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Estates and Trusts

The New Uniform Principal and Income Act: Friend or Foe?

Avishai Glikman

Code Sections Affected

Corporations Code § 10251 (amended); Probate Code §§ 16320, 16321, 16322, 16323, 16324, 16325, 16326, 16327, 16328, 16335, 16336, 16337, 16338, 16339, 16340, 16341, 16345, 16346, 16350, 16351, 16352, 16355, 16356, 16357, 16358, 16360, 16362, 16364, 16365, 16366, 16367, 16370, 16371, 16372, 16373, 16374, 16375 (new), 1063, 10531, 17351, 21524 (amended), 16300, 16301, 16302, 16303, 16314, 16315 (repealed).
AB 846 (Ackerman); 1999 STAT. Ch. 145

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I. INTRODUCTION

Chapter 145 enacts the new Uniform Principal and Income Act (UPIA),[1] making certain changes to the 1962 Revised Uniform Principal and Income Act (RUPIA).[2] First, it brings the prior outdated law into the twenty-first century, taking into account new estate planning principles and new financial tools that have emerged since the passage of the RUPIA.[3] Second, it conforms the law to the prudent investor rule enacted in California in 1995.[4] With these changes, Chapter 145 serves as an effective tool for trustees to maximize the trust's profits, while simultaneously protecting trustees from suit.

II. BACKGROUND

A. Definitions

A trust is a fiduciary relationship in which one person, the holder of the title to property, has a fiduciary duty to keep or use the property for the benefit of another.[5] A trust is created when a settlor transfers property to the trustee for the benefit of the beneficiary.[6] The trustee holds legal title to the property for the beneficiary.[7] The beneficiary is the person for whose benefit the trustee holds or uses the property.[8] Two classes of beneficiaries exist: income beneficiaries receive net income from the trust for a certain period; remainder beneficiaries receive what is left in the trust property at the termination of the income beneficiary's interest.[9]

The trustee receives money or other property from a variety of different sources. In each case, the trustee must decide whether to allocate the money to income or principal.[10] The general rule for allocating money to either income or principal is that money paid for the use of the trust property, and any benefit received as a gain from the employment of that property, is considered income, while substitutes for the original trust res (property) which are merely changes in form are to be considered trust principal.[11] For example, interest, rents, and cash dividends are generally considered to be trust income; however, the proceeds of a

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1. CAL. PROB. CODE §§ 16320-16375 (enacted by Chapter 145).
2. *Uniform Principal and Income Act*, 29 CAL. L. REVISION COMM'N REPORTS 245 (1999) [hereinafter CAL. L. REVISION COMM'N].
3. *Id.* at 249.
4. *Id.*
5. RESTATEMENT (SECOND) OF TRUSTS § 1 (1959).
6. WILLIAM M. MCGOVERN, JR. ET AL., WILLS, TRUSTS AND ESTATES 191 (1988).
7. *Id.*
8. RESTATEMENT (SECOND) OF TRUSTS § 3 (1959).
9. GEORGE G. BOGERT & GEORGE T. BOGERT, HANDBOOK OF THE LAW OF TRUSTS 405 (5th ed. 1973).
10. *Id.*
11. *Id.*

sale of trust property and money received in the collection of debts due to the trust should be credited to principal.[12]

B. *The Revised Uniform Principal and Income Act of 1962 and the Prudent Person Rule*

In 1931, the Uniform Laws Commission approved the first Uniform Principal and Income Act,[13] and California enacted the 1931 Act in 1941.[14] This Act attempted to resolve some of the differing opinions that estate planners in various jurisdictions had regarding their duties.[15] However, the Act itself caused additional confusion because it did not apply retroactively.[16] This meant that trustees applied the old rules to trusts created before the adoption of the 1931 Act, but applied new rules to trusts created after the adoption of the Act.[17]

After World War II, business practices, along with corporate and economic structures, drastically changed,[18] making the 1931 Act ineffective.[19] For example,

