceeding).

Subdivision (b) is continued in Section 403.040(b), with revisions to improve clarity. The reference to a motion by the court is deleted as redundant. See Section 403.040(a).

Subdivision (c) is unnecessary and is not continued. The Judicial Council has authority to promulgate rules governing reclassification of civil actions and proceedings. See Sections 403.050 (reclassification fees), 403.090 (rules governing reclassification procedure).

Subdivision (d) is continued without substantive change in Section 403.070(a) (reclassified action or proceeding).

Subdivision (e) is continued without substantive change in Section 403.010(b) (application and effect of chapter).

Subdivisions (f)-(g) are continued without substantive change in Section 403.040(c)-(d).

The first sentence of subdivision (h) is unnecessary and is not continued. The second sentence of subdivision (h) is continued in part in the introductory clause and the first sentence of Section 403.050(a) (reclassification fees). The remainder of the second sentence is superseded by Section 403.050(a)(1)-(2).

Code Civ. Proc. § 399.5 (repealed). Reclassification pursuant to Section 395.9

Comment. Section 399.5 is repealed and recodified for organizational clarity. Subdivisions (a)-(c) are continued without substantive change in Section 403.060 (proceedings on order granting motion for reclassification), except that (1) the consequences of failure to make payment are not addressed as fully, because this matter may be covered by rules of court promulgated pursuant to Section 403.050, and (2) the clerk is to reclassify the case upon payment of the reclassification fees, regardless of whether the time for filing a writ petition pursuant to Section 403.080 (petition for writ of mandate) has expired or such a petition is pending.

Subdivision (d) is not continued. See Section 403.090 (rules governing reclassification procedure).

Subdivision (e) is continued without substantive change in Section 403.070(b) (reclassified action or proceeding).

Code Civ. Proc. § 400 (amended). Petition for writ of mandate

Comment. Section 400 is amended for organizational clarity. The references to reclassification are continued without substantive change in Section 403.080 (petition for writ of mandate).

Code Civ. Proc. §§ 403.010-403.090 (added). Reclassification of civil actions and proceedings

Comment. The provisions governing reclassification of civil actions and proceedings (former Sections 395.9 and 399.5) are recodified in this chapter for organizational clarity, with modifications to eliminate ambiguities and improve procedures.

Code Civ. Proc. § 403.010 (added). Application and effect of chapter

Comment. Subdivision (a) of Section 403.010 makes clear that this chapter is limited to counties in which the trial courts have unified. For transfer between superior and municipal courts in counties in which the courts have not unified, see Chapter 1 (commencing with Section 392).

The first sentence of subdivision (b) continues former Section 395.9(e) without substantive change. The second sentence clarifies that this chapter does not affect the running of the statute of limitations.

Code Civ. Proc. § 403.020 (added). Reclassification by amending initial pleading

Comment. Section 403.020 is added to provide guidance where a plaintiff recognizes and acknowledges the need for reclassification. It does not affect whether a plaintiff is entitled to amend the complaint or other initial pleading. See Section 403.010 (application and effect of chapter). For authority to amend pleadings, see Sections 426.50 (amending to add cause of action), 472 (amendment once of course), 473 (amendment requiring leave of court).

See also Sections 32.5 (jurisdictional classification), 403.030 (reclassification of limited civil case by cross-complaint), 403.040 (motion for reclassification), 422.030 (caption).

Code Civ. Proc. § 403.030 (added). Reclassification of limited civil case by cross-complaint

Comment. Section 403.030 is added to provide guidance where a cross-complainant in a limited civil case recognizes and acknowledges the need for reclassification.

See also Sections 403.020 (reclassification by amending initial pleading), 403.040 (motion for reclassification), 422.30 (caption).

Code Civ. Proc. § 403.040 (added). Motion for reclassification

Comment. Subdivision (a) of Section 403.040 continues the first and third sentences of former Section 399.5(a) without substantive change. A new clause is added to expressly negate any inference that a motion for reclassification may only be granted upon a finding of fault. This is declarative of existing law.

