



TRUSTS & ESTATES SECTION

THE STATE BAR OF CALIFORNIA

UNIFORM PRINCIPAL AND INCOME ACT

LEGISLATIVE PROPOSAL (T&E 2016-08)

TO: Office of Governmental Affairs

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

DATE: July 21, 2015

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

SECTION ACTION AND CONTACTS

Date of Approval by Section Executive Committee: June 13, 2015

Approval Vote:

For: 25 Against: 0 Abstain: 0

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SUMMARY OF PROPOSAL

Probate Code section 16350 of the Uniform Principal and Income Act pertains to the allocation of amounts received from business entities 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 determines 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 year-end financial statements immediately preceding the initial receipt.

In 2013, TEXCOM sponsored AB 1029 (Stats. 2013, ch. 105), which amended Section 16350, primarily to provide a more effective and consistent test for determining if there has been a “partial liquidation” under the statute. Those amendments defined “capital asset” to mean “a capital asset as defined in Section 1221 of the Internal Revenue Code.” Section 16350 was amended again by AB 296 (Stats. 2014, ch. 867), but that bill did not touch the definition of “capital asset.” This legislative proposal corrects an unintended drafting oversight in section 16350 resulting from the definition of “capital asset.” Section 1221(a)(2) of the Internal Revenue Code expressly omits depreciable property, such as real estate used in a trade or business. This omission was unintended inasmuch as many entities, such as limited partnerships or limited liability companies, hold depreciable real estate. The proposed amendment to the definition of “capital asset” would define it as “property with an estimated life of one year or greater, other than inventory.”

ISSUES AND PURPOSE

Probate Code section 16350 became effective January 1, 2000, as part of the Uniform Principal and Income Act. Section 16350 superseded former section 16306 (“Corporate Distributions”) wherein the trustee was granted the 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 income unless the distribution falls within certain exceptions. In section 16350(a)(2) “capital asset” means a “capital asset as defined in Section 1221 of the Internal Revenue Code.” Under Section 1221(a)(2) of the Internal Revenue Code “capital asset” does not include “property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business.”

Many individuals and trusts are owners or co-owners of entities, such as limited partnerships and limited liability companies that hold depreciable real property. Ownership by an entity is deemed preferable because the entity provides centralized management, limited liability to the owners, and control over transfer of interests. The owners do not intend the “capital” within a limited partnership or limited liability company – specifically, real property - to be deemed “income” when the property is sold and the proceeds distributable from a tax perspective. If the trust or the individual owned the real property, the receipt of proceeds from sale of real property would be considered principal. The fact a limited partnership or limited liability company owns the real property does not convert an asset held as principal into income because there is a liquidation of the interest. The use of section 1221 of the Internal Revenue Code as a definition of “capital asset” is counter to the intentions of the party. A correct definition of “capital asset” is one recognized by accountants and others within the financial community as “property with an estimated life of one year or greater, other than inventory.”

The proposed statutory amendment is very straightforward. Section 16350 (a)(2) would be modified as follows:

(2) Capital asset means ~~a capital asset as defined in Section 1221 of the Internal Revenue Code~~ property with an estimated life of one year or greater, other than inventory.

Probate Code Section 62 provides: “‘Property’ means anything that may be the subject of ownership and includes both real and personal property and any interest therein.” And, the reference to that property generally recognized by accountants to be long term, and therefore a capital asset, if it has an estimated useful life of one year or greater, more accurately defines the property intended to be the subject of Probate Code section 16350. Inventory is not capital and is therefore excluded.

HISTORY

Probate Code section 16350 was added by AB 846 (Stats. 1999, ch. 145). It was amended by SB 296 (Stats. 2005, ch. 51), effective July 18, 2005; AB 1029 (Stats. 2013, ch. 105); and AB 296 (Stats. 2014, ch. 867), effective September 30, 2014.

IMPACT ON PENDING LITIGATION

None known.

LIKELY SUPPORT AND OPPOSITION

TEXCOM supports this legislation.

There is no known opposition.

FISCAL IMPACT

There is no anticipated fiscal impact.