> the accounting and financing practices of corporations had become much more complex and varied under the stress of efforts to minimize taxation; the investment trust and its distributions by way of income and capital gains had become important; court orders requiring corporations to dispose of holdings in other corporations had created new problems; and it was felt that the rules of the old Act regarding distributions from natural sources such as oil and gas were unduly favorable to remaindermen.[20]

In response, the 1931 Act was updated in the RUPIA.[21] RUPIA's main objective was to expand the significance of the expressed intent of the trust's settlor.[22] It also resolved some problems with the 1931 Act regarding allocation of money among trust beneficiaries.[23]

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12. *Id.*
13. UNIF. PRINCIPAL AND INCOME ACT, 7B U.L.A. (1931).
14. 1941 Cal. Stat. ch. 898, sec. 1, at 2476 (enacting CAL. PROB. CODE § 1).
15. Albert D. Spalding, *Put Your Trust in Trustees*, J. ACCT., Nov. 1, 1998, at 69, 69, *available in* 1999 WL 13734442.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. George G. Bogert, *The Revised Uniform Principal and Income Act*, 38 NOTRE DAME L. Rev. 50, 51 (1963).
21. *Id.*
22. *Id.*
23. *See id.* ("RUPIA-62 also resolved some issues of allocation among trust beneficiaries, with an eye to administrative convenience.").

California adopted the RUPIA in 1967.[24] Under this Act, the date the trust was created was irrelevant.[25] Thus, trustees who administered several trusts could apply just one set of rules and avoid misunderstandings such as those caused by the 1931 Act.[26]

One of the fundamental tenets of the RUPIA was to preserve the prudent person rule, which first appeared in *Harvard College v. Amory*.[27] That case stated that trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."[28] Operating under the prudent person rule, trustees were concerned with a trust's accounting income and with balancing that income with the need to avoid capital losses to the estate.[29] However, because the prudent person rule does not allow for any sort of speculation, trustees had difficulty meeting their goals when inflation was on the rise.[30]

When the trustee's investment activities were challenged, the trustee was held liable by the courts on an asset-by-asset basis.[31] For example, In *In re Bank of New York*,[32] the New York Court of Appeals considered a challenge to four investments held in trust.[33] During the four years the trust was managed, it experienced a gross gain of $1.7 million, with losses of $238,000.[34] The guardian of the trust brought an action for the losses.[35] The court concluded that the trustee Bank acted "in good faith and cannot be said to have failed to exercise 'such diligence and such prudence in the care and management (of the fund), as in general, prudent men of discretion and intelligence in such matters, employ in their own affairs.'"[36] However, even in light of its decision, the court noted that "[t]he fact that [the] portfolio showed [a] substantial overall increase in total value during the accounting period does not insulate the trustee from responsibility for imprudence with respect to individual investments for which it would otherwise be surcharged."[37] In other

24. 1967 Cal. Stat. ch. 1508, sec. 1, at 3576 (enacting CAL. CIV. CODE § 730).

25. *Id.*

26. Joseph Erdman & Diane E. Lederman, *Effective Drafting and Administration Under the Revised Uniform Principal and Income Act*, 18 EST. PLAN. 92, 92 (1991).

27. 26 Mass. (9 Pick.) 446 (1830).

28. *Id.*

29. Spalding, *supra* note 15, at 69.

30. Brantley Phillips, Jr., Note, *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 WASH. & LEE L. REV. 335, 342 (1997).

31. Spalding, *supra* note 15, at 69.

32. 323 N.E.2d 700 (1974).

33. *Id.* at 700.

34. Phillips, *supra* note 30, at 335, 369.

35. *Id.*

36. *Bank of New York*, 323 N.E.2d at 704.

37. *Id.*

words, the courts did not look at the overall return of the trust, but rather analyzed whether the trustee had acted in good faith.

