



## TRUSTS & ESTATES SECTION

THE STATE BAR OF CALIFORNIA

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

### **LEGISLATIVE PROPOSAL (T&E-2013-13)**

**TO:** Office of Governmental Affairs

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

**DATE:** May 11, 2012

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

#### **SECTION ACTION AND CONTACTS**

Date of Approval by Section Executive Committee: May 11, 2012

Approval Vote: For: 30 Against: 0 Abstain: 0

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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. As a result, the current allocation of receipts is based upon a rigid formula that ignores important facts.

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, 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 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.”

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\* In 2010, the then Board of Governors approved a legislative proposal that would have addressed the same issues addressed by this proposal, but with different proposed statutory language aimed at resolving those issues. Some issues were subsequently raised about that proposed statutory language, and the proposal was never placed as legislation. The proposed statutory language has since been revised, as a result of discussions with representatives of the California Bankers Association. In addition, as discussed below, a second case has been decided since the proposal that was approved in 2010 was drafted. There is now a disagreement in case law concerning the interpretation of the statute in question, resulting in even more confusion in this area.

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 sections 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 **first** 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 board of directors was not specific enough for the trustee to rely upon as an “indication” of a partial liquidation. Notwithstanding a written communication from the corporate board member/vice-president/tax attorney of the corporation that he “understood the distribution constituted a principal distribution”, the Court disregard such information as “not specific enough” to be an “indication” for purposes of Section 16350.

On the other hand, a **second** case decided in 2010, *Manson v. Shepherd* (2010) 188 Cal.App.4th 1244, analyzed the “indications” test differently, using a “plain meaning” definition of “indications”. It held the “indications” means “to point out, point to, make known, show more or less directly.” In *Manson* the trustee/surviving spouse and controlling member of the distributing corporation actually knew because of her personal involvement that the source of a distribution from an entity was in partial liquidation of that entity, but, nevertheless, controlled the corporate resolution to state that the distribution received was a “dividend.” The Court of Appeal affirmed the Trial Court determination that the source of the distribution was in partial liquidation, finding substantial evidence to “indicate” the distribution in partial liquidation of the entity.

There exists, therefore, disagreement in case law concerning what “indications” means in section 16350, calling for a legislative resolution.

*Hasso* also illustrates deficiencies in the “bright-line” test of section 16350 that relies on “gross assets” in applying the percentage test. *Hasso* shows that using “gross assets” for 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 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. How to determine value is resolved by a “tiered” group of criteria in order to find the most appropriate determination of value:
  - First, if the interest of the trust in the entity is a security publicly-traded on a public exchange or market, then the value is determined by the closing price of the security on the last business day before the date of receipt.
  - Second, in the case of an interest that is not a security publicly traded on a public exchange or market, the value as set forth by a professional appraiser of the trust’s interest in the distributing entity within a valuation date of 3 years of the date of receipt, if such appraised value is actually known by the trustee.
  - Third, in the case of an interest that is not a security publicly traded on a public exchange or market and for which there is no appraisal meeting the requirements of (D)(ii), the value of the trust’s interest in the distributing entity shall be the trust’s proportionate share of the distributing entity’s net assets as shown in the distributing entity’s yearend financial statements immediately preceding receipt.
  - Fourth, if the trusts interest in the distributing entity cannot be valued under subparagraphs (D)(i), (D)(ii), or (D)(iii), the federal cost basis of the trust’s interest in the distributing entity immediately before the date of the receipt.

Under none of the tests above is there an 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 “tiered” determination under (2) becomes operative.

- (3) New (f) gives the trustee protection from liability based upon subsequently discovered information in situations where the trustee has already made an allocation based on information available at the time where such information is received within a reasonable

time period after the distribution from the entity is received. This safe harbor time period is defined to extend to the date that is 60 days after the date of receipt of the distribution. If the trustee allocates the distribution by that date, the trustee may rely on information the trustee has received within the first 30 days after receipt of the distribution. Protection is also provided for trustees who make an allocation after the first 60 days, but such protection is limited solely to protection from liability for information that is received after the actual date of allocation.

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

**HISTORY:**

No similar legislation has been introduced to date.

**IMPACT ON PENDING LITIGATION:**

None known.

**FISCAL IMPACT:**

No anticipated fiscal impact.

**LIKELY SUPPORT/OPPOSITION:**

The Executive Committee of the Trusts and Estates Section (TEXCOM) does not anticipate any opposition.

**GERMANENESS:**

TEXCOM 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 members of TEXCOM.