Subdivision (b) continues former Section 395.9(b), with revisions to improve clarity. The reference to a motion by the court is deleted as redundant. See subdivision (a).

Subdivisions (c)-(d) continue former Section 395.9(f)-(g) without substantive change.

For the procedure on granting a motion for reclassification, see Sections 403.060 (proceedings on order granting motion for reclassification), 403.070 (reclassified action or proceeding). For reclassification fees, see Section 403.050. See also Sections 403.020 (reclassification by amending initial pleading), 403.030 (reclassification of limited civil case by cross-complaint).

Code Civ. Proc. § 403.050 (added). Reclassification fees

Comment. The introductory clause and the first sentence of subdivision (a) of Section 403.050 continue the second sentence of former Section 395.9(h) without substantive change, except that they do not specify which party is to make payment. Like former Section 395.9(h), this section does not authorize an award of attorney's fees attributable to misclassification of a case. For authority to make such an award under limited circumstances, see Sections 128.6, 128.7.

Paragraphs (1)-(2) of subdivision (a) clarify the fees due on reclassification pursuant to order of the court. See Gov't Code §§ 26820.4 (fee for filing first paper in case other than limited civil case), 26826 (fee for filing defendant's first paper in case other than limited civil case), 72055 (fee for filing first paper in limited civil case), 72056 (fee for filing defendant's first paper in limited civil case). The Judicial Council may promulgate rules governing the details of making payment. For example, the Judicial Council may specify by rule that the losing party is to pay the reclassification fees in the first instance, subject to reimbursement by the other parties in accordance with this provision.

Under subdivision (b), if a limited civil case is reclassified by filing an amended complaint pursuant to Section 403.020, and the defendant has already answered the original complaint, the reclassification fees include, for example, the difference between the fee for filing the defendant's first paper in a limited civil case (Gov't Code § 72056) and the fee for filing the defendant's first paper in a case other than a limited civil case (Gov't Code § 26826). The same approach applies where a cross-complainant reclassifies a limited civil case by filing a cross-complaint pursuant to Section 403.030.

See Section 403.040 (motion for reclassification). See also Section 422.30 (caption).

Code Civ. Proc. § 403.060 (added). Proceedings on order granting motion for reclassification

Comment. Subdivisions (a)-(c) of Section 403.060 continue former Section 399.5(a)-(c) without substantive change, except that (1) the consequences of failure to make payment are not addressed as fully, because this matter may be covered by rules of court promulgated pursuant to Section 403.050, and (2) the clerk is to reclassify the case on payment of the reclassification fees, regardless of whether the time for filing a writ petition pursuant to Section 403.080 (petition for writ of mandate) has expired or such a petition is pending.

For rules governing reclassified actions or proceedings, see Section 403.070. For authority of the court of appeal to stay an action or proceeding pending determination of a writ proceeding, see Section 403.080.

Code Civ. Proc. § 403.070 (added). Reclassified action or proceeding

Comment. Subdivision (a) of Section 403.070 continues former Section 399.5(d) without substantive change. Subdivision (b) continues without substantive change former Section 399.5(e) and the second sentence of former Section 395.9(a).

See also Sections 403.020 (reclassification by amending initial pleading), 403.030 (reclassification of limited civil case by cross-complaint), 403.040 (motion for reclassification), 403.050 (reclassification fees), 422.30 (caption).

Code Civ. Proc. § 403.080 (added). Petition for writ of mandate

Comment. Section 403.080 continues without substantive change the references to reclassification deleted from Section 400.

Code Civ. Proc. § 403.090 (added). Rules governing reclassification procedure

Comment. Section 403.090 is added to facilitate refinement of the procedures governing reclassification of civil actions. See also Section 403.050 (Judicial Council authority to prescribe rules governing manner of paying reclassification fees and consequences of failure to make payment).

Code Civ. Proc. § 422.30 (amended). Caption

Comment. Subdivision (c) of Section 422.30 is amended to clarify that the clerk is to rely on the caption in determining how to classify a civil case that is brought in a unified superior court. For the rules governing reclassification, see Sections 403.010-403.090. See also Section 32.5 (jurisdictional classification).

