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## **Analysis re Adjustment between Principal and Income**

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Note: The Uniform Law Commission comments on the model Principal and Income Act are helpful to this analysis. A link to that document follows: [Link to Uniform Law Commission](#).

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Based on my review of the California Principal and Income Act, the Uniform Law Commission's comment on the model Act, and the trust document(s), I conclude that the trustee DOES have the authority to make adjustments between income and principal annually upon some established policy or consistent with the adoption of a unitrust administrative scheme. Following is my analysis. I recommend the trustee have their legal counsel review this analysis.

### **Purpose and Scope of the California P&I Act**

The purpose of the Act 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.

The Act 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 16335(a) that he is unable to comply with Section 16335(b).

In deciding whether and to what extent to exercise the power to adjust, the trustee is required to consider the factors described in Section 16336(a), but the trustee may not make an adjustment in circumstances described in Section 16336(b).

**CA Prob Code § 16336:**

(a) Subject to subdivision (b), a trustee may make an adjustment between principal and income to the extent the trustee considers necessary if all of the following conditions are satisfied:

(1) The trustee invests and manages trust assets under the prudent investor rule. **It does manage the trust within the “context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.”**

(2) The trust describes the amount that shall or may be distributed to a beneficiary by referring to the trust’s income. **The trust documents direct that “net income” of the trust be distributed.**

(3) The trustee determines, after applying the rules in subdivision (a) of Section 16335, and considering any power the trustee may have under the trust to invade principal or accumulate income **[he has no power to invade principal or accumulate income under this trust]**, that the trustee is unable to comply with subdivision (b) of Section 16335. **Under the current Net Income distribution scheme the trustee is *unable to balance* the interest of the income beneficiary and remainder beneficiaries. The Net Income administrative construct of the trust and the trusts current investment allocation create an outcome that unfairly preferences the remainder beneficiary over the interest of the current beneficiary. The trustee finds it impossible (impracticable) to administer the trust impartially given these constraints.**

(b) A trustee ***may not make*** an adjustment between principal and income in any of the following circumstances:

(1) Where it would diminish the income interest in a trust (A) that requires all of the income to be paid at least annually to a spouse and (B) for which, if the trustee did not have the power to make the adjustment, an estate tax or gift tax marital deduction would be allowed, in whole or in part. **The current beneficiary is not the testator's spouse, and no marital deduction would be affected by an adjustment.**

(2) Where it would reduce the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion. **This is a long settled trust, and no transfer of property to the trust can be made nor is any gift tax exclusion affected by this adjustment.**

(3) Where it would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets. **According to the Uniform Law Commission, the purpose of this section is to prohibit adjustments to annuity trusts and unitrusts where the payout rate has already been established or to trusts with charitable income or remainder beneficiaries.** [Link to Uniform Law Commission... see page 15](#)

(4) Where it would be made from any amount that is permanently set aside for charitable purposes under a will or trust, unless both income and principal are so set aside. **In this case no amount of this trust has been permanently set aside for a charitable purpose which would prevent an adjustment.**

(5) Where possessing or exercising the power to make an adjustment would cause an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment. **In this case the adjustment would not cause any part to be treated as the owner of all or part of the trust for income tax purposes.**

(6) Where possessing or exercising the power to make an adjustment would cause all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment. **In this case the adjustment would not cause all or part of the trust assets to be included in the beneficiary's estate.**

(7) Where the trustee is a beneficiary of the trust. **In this case the trustee is not the beneficiary of the trust.**

(8) During any period in which the trust is being administered as a unitrust pursuant to the trustee's exercise of the power to convert provided in Section 16336.4 or 16336.5, or pursuant to the terms of the governing instrument. **In this case the adjustment will not be made during a period in which the trust is being administered as a unitrust.**

(c) Notwithstanding Section 15620, if paragraph (5), (6), or (7) of subdivision (b) applies to a trustee and there is more than one trustee, a cotrustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the trust. **In this case there is only one trustee.**

(d) A trustee may release the entire power conferred by subdivision (a) or may release only the power to adjust from income to principal or the power to adjust from principal to income in either of the following circumstances: (1) If the trustee is uncertain about whether possessing or exercising the power will cause a result described in paragraphs (1) to (6), inclusive, of subdivision (b). (2) If the trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subdivision (b). **In this case the trustee does NOT seek to release the power conferred by section (a) to make an adjustment between principal and income. Nor has the trustee concluded that exercising this power to adjust will deprive the trust of a tax benefit or impose a tax burden upon the trust.**

(e) A release under subdivision (d) may be permanent or for a specified period, including a period measured by the life of an individual. **The trustee seeks no such release from the power to make an adjustment between principal and income.**

(f) A trust that limits the power of a trustee to make an adjustment between principal and income does not affect the application of this section unless it is clear from the trust that it is intended to deny the trustee the power of adjustment provided by subdivision (a). **There is no language in the trust that prohibits or denies the trustee the power to adjust.**

(g) In deciding whether and to what extent to exercise the power to make adjustments under this section, the trustee may consider, but is not limited to, any of the following: (1) The nature, purpose, and expected duration of the trust. (2) The intent of the settlor.

(3) The identity and circumstances of the beneficiaries. (4) The needs for liquidity, regularity of income, and preservation and appreciation of capital. (5) The assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor. (6) The net amount allocated to income under other statutes and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available. (7) Whether and to what extent the trust gives the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income. (8) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation. (9) The anticipated tax consequences of an adjustment. **The trustee has carefully considered all of these factors.**

(h) Nothing in this section or in this chapter is intended to create or imply a duty to make an adjustment, and a trustee is not liable for not considering whether to make an adjustment or for choosing not to make an adjustment.