**DISCLAIMER:**

This position is only that of the Trusts and Estates Section of the State Bar of California. This position has not been adopted by either the State Bar's Board of Trustees or overall membership, and is not to be construed as representing the position of the State Bar of California.

Membership in the Trusts and Estates Section is voluntary and funding for section activities, including all legislative activities, is obtained entirely from voluntary sources.

## **TEXT OF PROPOSAL**

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

#### **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 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 as defined in Section 1221 of the Internal Revenue Code. 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 source of the receipt.~~

[Inserted text begins](2) A trustee may rely without investigation on any other information which is actually known by the trustee regarding the source of the receipt. [Inserted text ends]

[Inserted text begins](3) If within thirty (30) days from the date of receipt the distributing entity provides no written statement to the trustee regarding the source of the receipt and the trustee has no actual knowledge regarding the source of the receipt, then the following shall apply:[Inserted text ends]

[Inserted text begins](A) The trustee shall have no duty to inquire or investigate whether a receipt from the distributing entity is in partial liquidation of the entity. [Inserted text ends]

[Inserted text begins](B) Each receipt from the distributing entity in excess of ten percent (10%) of the value of the trust's interest in the distributing entity shall be deemed to be received in partial liquidation of the distributing entity, and the trustee shall allocate all of such receipt to principal. [Inserted text ends]

[Inserted text begins](C) This paragraph (d)(3) shall apply separately to each receipt from a distributing entity.[Inserted text ends]

[Inserted text begins](D) For purposes of sub-paragraph (B), the value of the trust's interest in the distributing entity shall be determined as follows:[Inserted text ends]

[Inserted text begins](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:[Inserted text ends]

[Inserted text begins](ii) In the case of an interest that is not a security regularly traded on a public exchange or market, the value as set forth in the most recent appraisal prepared by a professional appraiser of the trust's interest in the distributing entity with a valuation date within 3 years of the date of the receipt, if such appraised value is actually known to the trustee without any duty of the trustee to investigate the existence of such appraisal. The trustee shall have no duty to obtain an appraisal for purposes of this sub-paragraph (D) or sub-paragraph (B), nor shall the trustee have any liability for relying upon an appraisal prepared by a professional appraiser for purposes of this sub-paragraph (D) or sub-paragraph (B). 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:[Inserted text ends]

[Inserted text begins](iii) In the case of an interest that is not a security regularly traded on a public exchange or market and for which there is no appraisal meeting the requirements of subparagraph (D)(ii), the value of the trust's interest in the distributing entity shall be the trust's proportionate share of the distributing entity's net assets as shown in the distributing entity's yearend financial statements immediately preceding the receipt; [Inserted text ends]

[Inserted text begins](iv) If the trust's interest in the distributing entity cannot be valued under subparagraphs (D)(i), (D)(ii) or (D)(iii), the federal cost basis of the trust's interest in the distributing entity on the date immediately before the date of the receipt. [Inserted text ends]

[Inserted text begins](e) For purposes of subdivision (d) of this Section, a written statement or other information "regarding the source of the receipt" refers to a written statement or other information indicating whether or not such 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 as defined in Section 1221 of the Internal Revenue Code. [Inserted text ends]

[Inserted text begins](f) (1) If within 60 days of the date of the receipt 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), based on information received or actually known by the trustee on the date that is 30 days after the date of the receipt, 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 within 30 days of the date of the receipt. [Inserted text ends]

[Inserted text begins](2) 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), more than 60 days after the date of receipt, and on the date of allocating the receipt the trustee has neither received information nor has any actual knowledge, without any duty to investigate, of the source 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. [Inserted text ends]

[Inserted text begins](g) Notwithstanding anything to the contrary in subdivision (d), if the receipt was [Inserted text ends] allocated between December 2, 2004 and [Deleted text begins]the operative date of the act adding this sentence[Deleted text end][Inserted text begins] July 18, 2005 [Inserted text ends], 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, [Deleted text begins]exceeds[Deleted text end] [Inserted text begins]exceeded[Inserted text ends] 20 percent of the entity's gross assets, but the amount received by the trustee [Deleted text begins]does[Deleted text end] [Inserted text begins]did[Inserted text ends] not exceed 20 percent of the entity's gross assets.

(h) Money is not received in partial liquidation, nor may it be taken into account under [Deleted text begins]clause (B) of paragraph(1) [Deleted text end][Inserted text begins] subdivision (d)[Inserted text ends], 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.

[Deleted text begins] (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. [Deleted text end]