Code Civ. Proc. § 871.3 (amended). Good faith improver

Comment. Section 871.3 is amended to reflect relocation of the provisions governing reclassification of a civil case.

Code Civ. Proc. § 1014 (amended). Appearance by defendant

Comment. Section 1014 is amended to reflect relocation of the provisions governing reclassification of a civil case.

Code Civ. Proc. § 1068 (amended). Courts authorized to grant writ of review

Comment. Section 1068 is amended to fully reflect the writ jurisdiction of the appellate division. Cal. Const. art. VI, §§ 10, 11(b). See also Penal Code §§ 691(g) (“misdemeanor or infraction case” defined), 1466 (appeal in misdemeanor or infraction case).

Code Civ. Proc. § 1085 (amended). Courts authorized to grant writ of mandate

Comment. Section 1085 is amended to fully reflect the writ jurisdiction of the appellate division. Cal. Const. art. VI, §§ 10, 11(b). See also Penal Code §§ 691(g) (“misdemeanor or infraction case” defined), 1466 (appeal in misdemeanor or infraction case).

Code Civ. Proc. § 1103 (amended). Courts authorized to grant writ of prohibition

Comment. Section 1103 is amended to fully reflect the writ jurisdiction of the appellate division. Cal. Const. art. VI, §§ 10, 11(b). See also Penal Code §§ 691(g) (“misdemeanor or infraction case” defined), 1466 (appeal in misdemeanor or infraction case).

Code Civ. Proc. § 1167.3 (amended). Default in unlawful detainer case

Comment. Section 1167.3 is amended to correct cross-references.

C O R P O R A T I O N S C O D E

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

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

G O V E R N M E N T C O D E

Gov’t Code § 26863 (amended). Automation fee

Comment. Section 26863 is amended to restore amendments made by Chapter 406 of the Statutes of 1998 that were chaptered out by Chapter 931 of the Statutes of 1998.

Gov’t Code § 71042.6 (amended). Map to establish district boundaries

Comment. Section 71042.6 is amended to accommodate unification of the municipal and superior courts. Cal. Const. art. VI, § 5(e). This preserves the effect of statutes that specify publication by judicial district, rather than by county. See, e.g., Bus. & Prof. Code § 21707; Civ. Code §§ 2924f, 3440.1, 3440.5; Code Civ. Proc. §§ 701.540, 1208.5; Com. Code §§ 6105, 7210; Rev. & Tax. Code §§ 3381, 3702. *Cf.* Code Civ. Proc. § 38 (“judicial district” defined, subject to contrary statute).

P E N A L C O D E

Penal Code § 1214 [operative Jan. 1, 2000] (amended). Enforcement

Comment. Section 1214, as operative (with exceptions) January 1, 2000, is amended to accommodate unification of the municipal and superior courts. Cal. Const. art. VI, § 5(e). New subdivision (c) continues the policy of former Code of Civil Procedure Section 86(a)(11), which provided that the municipal court had original jurisdiction in all actions to enforce restitution orders or restitution fines that were imposed by the municipal court (without any limitation on amount in controversy). In certain criminal cases, a municipal court could impose a restitution order or restitution fine. Penal Code §§ 1462(a) (misdemeanor or infraction case), 1462(b) (pronouncing judgment in noncapital criminal case). In a county in which there is no municipal court, Section 1462(d) gives the superior court the jurisdiction provided in Section 1462(a)-(b).

Thus, new subdivision (c) of this section accommodates trial court unification and continues the effect of former law.

See Code Civ. Proc. §§ 85 (limited civil cases), 86(a)(8) (enforcement of judgment in limited civil case).

Penal Code § 1238 (amended). Appealable orders in felony cases

Comment. Paragraph (11) is added to subdivision (a) of Section 1238 for consistency with Section 1424(a)(2) (appeal from order of recusal in felony case made pursuant to Chapter 1 (commencing with Section 1235) of Title 9).

Penal Code § 1382 (amended). Time for bringing case to trial

Comment. Section 1382 is amended to accommodate unification of the municipal and superior courts. Cal. Const. art. VI, § 5(e).