C. Modern Portfolio Theory

The reason the prudent person rule was preserved was because high returns had never been the main goal of a trust.[38] The main goal of a trust is to preserve the principal and to provide income.[39] The trustee was responsible for making sure that each investment was safe while maintaining the level of prudence required under the rule.[40]

However, Modern Portfolio Theory revolutionized the world of fiduciary investment in the 1990s.[41] The theory rejects the notion that risky investments are imprudent investments.[42] Instead, it emphasizes that any asset, if bought at the right price and properly placed in a portfolio, can be a wise investment.[43] The key to this theory is diversification,[44] in which investors reduce their risk by holding many different investments rather than by assuring that each investment is safe.[45] In other words, investors should think in terms of their entire portfolio and not in terms of individual investments.[46] Therefore, the impact of the Modern Portfolio Theory is that stocks are no longer viewed as risky investments for trustees.[47] Even highly speculative stocks become appropriate if purchased as part of a diversified portfolio.[48]

D. The Uniform Prudent Investor Act

In 1995, California enacted the Uniform Prudent Investor Act.[49] The Act "utilizes the modern portfolio theory of investments, which provides that no investment will be viewed in [isolation as under the prudent person rule], but rather [will be viewed] as part of the entire portfolio."[50] Thus, an investor loses trust assets on one or more investments but has an overall positive return is not likely to be held

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38. Sara Hansard, *States Pushing Trust Companies, Despite Kicks, Not Stocks*, INVESTMENT NEWS, Mar. 29, 1999, at 18, 19.
39. *Id.*
40. *Id.*
41. Phillips, *supra* note 30, at 345.
42. *Id.* at 349.
43. *Id.* at 352.
44. *Id.*
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.*
49. CAL. PROB. CODE §§ 16045-16054 (West 1996).
50. Robert J. Alberts & Percy S. Poon, *The New Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries*, 34 AM. BUS. L.J. 39, 44 (1996).

liable to the beneficiaries.[51] The main goal of the prudent investor rule is to create a flexible standard that is in contrast to the historical approach, which favored only investments in government-backed securities and viewed investments in isolation.[52] Under the Prudent Investor Act, investors can invest in virtually any type of property they think is reasonable at the time of investment.[53]

III. CHAPTER 145

A. *General Revisions*

Chapter 145 enacts a new Uniform Principal and Income Act,[54] and makes a few technical revisions to the RUPIA.[55] The UPIA applies probate administration rules to revocable living trusts after the settlor's death and to other terminating trusts.[56] The new law also describes the procedure to determine and distribute net income and principal after the decedent's death,[57] and sets rules in the logical order in which a fiduciary should make determinations and allocations.[58] While interest from any monetary gift to the beneficiary must be provided from the remaining net income or from the principal if the net income is insufficient,[59] the UPIA provides several rules which the fiduciary must use in determining the remaining net income.[60] For example, the fiduciary must include in net income all income earned

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51. *Id.*
52. *Id*
53. *Id.*
54. CAL. PROB. CODE § 16320 (enacted by Chapter 145).
55. CAL. L. REVISION COMM'N, *supra* note 2, at 249.
56. *Id.*
57. CAL. PROB. CODE §16340(a) (enacted by Chapter 145).
58. CAL. L. REVISION COMM'N, *supra* note 2, at 285.
59. *See* CAL. PROB. CODE §16340(b) (enacted by Chapter 145) ("The fiduciary shall distribute to a beneficiary who receives a pecuniary amount, whether outright or in trust the interest or any other amount provided by the will, the trust . . . or from the remaining net income determined under subdivision (c) or from principal to the extent that net income is insufficient.")
60. *See id.* § 16340(c) (enacted by Chapter 145). The statute provides that:

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

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

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

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

Id.

from property that is to be used to discharge liabilities.[61] Furthermore, the fiduciary has the discretion to pay administrative fees from either principal or income.[62]

Another new rule promulgated by the UPIA allows the trustee to maintain separate accounting records if doing so is in the best interest of the beneficiaries.[63] The thrust of this section is to give the trustee broad authority and flexibility to select business record-keeping methods that best suit the activity in which the trustee is engaged.[64]

B. Obligation to Pay Money

Chapter 145 also revises the rules regarding the obligation to pay money.[65] Under the new law, money received as interest on a loan on an obligation to pay money is allocated to the principal.[66] However, after one year, money received from the sale or redemption of an obligation to pay money—including an obligation whose purchase price is less than its value at maturity—shall be allocated to principal.[67] In addition, funds received as interest on "an obligation to pay money" are "allocated to income."[68]

