



TRUSTS & ESTATES SECTION

THE STATE BAR OF CALIFORNIA

REVISED PROBATE CODE SECTION 16350 (Uniform Principal and Interest Act)

LEGISLATIVE PROPOSAL (T&E-2011-11)

TO: Saul Bercovitch, Legislative Counsel
State Bar Office of Governmental Affairs

FROM: Bart J. Schenone, Member of Executive Committee, Trusts and Estates Section

DATE: July 20, 2010

RE: Proposal to amend Probate Code section 16350 (Uniform Principal and Interest Act).

SECTION ACTION AND CONTACTS

Date of Approval by Section Executive Committee: April 24, 2010

Approval Vote:

For: 27 Against: 0 Abstain: 1

Contacts	Section Legislative Co-Chairs
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SUMMARY OF PROPOSAL:

Probate Code section 16350 of the Uniform Principal Income Act pertains to the manner in which amounts received from business entities are allocated as between principal beneficiaries and income beneficiaries of a trust. In general, funds from a business entity that are received in “partial liquidation” are deemed to be a principal receipt. Existing Section 16350 currently divides such receipts from business entities by determining whether there has been a partial liquidation according to a “bright-line” test.

Specifically, current Section 16350 deems a receipt from a business entity to be in “partial liquidation” (and therefore allocable to principal) in two situations: (1) the entity, at or near the time of a distribution, “indicates” that it is a distribution in partial liquidation; or (2) if the total amount of money and property received by all owners in the partial liquidation, collectively, in one or more distributions, is greater than 20 percent of the entity’s gross assets as shown by the entity’s yearend financial statements immediately preceding the initial receipt.

Recent caselaw has illustrated that the existing bright line rule ignores important considerations and can lead to inconsistent and arguably unfair results. In particular, what constitutes an indication from an entity that a distribution is in “partial liquidation” is very limited. The existing bright line test also precludes a trustee from relying upon information actually known to the trustee. Further, the existing rule generally does not provide for apportioning a receipt as between income or principal, instead requiring a receipt to be allocated either all to income or all to principal. As a result, the current allocation of receipts is based upon a rigid formula that ignores important facts and often results in an arbitrary “all or nothing” division between income and remainder interests.

This proposal would bring greater clarity and fairness to the categorization of amounts received from business entities as between principal and income. This proposal seeks to achieve this by permitting the trustee to act on facts concerning distributions actually known to the trustee, by providing for apportionment of a particular receipt between income and principal, and by providing an improved bright line test that would operate in the absence of the trustee having any information about the character of a receipt. This proposal would also provide protection from liability to trustees who rely on Section 16350 to make allocations of income and principal.

ISSUES AND PURPOSE:

Probate Code section 16350 became effective January 1, 2000, as part of the Uniform Principal and Income Act. Section 16350. Section 16350 superseded former section 16306 (“Corporate Distributions”) wherein the trustee was granted to discretion to “rely upon any statement of the distributing corporation as to any fact relevant under any provision of this chapter concerning the source or character of dividends or distributions of corporate assets.”

Under section 16350 distributions from a business entity are considered as income unless the distribution falls within certain exceptions. The pertinent exception with which this proposal is

concerned is “money received in one or a series of related distributions in exchange for part or all of a trust’s interest in the entity” [(c)(2)] or “money received in total or partial liquidation of the entity” [(c)(3)] .

Subdivision (d) states that money received in partial liquidation is allocable to principal in two situations: (1) the entity, at or near the time of a distribution, “indicates” that it is a distribution in partial liquidation; or (2) if the total amount of money and property received by all owners in the partial liquidation, collectively, in one or more distributions, is greater than 20 percent of the entity’s gross assets as shown by the entity’s yearend financial statements immediately preceding the initial receipt.

Under subdivision (d) if the entity does not “indicate” that the distribution is in partial liquidation and if the gross amount distributed among owners is 20% or less of the entity’s gross assets, then the distribution is allocated to income without regard to the amount of distribution.

Existing section 16350 creates these problems:

- (1) Trustees are not allowed to make allocations of income or principal based on information available or known to them; the “indications” test of existing section 16350 as interpreted by the courts is unnecessarily rigid.
- (2) The distributions are based on a “gross asset” test instead of a fair market value test which takes debt into account.
- (3) The 20% threshold to determine principal distributions is too high and is inconsistent with the more commonly utilized 10% threshold found in analogous section of the Principal and Income Act used to allocate income and principal.
- (4) Protections from liability for the trustee are inadequate in light of the deficiencies enumerated above.