PROBATE CODE

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

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

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

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

Prob. Code §§ 16300-16315 (repealed). 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.

Prob. Code § 16300 (repealed). Short title

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

Prob. Code § 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).]

Prob. Code § 16302 (repealed). Duty of trustee as to receipts and expenditures

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

Prob. Code § 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).

Prob. Code § 16304 (repealed). When right to income arises; apportionment of income

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

Prob. Code § 16305 (repealed). Income earned during administration of decedent’s estate

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

Prob. Code § 16306 (repealed). Corporate distributions

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

Prob. Code § 16307 (repealed). Bonds and other obligations for payment of money

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

Prob. Code § 16308 (repealed). Business and farming operations

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

Prob. Code § 16309 (repealed). Natural resources

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

Prob. Code § 16310 (repealed). Other property subject to depletion

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

Prob. Code § 16311 (repealed). Underproductive property

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

Prob. Code § 16312 (repealed). Charges against income and principal

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

Prob. Code § 16313 (repealed). Reserve or allowance for depreciation or depletion

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

Prob. Code § 16314 (repealed). Income and interest on trust distributions

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

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

Comment. Former Section 16315 is not continued. See Section 16339 (application of chapter to existing trusts and estates).

Prob. Code §§ 16320-16375 (added). 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 (RUPIA) 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.

Prob. Code § 16320 (added). Short title [UPAIA § 101]

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).

Prob. Code § 16321 (added). Application of definitions [UPAIA § 102]

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).

Prob. Code § 16322 (added). Accounting period [UPAIA § 102(1)]

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).

Prob. Code § 16323 (added). Fiduciary [UPAIA § 102(3)]

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.

Prob. Code § 16324 (added). Income [UPAIA § 102(4)]

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).

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

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).]

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

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).

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

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).

Prob. Code § 16328 (added). Net income [UPAIA § 102(8)]

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).]

Prob. Code § 16335 (added). General fiduciary duties [UPAIA § 103]

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 Prob. Code § 16340)] and [4 (commencing with Prob. Code § 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 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).]

Prob. Code § 16336 (added). Trustee’s power to adjust [see UPAIA § 104]

Comment. Section 16336 is drawn in large part from Section 104 of the Uniform Principal and Income Act (1997). The purpose of this section is to provide a way to reconcile the tension that may exist between the duties under the Uniform Prudent Investor Act (Section 16045 *et seq.*) and the technical trust accounting rules governing allocations between principal and income provided in other parts of this chapter, the Uniform Principal and Income Act. The power to adjust is a discretionary power and is subject to rules governing exercise of discretionary powers, both under the trust terms and the law of trusts. If a trustee decides to exercise the power to adjust, the trustee may exercise the power under the authority of this section and related rules, or may prefer to seek the agreement of beneficiaries before making the adjustment. A procedure for giving notice of proposed action is provided in Section 16337. The trustee may also seek court approval under Section 17200(b)(5) of a decision to make an adjustment. Subdivision (h) reaffirms and expands on the portion of subdivision (a) providing that the trustee *may* make an adjustment *to the extent the trustee considers necessary*. Subdivision (h) makes clear that the existence of the adjustment power does not create or imply a duty to consider its use or to use it. The *existence* of the power to adjust is a neutral factor. The trustee may, without liability, decide as an institutional policy or with respect to individual trusts or classes of trusts, whether and under what conditions it will use the adjustment power. This rule is a corollary of the principle stated in Section 16202 that the grant of a power does not authorize its use and that exercise of a power is subject to fiduciary duties. Subdivision (h) does not, however, affect any liability that may result from breach of a duty under other trust law.

The condition expressed in subdivision (a)(1) — that the trustee invests and manages trust 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, and are set out in subdivision (g) by way of illustration. Consideration of the factors in the course of determining whether or how to make an adjustment is discretionary, as is clear from the introductory language of subdivision (g) (“trustee may consider ... any of the following”). See also subdivision (h).