Subdivision (b) of section 16357 of California's Probate Code applies to all obligations acquired at a discount, including short term obligations such as U.S. treasury bills, as well as 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.[69] Under subdivision (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 period of less than one year.[70] Subdivision (b) also applies to inflation index 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.[71]

Section 16355 of the Probate Code promulgates the rules on allocation of principal receipts. Section (a) states that trustees must allocate assets received from

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61. *Id.* § 16340(c)(1) (enacted by Chapter 145).
62. *Id.* § 16340(c)(2) (enacted by Chapter 145).
63. *Id.* §16352(a) (enacted by Chapter 145).
64. CAL. L. REVISION COMM'N, *supra* note 2, at 301.
65. CAL. PROB. CODE § 16357(a) (enacted by Chapter 145).
66. *Id.*; *see id.* ("An amount received as interest, whether determined at a fixed, variable, or floating rate, on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, shall be allocated to principal.")
67. *Id.* § 16357(b) (enacted by Chapter 145).
68. *Id.* § 16357(a) (enacted by Chapter 145).
69. *Id.* § 16357(b).
70. *Id.*
71. *Id.*

a transfer of property, a decedent's estate, a trust with a terminating income interest, or a payer under a contract naming the trust or its trustee as beneficiary to principal.[72] The statute further includes instances in which the trustee must allocate money to income. These instances include amounts recovered from third parties to reimburse the trust[73] and proceeds of property taken by eminent domain.[74]

C. Trustee's Power to Allocate Principal and Income

Chapter 145 allows a trustee to make an adjustment between principal and income if certain conditions are satisfied.[75] For example, a trustee may adjust or shift receipts and expenses that have long been considered to be principal assets of a trust to income, and to pay such monies as income to the income beneficiaries.[76] The UPIA also permits the reverse: that is, a trustee has discretion to adjust or reallocate receipts and expenses that have traditionally been allocated to income to be treated thenceforth as principal and withheld from income beneficiaries.[77]

IV. ANALYSIS OF THE NEW LAW

A. The Opposition

The most controversial aspect of the UPIA is its empowerment of the trustee to adjust between principal and income accounts.[78] Under the 1962 RUPIA, the type of receipt determined whether an item was income or principal.[79] Traditionally, most capital gains were considered principal while stock dividends were income.[80] Using this allocation scheme, fiduciaries had a difficult time maximizing investment performance because of statutory requirements to balance portfolios between income-oriented investments and growth-oriented investments.[81] For

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72. *Id* § 16355(a) (enacted by Chapter 145).
73. *Id.* § 16355(c) (enacted by Chapter 145).
74. *Id.* § 16355(d) (enacted by Chapter 145).
75. CAL. PROB. CODE §16336(a) (enacted by Chapter 145); *see id.* (stating that:

A trustee may make an adjustment between principal and income to the extent the trustee considers necessary if all of the following provisions are satisfied:

(1) the trustee invests and manages trust assets under the prudent investor rule.
(2) the trust describes the amount that shall be distributed to a beneficiary by referring to the trust's income.
(3) The trustee determines, after applying the rules in subdivision (a) of section 16355, and considering any power the trustee may have under the trust to invade principal or accumulate income, that the trustee is unable to comply with subdivision (b) of section 16355).

76. *Id.*
77. *Id.*
78. Spalding, *supra* note 15, at 69.
79. *Id.*
80. *Id.*
81. *Id.*

example, fiduciaries did not have the power to transfer assets and follow market trends in order to maximize trust profits.[82] The UPIA further grants fiduciaries the power to distribute "investment returns to income and principal, irrespective" of how the income was derived.[83] The provision's thrust is to invest the trust's assets in a way that would maximize return and then take that return and allocate it to principal and income beneficiaries.[84]