The one case interpreting section 16350 is the 2007 case of *Hasso v. Hasso* (2007) 148 Cal.App.4th 329. The *Hasso* case illustrates several of the shortcomings of existing Section 16350. In *Hasso* the trustee held approximately 15 percent of the common stock of a corporation. This corporation also held an interest in an affiliate. The affiliate owned a holding company in France and an office building in France. During 2003 the affiliate sold the holding company and later sold the office building, distributing the sale proceeds to the corporation, which eventually received more than \$125 million. The total of the distributions received by the corporation was then distributed to its shareholders, including the Hasso trust. These distributions amounted to between 35 and 50 percent of the corporation’s net value. In total, the Hasso trust received tens of millions of dollars through these distributions. The board of directors of the corporation characterized the sales proceeds as a return of capital and appreciation and stated that 85-90 percent of the distribution would result in capital gains. This characterization was followed by a letter from a corporation board member (and who was also the vice president of the corporation and a tax attorney) advising he “understood the distribution constituted a principal distribution”.

At issue, in *Hasso*, therefore, was whether this distribution of tens of millions of dollars was income or principal. If characterized as income, the net result would be a significant reduction in the value of the remainder interest of the trust, and, correspondingly, would result in a significant trust distribution to the income beneficiary. If characterized as principal, the receipt would remain in trust and presumably would ultimately be available for future distribution to the remainder beneficiaries.

The *Hasso* court held that the distribution was income, relying on the fact that the distribution was less than 20% of value of the corporation “gross assets.” Although the amounts received by all owners were between 35 and 50 percent of the corporation’s net value, Section 16350 utilizes valuation based on “gross assets” without regard to debt.

The *Hasso* court also determined that the “indications” test of section 16350(d)(1)(A) was not met. In reaching this finding, the court held that the language used by the corporation’s board of directors was not specific enough for the trustee to rely upon as an “indication” of a partial liquidation.

In applying the “bright-line test” the *Hasso* court highlighted the short-comings of existing Section 16350. In particular, relying on “gross assets” in applying the percentage test is an inaccurate method of measuring value. In the *Hasso* case the corporation was highly leveraged; its debt was \$534 million. As a result, where a company is highly leveraged, a distribution that constitutes a large percentage of the net value of a corporation would, under Section 16350, still not be deemed to be in “partial liquidation” and thus would be allocated to income. Presumably, the concept of “partial liquidation” was meant to capture distributions that returned a portion of the capital or principal of a trust’s investment in an entity, as opposed to distributions that constitute interest or dividends received on that underlying investment. Utilizing a net assets valuation test would more closely track this intention. By contrast, reliance on the entity’s gross assets produces inconsistent and arguably improper results.

Moreover, the “bright line” rule produces different results in situations which are relatively the same. For instance, assume two different trusts, A and B. The A Trust owns 20 parcels of real property, all of equal value. The B Trust owns the same identical properties, except that the settlor transferred the 20 real properties into a family limited partnership so that the trust only owns an interest in the partnership rather than direct ownership of the real properties. During 2006 the A Trust sells two parcels; the proceeds are properly allocated to principal. In the same year the B Trust sells two properties. If the partnership then distributes the sale proceeds to Trust B, under section 16350 the distributions of the sale proceeds must be allocated to income because the distributions are less than 20% of the value of the family limited partnership’s gross assets.

The results of the “bright line test” becomes even more arbitrary by the “all or nothing” rule: if the distribution is greater than 20% of “gross assets” the remainder beneficiaries receive all of the distribution and are therefore the “winners”; if less, the income beneficiaries are the “winners.” Section 16350 does not permit a distribution to be split or apportioned.

The 20% “bright line” test is also inflexible. Further, why 20%? Why not 10% as is commonly utilized in other similar statutes? For example, Probate Code section 16362 directs the trustee to distribute 10% of a “liquidating asset” (e.g. leasehold, patent, copyright or royalty right) to income and the remaining 90% to principal. Probate Code section 16362 deals with the same situation as section 16350: a “liquidating asset”. Similarly, recently-amended section 16361 specifies a distribution of 10% of a payment, unspecified as to character, from a “separate fund” to income and the remaining 90% to principal. Thus, use of a 10% income rule would be consistent with other provisions in similar situations in the Uniform Principal and Income Act.