GERMANENESS

Members of TEXCOM deal with estate and trust administration on a regular basis. The subject matter of the proposed legislation comes within the particular scope of the interests and knowledge of TEXCOM.

TEXT OF PROPOSAL

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

(a) For the purposes of this section:

(1) "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.

(2) "Capital asset" means ~~a capital asset as defined in Section 1221 of the Internal Revenue Code~~ property with an estimated life of one year or greater, other than inventory.

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

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

(1) Property other than money.

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

(3) Money received in total liquidation of the entity or in partial liquidation of the entity, as defined in subdivision (d), except for money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a net short-term capital gain distribution.

(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. A capital gain dividend shall not include money received as a net short-term capital gain distribution from a regulated investment company or real estate investment trust.

(d) For purposes of paragraph (3) of subdivision (c), money shall be treated as received in partial liquidation to the extent the amount received from the distributing entity is attributable to the proceeds from a sale by the distributing entity, or by the distributing entity's subsidiary or affiliate, of a capital asset. The following shall apply to determine whether money is received in partial liquidation:

(1) A trustee may rely without investigation on a written statement made by the distributing

entity regarding the receipt.

(2) A trustee may rely without investigation on other information actually known by the trustee regarding whether the receipt is attributable to the proceeds from a sale by the distributing entity, or by the distributing entity's subsidiary or affiliate, of a capital asset.

(3) With regard to each receipt from a distributing entity, if within 30 days from the date of the receipt the distributing entity provides no written statement to the trustee that the receipt is a distribution attributable to the proceeds from a sale of a capital asset by the distributing entity or by the distributing entity's subsidiary or affiliate and the trustee has no actual knowledge that the receipt is a distribution attributable to the proceeds from a sale of a capital asset by the distributing entity or by the distributing entity's subsidiary or affiliate, then the following shall apply:

(A) The trustee shall have no duty to investigate whether the receipt from the distributing entity is in partial liquidation of the entity.

(B) If, on the date of receipt, the receipt from the distributing entity is in excess of 10 percent of the value of the trust's interest in the distributing entity, then the receipt shall be deemed to be received in partial liquidation of the distributing entity, and the trustee shall allocate all of the receipt to principal. For purposes of this subparagraph, the value of the trust's interest in the distributing entity shall be determined as follows:

(i) In the case of an interest that is a security regularly traded on a public exchange or market, the closing price of the security on the public exchange or market occurring on the last business day before the date of the receipt.

(ii) In the case of an interest that is not a security regularly traded on a public exchange or market, the trust's proportionate share of the value of the distributing entity as set forth in the most recent appraisal, if any, actually received by the trustee and prepared by a professional appraiser with a valuation date within three years of the date of the receipt. The trustee shall have no duty to investigate the existence of the appraisal or to obtain an appraisal nor shall the trustee have any liability for relying upon an appraisal prepared by a professional appraiser. The term "professional appraiser" shall refer to an appraiser who has earned an appraisal designation for valuing the type of property subject to the appraisal from a recognized professional appraiser organization.

(iii) If the trust's interest in the distributing entity cannot be valued under clause (i) or clause (ii), the trust's proportionate share of the distributing entity's net assets, to be calculated as gross assets minus liabilities, as shown in the distributing entity's yearend financial statements immediately preceding the receipt.

(iv) If the trust's interest in the distributing entity cannot be valued under clause (i), (ii), or (iii), the federal cost basis of the trust's interest in the distributing entity on the date immediately before the date of the receipt.

(e) If a trustee allocates a receipt to principal in accordance with subdivision (d), or allocates a receipt to income because the receipt is not determined to be in partial liquidation under subdivision (d), the trustee shall not be liable for any claim of improper allocation of the receipt that is based on information that was not received or actually known by the trustee as of the date of allocation.

(f)(1) Notwithstanding anything to the contrary in subdivision (d), if the receipt was allocated between December 2, 2004, and 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, exceeded 20 percent of the entity's gross assets, but the amount received by the trustee did not exceed 20 percent of the entity's gross assets.

(2) Money is not received in partial liquidation, nor may it be taken into account under 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.