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 "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 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 [see Prob. Code § 16045 *et seq.*] or judicial approval of the rule in Restatement of Trusts 3d: Prudent Investor Rule. Wills and trust instruments executed after the rule is adopted can be drafted to describe a beneficiary's distribution rights in terms that do not depend upon the amount of trust accounting income, but to the extent that drafters of trust documents continue to describe an income beneficiary's distribution rights by referring to trust accounting income, Section 104 [Prob. Code § 16336] will be an important tool in trust administration.

Three conditions to the exercise of the power to adjust. The first of the three conditions [Prob. Code § 16336(a)(1)] that must be met before a trustee can exercise the power to adjust — that the trustee invest and manage trust assets as a prudent investor — is expressed in this Act by language derived from the Uniform Prudent Investor Act, but the condition will be met whether the prudent investor rule applies because the Uniform Act or other prudent investor legislation has been enacted, the prudent investor rule has been approved by the courts, or the terms of the trust require it. [See California Uniform Prudent Investor Act, Prob. Code §§ 16045-16054.] Even if a State's legislature or courts have not formally adopted the rule, the Restatement establishes the prudent investor rule as an authoritative interpretation of the common law prudent man rule, referring to the prudent investor rule as a "modest reformulation of the Harvard College dictum and the basic rule of prior Restatements." Restatement of Trusts 3d: Prudent Investor Rule, Introduction, at 5. As a result, there is a basis for concluding that the first condition is satisfied in virtually all States except those in which a trustee is permitted to invest only in assets set forth in a statutory "legal list."

The second condition [Prob. Code § 16336(a)(2)] will be met when the terms of the trust require all of the "income" to be distributed at regular intervals; or when the terms of the trust require a trustee to distribute all of the income, but permit the trustee to decide how much to distribute to each member of a class of beneficiaries; or when the terms of a trust provide that the beneficiary shall receive the greater of the trust accounting income and a fixed dollar amount (an annuity), or of trust accounting income and a fractional share of the value of the trust assets (a unitrust amount). If the trust authorizes the trustee in its discretion to distribute the trust's income

to the beneficiary or to accumulate some or all of the income, the condition will be met because the terms of the trust do not permit the trustee to distribute more than the trust accounting income.

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

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

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

For a discussion of investment considerations involving specific investments and techniques under the prudent investor rule, see Restatement of Trusts 3d: Prudent Investor Rule § 227, Comments *k-p*. [See also Prob. Code §§ 16045-16054, California Uniform Prudent Investor Act.]

Factors to consider in exercising the power to adjust. Section 104(b) requires [not required in Prob. Code § 16336 — subdivision (g) of the California section lists discretionary factors by way of illustration] a trustee to consider factors relevant to the trust and its beneficiaries in deciding whether and to what extent the power to adjust should be exercised. Section 2(c) of the Uniform Prudent Investor Act [see Prob. Code § 16047(c)] sets forth circumstances that a trustee is to consider in investing and managing trust assets. The circumstances in Section 2(c) of the Uniform Prudent Investor Act are the source of the factors in paragraphs (3) through (6) and (8) of Section 104(b) (modified where necessary to adapt them to the purposes of this Act) so that, to the extent possible, comparable factors will apply to investment decisions and decisions involving the power to adjust. [See Prob. Code §§ 16047(c)(3)-(6) & (8), 16336(g).] If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal

to income may be necessary under Section 104. On the other hand, if a trustee decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust.

Assets received from the settlor. Section 3 of the Uniform Prudent Investor Act provides that “[a] trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.” [For a comparable rule, see Prob. Code § 16048.] The special circumstances may include the wish to retain a family business, the benefit derived from deferring liquidation of the asset in order to defer payment of income taxes, or the anticipated capital appreciation from retaining an asset such as undeveloped real estate for a long period. To the extent the trustee retains assets received from the settlor because of special circumstances that overcome the duty to diversify, the trustee may take these circumstances into account in determining whether and to what extent the power to adjust should be exercised to change the results produced by other provisions of this Act that apply to the retained assets. See Section 104(b)(5) [Prob. Code § 16336(g)(5)]; Uniform Prudent Investor Act § 3, Comment, 7B U.L.A. 18, at 25-26 (Supp. 1997); Restatement of Trusts 3d: Prudent Investor Rule § 229 and Comments *a-e*.