Finally, the entity indication exception under section 16350(d)(1)(A) provides little assistance if it is limited to “specific” statements made by the entity, particularly when “specific” itself is ambiguous and lacks definition. As evidenced by the *Hasso* court’s decision, this definition may be very limited. In *Hasso*, the board of director’s and vice-president’s statements failed to meet the “specificity” standard of the *Hasso* court.. A trustee ought to be able to rely upon, not only specific statements made by an entity, but on the trustee’s own actual knowledge concerning the character of the distribution. On this point, former section Probate Code 16306 provided more flexibility to the trustee by allowing reliance upon “any statement of the distributing corporation as to any fact relevant under any provision of this chapter.”

Unquestionably, however, if reliance is to be made by a trustee on information received or actually known, then the trustee should also be protected in situations where the trustee in good faith properly applies the test provided in Section 16350 based upon the information the trustee knows as of the time of allocation. If the trustee later receives information after acting in reliance on the information available at the time of the allocation, such trustee should not be held liable on the basis of such subsequently discovered information.

EXPLANATION OF PROPOSED CHANGES:

The proposal continues the general rule that any distribution is income unless certain exceptions are found. With respect to distributions made in partial liquidation under (c)(3), the proposal makes the following changes in section 16350, subdivision (d):

- (1) The “entity indicates” language is replaced by language that a trustee “may rely, without independent investigation, on a statement made by the entity about the source or character of the receipt or any other information which is actually known by the trustee about the source or character of the receipt”
- (2) In circumstances where the trustee has no information concerning the character of the receipt, the “bright-line” rule of 20% of the value of the “gross assets” value is replaced by a test which measures whether the distribution is more than 10% of the value of the trust’s interest in the entity. If the interest of the trust in the entity is in securities publicly-traded on a public exchange or market, then the value is determined as of the last trade of the security on the public exchange or market occurring before the date the first distribution is paid during the accounting period. If the interest of the trust is in other

assets, then the default rule is to use the trust's book value unless there is a more recent appraisal.

Under (1) and (2) there is no obligation of the trustee to make an independent inquiry into the nature of the distribution. As stated above, the information received or actually known by the trustee is the first test to be applied. If there is no information, then the test under (2) becomes operative.

(3) New (d)(3) gives the trustee protection from liability based upon subsequently discovered information in situations where the trustee has made an allocation based on information available at the time where such information is received after a reasonable time period after the distribution from the entity is received. Such reasonable time period is defined as the earlier of the date that is 90 days after the date of receipt of the distribution or the date that is 45 days after the end of the trust's fiscal year. These dates correspond to when the trustee commonly will make income distributions: generally quarterly or within 65 days after the fiscal year-end.

(4) Other portions of section 16350 remain unchanged, although their placement within the section has been modified.

HISTORY :

Has a similar bill been introduced either this session or during a previous legislative session? No.

IMPACT ON PENDING LITIGATION:

Will the proposal have any impact on litigation currently pending? None known.

FISCAL IMPACT:

No anticipated fiscal impact.

LIKELY SUPPORT/OPPOSITION:

After *Hasso* was decided, a group that included representatives of TEXCOM and the California Bankers Association had a series of discussions to address potential amendments to Probate Code section 16350, in response to *Hasso*. The working group did not reach a final resolution, and eventually TEXCOM took the lead in drafting proposed statutory amendments, which resulted in this legislative proposal. Other participants in the working group have been made aware of this proposal, and TEXCOM is seeking their input. At this point, the extent of support for or opposition to the proposed statutory amendments (or any other proposed amendments that would vary a provision of the Uniform Principal and Income Act) is uncertain, but TEXCOM plans to continue seeking input from other interested parties.

GERMANENESS:

The State Bar's Trusts and Estates Section deals with estate and trust administration. Section members are involved in administration on a regular basis. The subject matter of the legislation comes within the scope of the interests and knowledge of the Trust and Estates Section of the State Bar of California.

TEXT OF PROPOSAL

SECTION 1. Section 16350 of the Probate Code is amended to read:

16350. (a) For the purposes of this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or decedent's estate to which Section 16351 applies, a business or activity to which Section 16352 applies, or an asset-backed security to which Section 16367 applies.

(b) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.