In light of the UPIA's empowerment of trustees to allocate principal and income as the trustees see fit, critics say that the UPIA does not provide trustees with any standards they can follow in exercising discretion.[85] Section 16336, which governs the allocation between principal and income, gives no direction as to how trustees should implement the option to adjust.[86] As a result, opponents say that the new law is "vague, nonspecific, and of no help to trustees, and could justify differing results in similar situations among a variety of trustees."[87] Thus, the new law's detractors argue that the UPIA's vagueness and non-specificity gives rise to a possibility of disputes and litigation between beneficiaries and trustees regarding the extent of a beneficial interest.[88] Furthermore, opponents also contend that giving trustees the power to allocate assets between principal and income will increase the costs of managing a trust,[89] and that bestowing this power upon trustees will increase delays and make the process of administering a trust more complex—"a result that is in no one's best interest."[90]

B. In Support of the New Law

E. James Gamble attempts to dispel the worries about the effect of allowing trustees to adjust income and principal.[91] According to Mr. Gamble, the transition to the UPIA should be relatively easy with regard to existing trusts because the level of income that the trustee considers as fair for both income and remainder beneficiaries has already been established.[92] If the trustee of an existing trust begins to operate under the prudent investor rule and restructures the portfolio to produce a larger portion of total return in capital appreciation and a smaller portion in trust

82. *Id.*
83. *Id.*
84. *Id.*
85. *See, e.g.*, Alexander P. Misheff, *The Uniform Principal and Income Act: Look Before You Leap*, TR. LETTER, Mar. 1, 1998, at 10, *available in* 1999 WL 30047898 ("The act gives no meaningful standards for trustees to follow in exercising discretion.").
86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*
91. E. James Gamble, *The Power to Adjust Between Principal and Income Under the 1997 Uniform Principal and Income Act*, TR. LETTER, Aug. 1, 1998, at 7, *available in* 1999 WL 30047999.
92. *Id.*

accounting income, the trustee can look to the distribution history of the trust in determining the extent to which the power to adjust should be exercised under section 16336.[93]

Operating under the prudent investor rule does not necessarily mean that the trust accounting income will always be reduced.[94] If a trustee using the prudent investor rule decides that the risk and return objectives of the trust are best achieved by a portfolio in which the interest and dividend income is sufficient to provide the income beneficiary with the interest she should receive, the trustee will conclude that exercising the power to adjust is unnecessary.[95] However, if a trustee decides to change the portfolio so that it is composed of 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 will be necessary.[96]

The purpose of section 16336 is to protect a trustee who operates under the prudent investor rule and who manages the trust with a positive return but only a small amount of trust accounting income.[97] If the trustee decides that the principal invasion provision in the trust instrument is inadequate to provide the income beneficiary with a sufficient cash distribution, or if no principal invasion provision exists, section 16336 gives the trustee a power to adjust from principal to income.[98] In other words, UPIA empowers trustees to reallocate investment returns to either principal or income, irrespective of how the return was derived.[99] The goal of this provision is to allow trustees to make "aggregate investment decisions that maximize overall return and to reallocate that return among principal and income beneficiaries in a reasonable manner."[100] The following example sheds light on the effect of UPIA and the Prudent Investor Act:

> Allen is the trustee of a trust that provides trust income to the settlor's surviving spouse for life, with the remainder to the settlor's children. Allen received a portfolio of investments from the settlor comprising of 95% bonds and certificates of deposit and 5% stocks. Under the old rules, Allen would account for interest and dividends as income and capital gains as principal. Under UPIA, however, Allen would consider whether to allocate a portion of the interest income to principal as a return of capital. In

93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.*
99. Spalding, *supra* note 15, at 69.
100. *Id.*

making this determination Allen would consider the loss of principal value due to inflation and other factors.[101]

V. CONCLUSION

The UPIA raises the standard of care because it requires trustees to incorporate modern portfolio theory in their investment strategies.[102] For example, a trustee operating under the UPIA has the power to shift trust investments from the stock market to bonds during times of high volatility, thereby increasing trust income.[103] Once the trust income is realized, the UPIA allows the trustee to allocate that income to principal so that income beneficiaries do not enjoy a windfall "triggered solely by the trustee's compliance with the Uniform Prudent Investor Act."[104] As illustrated, the UPIA is an important step toward bringing estate planning into the twenty-first century. The implementation of the UPIA along with the prudent investor rule should modernize the administration of trusts for years to come.

101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*