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

Under subsection (c)(1) [Prob. Code § 16336(b)(1)], a trustee cannot make an adjustment that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction is allowed; but this subsection does not prevent the trustee from making an adjustment that increases the amount of income paid from a marital deduction trust to the spouse. Subsection (c)(1) [Prob. Code § 16336(b)(1)] applies to a trust that qualifies for the marital deduction because the spouse has a general power of appointment over the trust, but it applies to a qualified terminable interest property (QTIP) trust only if and to the extent that the fiduciary makes the election required to obtain the tax deduction. Subsection (c)(1) [Prob. Code § 16336(b)(1)] does not apply to a so-called “estate” trust. This type of trust qualifies for the marital deduction because the terms of the trust require the principal and undistributed income to be paid to the surviving spouse’s estate when the spouse dies; it is not necessary for the terms of an estate trust to require the income to be distributed annually. Reg. § 20.2056(c)-2(b)(1)(iii).

Subsection (c)(3) [Prob. Code § 16336(b)(3)] applies to annuity trusts and unitrusts with no charitable beneficiaries as well as to trusts with charitable income or remainder beneficiaries; its 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)-(7); 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 pay double-digit interest and determines that a portion of the interest, which is allocated to income under Section 406 of this Act [Prob. Code § 16357], is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that *T* considers relevant, *T* may transfer part of the interest to principal.

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

Example (4) — *T* is the trustee of a trust that is governed by the law of State *X*. The trust became irrevocable before State *X* adopted the prudent investor rule. The terms of the trust require all of the income to be paid to *G* for life, remainder to *H*, and also give *T* the power to invade principal for the benefit of *G* for "dire emergencies only." The terms of the trust limit the aggregate amount that *T* can distribute to *G* from principal during *G*'s life to 6% of the trust's value at its inception. The trust's portfolio is invested initially 50% in stocks and 50% in bonds, but after State *X* adopts the prudent investor rule *T* determines that, to achieve suitable risk and return objectives for the trust, the assets should be invested 90% in stocks and 10% in bonds. This change increases the total return from the portfolio and decreases the dividend and interest

income. Thereafter, even though *G* does not experience a dire emergency, *T* may exercise the power to adjust under Section 104(a) [Prob. Code § 16336(a)] to the extent that *T* determines that the adjustment is from only the capital appreciation resulting from the change in the portfolio's asset allocation. If *T* is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to *G* for dire emergencies do not exceed the 6% limitation, *T* may not exercise the power to adjust. See Joel C. Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 Iowa L. Rev. 273 (1981).

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

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

Prob. Code § 16337 (added). Notice of proposed action

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.

Prob. Code § 16338 (added). Remedy in proceedings concerning adjustment

Comment. Section 16338 limits the remedy in proceedings concerning adjustments under Section 16336 to correcting the adjustment. This rule recognizes that if there is a dispute concerning exercise of the adjustment power, it is between the affected beneficiaries, and not between the trustee and beneficiaries. Accordingly, the trustee is not liable for a surcharge or denial of fees where the dispute relates to the exercise or nonexercise of the power to adjust or the proper level of an adjustment, if any.

Prob. Code § 16339 (added). Application of chapter to existing trusts and estates [UPAIA § 605]

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

See also Section 3 (general transitional provisions).

Prob. Code § 16340 (added). Determination and distribution of net income and principal [UPAIA § 201]

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).]

Prob. Code § 16341 (added). Distribution to residuary and remainder beneficiaries [UPAIA § 202]

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).]

Prob. Code § 16345 (added). When right to income begins and ends [UPAIA § 301]

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

See also Sections 24 (“beneficiary” defined), 84 (“trustee” defined), 16324 (“income” defined), 16325 (“income beneficiary” defined), 16326 (“income interest” defined), 16328 (“net income” defined).