(c) A trustee shall allocate to principal the following receipts from an entity:

(1) Property other than money.

(2) Money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity.

(3) Money received in one distribution or a series of distributions in total or partial liquidation of the entity.

(4) Money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

(d) For purposes of paragraph (3) of subdivision (c) ~~(1) Money is received in partial liquidation (A) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation, or (B) if the total amount of money and property received by all owners, collectively, in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as shown by the entity's yearend financial statements immediately preceding the initial receipt. If that receipt is money shall be treated as received in a distribution in partial liquidation to the extent the receipt is attributable to the proceeds from a sale, directly or indirectly, by the entity of a capital asset, subsidiary, or, business line. With respect to determining whether money is received in partial liquidation a trustee may rely, without independent investigation, on a statement made by the entity about the source or character of the receipt or any other information which is actually known by the trustee about the source or character of the receipt. If the entity provides no such information to the trustee~~

and the trustee has no actual knowledge of the source or character of the receipt, the following shall apply:

(1) *The trustee shall have no duty to inquire or investigate whether a receipt is in partial liquidation of an entity.*

(2) *If the amount of the receipt or series of receipts received during a single accounting period of the trust is in excess of ten percent (10%) of the value of the trust's interest in the distributing entity, the receipt or series of receipts shall be deemed to be received in partial liquidation of the distributing entity, and the trustee shall allocate such receipts to principal. Notwithstanding the foregoing, a trustee may, in the trustee's discretion, allocate to income from such receipts an amount that does not exceed ten percent (10%) of the value of the trust's interest in the entity. If the amount of the receipt or series of receipts received during a single accounting period of the trust is less than or equal to ten percent (10%) of the value of the trust's interest in the distributing entity, the receipt or series of receipts shall not be deemed to be received in partial liquidation of the distributing entity, and the trustee shall allocate such receipts to income. If the trust's accounting period is longer or shorter than one year, the ten percent (10%) amount shall be adjusted accordingly. If the trust's interest in the distributing entity changes during the accounting period as a result of a sale, exchange, purchase or other transaction, each receipt shall be measured against the value of the trust's interest in the distributing entity at the time of the receipt by the trust to determine the percentage of the interest the receipt represents, and the resulting percentages of all receipts received during the accounting period shall be added together to determine whether the total exceeds ten percent (10%) of the value of the trust's interest in the distributing entity.*

(3) *For purposes of paragraph (2) of this subdivision, the value of the trust's interest in the distributing entity shall be (i) in the case of an interest that is a security regularly traded on a public exchange or market, the same per-unit price of the last trade of the security on the public exchange or market occurring before the date the first distribution is made, or (ii) in the case of other interests, the carrying value on the trustee's accounting books as of the date the first distribution is made during the accounting period, provided, however, if the interest (or similar interest) has been appraised by a qualified appraiser as of a date that is after the carrying value was first established and before the date of the first distribution during the accounting period, and if that appraised value is known to the trustee, then the value of the interest shall be as set forth on the latest such appraisal.*

(e) (1) *If a trustee allocates a receipt to income or principal in accordance with subdivision (d) on, before, or within 30 days after the applicable date based on information received or actually known by the trustee as of the applicable date, the trustee shall not be liable for any claim of improper allocation of a receipt which is based on information that was not received or actually known by the trustee before the applicable date.*

(2) *If a trustee allocates a receipt to income or principal in accordance with subdivision (d) more than 30 days after the applicable date and on the date of allocating the receipt the trustee has neither received information nor has any actual knowledge of the source or character of the receipt, then the trustee shall not be liable for any claim of improper allocation of the receipt which is based on information that was not received or actually known by the trustee as of the date of allocation.*

(3) *For purposes of this subdivision, the term "applicable date" is the earlier of (i) the date that is 90 days after the receipt of the distribution, or (ii) 45 days after the end of the trust's fiscal year.*

(f) *Notwithstanding anything to the contrary in subdivision (d), if the receipt was allocated between December 2, 2004 and ~~the operative date of the act adding this sentence~~ July 18, 2005, a trustee shall not be liable for allocating the receipt to income if the amount received by the trustee, when considered together with the amount received by all owners, collectively, ~~exceeds~~ exceeded 20 percent of the entity's gross assets, but the amount received by the trustee ~~does~~ did not exceed 20 percent of the entity's gross assets.*

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

(e) *A trustee may rely on a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.*