Background from Uniform Act

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

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

Prob. Code § 16346 (added). Apportionment of receipts and disbursements when decedent dies or income interest begins [UPAIA § 302]

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).]

Prob. Code § 16347 (added). Apportionment when income interest ends [UPAIA § 303]

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).]

Prob. Code § 16350 (added). Character of receipts [UPAIA § 401]

Comment. Section 16350 is the same in substance as Section 401 of the Uniform Principal and Income Act (1997), with several minor changes. 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).]

Prob. Code § 16351 (added). Distribution from trust or estate [UPAIA § 402]

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

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

Background from Uniform Act

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

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

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

Prob. Code § 16352 (added). Business and other activities conducted by trustee [UPAIA § 403]

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).]

Prob. Code § 16355 (added). Principal receipts [UPAIA § 404]

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).]

Prob. Code § 16356 (added). Rental property [UPAIA § 405]

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(g) & 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).]

Prob. Code § 16357 (added). Obligation to pay money [UPAIA § 406]

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).]

Prob. Code § 16358 (added). Insurance policies and similar contracts [UPAIA § 407]

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).

Prob. Code § 16360 (added). Insubstantial allocations not required [UPAIA § 408]

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).]

Prob. Code § 16361 (added). Deferred compensation, annuities, and similar payments [UPAIA § 409]

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).]

Prob. Code § 16362 (added). Liquidating asset [UPAIA § 410]

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

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

Background from Uniform Act

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

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

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

Prob. Code § 16363 (added). Minerals, water, and other natural resources [UPAIA § 411]

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).]

Prob. Code § 16364 (added). Timber [UPAIA § 412]

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).]

Prob. Code § 16365 (added). Property not productive of income [UPAIA § 413]

Comment. Section 16365 is the same as Section 413 of the Uniform Principal and Income Act (1997), with the 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).]

Prob. Code § 16366 (added). Derivatives and options [UPAIA § 414]

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).]

Prob. Code § 16367 (added). Asset-backed securities [UPAIA § 415]

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).]

Prob. Code § 16370 (added). Disbursements from income [UPAIA § 501]

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).]

Prob. Code § 16371 (added). Disbursements from principal [UPAIA § 502]

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

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

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

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

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

Prob. Code § 16372 (added). Transfers from income to principal for depreciation [UPAIA § 503]

Comment. Section 16372 supersedes former Section 16313 and is the same as Section 503 of the Uniform Principal and Income Act (1997), with some clarifying language and the addition of the generally accepted accounting principles standard in subdivision (b). This addition continues the substance of former Section 16312(b)(2). Section 16372 also supersedes the last part of former Section 16312(d)(3). The word "may" in subdivision (b) has the same meaning as the phrase "is not required to" in former Section 16313.

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

Background from Uniform Act

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

One purpose served by transferring cash from income to principal for depreciation is to provide funds to pay the principal of an indebtedness secured by the depreciable property. Section 504(b)(4) [Prob. Code § 16373(b)(4)] permits the trustee to transfer additional cash from income to principal for this purpose to the extent that the amount transferred from income to principal for depreciation is less than the amount of the principal payments.

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

Prob. Code § 16373 (added). Transfers from income to reimburse principal [UPAIA § 504]

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

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

Prob. Code § 16374 (added). Income taxes [UPAIA § 505]

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

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

Background from Uniform Act

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

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

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

Prob. Code § 16375 (added). Adjustments between principal and income because of taxes [UPAIA § 506]

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

See also Sections 16323 (“fiduciary” defined), 16324 (“income” defined), 16325 (“income beneficiary” defined).

Background from Uniform Act

Discretionary adjustments. Section 506(a) [Prob. Code § 16375(a)] permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust’s federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C.

Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 Iowa L. Rev. 273 (1981).

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

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

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

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

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

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

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

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).

REVENUE AND TAXATION CODE

Rev. & Tax. Code § 19280 (technical amendment). Referral of fines and penalties to Franchise Tax Board

Comment. Section 19280 is amended to add the word “or” in subdivision (a)(1). This is a technical, nonsubstantive change.
