



2000 California Principal & Income Law

California has changed its Principal and Income Law effective January 1, 2000. The purpose of the law is to define the terms "principal" and "income" as those terms are used in trusts and wills. For example, many trusts provide that a beneficiary is entitled to receive all "income", so it becomes important to know if a particular receipt received by the Trustee is income or principal. In many cases, the answer is obvious. For example, in most cases, interest and dividends will be income. On the other hand, capital gains are almost always principal (even though these receipts are subject to income tax.) However, there are many situations where the answer is far from obvious. For example, how should the Trustee account for extraordinary dividends that may amount to a partial liquidation of a corporation? How should the Trustee account for income from apartment buildings where much of the rental income must be used to pay off mortgages? Should the Trustee reduce the income for depreciation deductions?

This memorandum assumes that the reader has a general familiarity with the existing California principal and income law. Thus, this memorandum focuses on changes from the prior law. We've greatly simplified a number of complex rules and ignored many refinements and exceptions. All references are to the California Probate Code.

As a general rule, the effect of the new law is to treat as principal many items that previously were considered income.

1. **Presumption of Receipt as Principal.** There is a presumption in favor of a receipt being principal. Section 16335(a)(4).
2. **Right of Independent Trustee To Make Adjustments.** Generally, an independent trustee can make adjustments between income and principal, notwithstanding the provisions of the Act, if (a) the trustee invests and manages under the prudent investor rule, (b) the definition of "income" matters with respect to distributions, and (c) the trustee can't administer the trust impartially under the normal rules. Section 16336. For this purpose, an "independent trustee" means someone who isn't a beneficiary; it does not mean an "independent trustee" as defined under the income tax law. An independent trustee can't make these adjustments if certain adverse tax effects would result. Section 16336(b). For example, the trustee can't make an adjustment to reduce income if it would jeopardize the requirement of the estate tax marital deduction that the surviving spouse receive all of the income of a marital deduction trust. Presumably, couldn't reduce income of certain trusts holding stock in Subchapter S corporations, which require that the beneficiary receive all of the income.

3. **Distributions from Business Entities.** When a business entity makes a distribution, cash is income (unless it is part of a partial or full liquidation), while other assets distributed are principal. A mutual fund or REIT capital gain distribution is principal. A partial liquidation includes any distribution or distributions of more than 20% of the value of the entity. Section 16350.

4. **Income of Pass-thru Entities.** When a trustee is taxed on a business entity's income (such as for a partnership, LLC or S Corporation), then the tax is paid from income to the extent of receipts from the entity allocable to income, with the balance paid from principal. Section 16374(c). The law doesn't deal expressly with what happens if an entity throws off a tax loss, except for Section 16375 allowing a trustee to make adjustments between principal and income to take account of the shifting of tax benefits between the accounts.

5. **Trustee Conducting A Business Enterprise (Including Rental Realty).** If a trustee conducts a business operation (including rental of real estate), a separate set of books can be maintained, and the trustee can retain net cash receipts for working capital or reserves. Section 16352.

6. **Rentals Not Treated As Businesses.** If a trustee doesn't treat a rental activity as a separate business, then all rents are income (including bonuses for renewal or cancellation); deposits (including a payment for the last month's rent paid in advance) are not income. Section 16356.

7. **Bond Premiums and Discounts; Zero Coupon Bonds.** Income includes interest (including a bonus for repaying principal), and the premium received on sale or redemption of a bond purchased at a discount which matures within one year from purchase. No amortization of bond premium is required. Principal includes amounts received on sale or redemption of bonds (other than those bought at a discount and maturing within a year). Section 16357.

8. **Assets Considered As Having A Limited Life.** The following allocations can be ignored (and the entire receipt be treated as principal) if they result in an "insubstantial" change in the income, and if recharacterizing the receipt as principal won't cause the loss of a tax benefit (such as loss of the estate tax marital deduction.) Insubstantial means that the income would change by less than 10%, or if the assets producing income subject to the following allocations constitute less than 10% of the trust's assets. Otherwise, the following are (subject to the usual rules about following the trust's terms) mandatory. Section 16360.

a. **Retirement Plan Distributions.** Generally, payments from an annuity, IRA, or retirement plan (other than lump sum payments) must be allocated 10% to income and the rest to principal. However, if more must be treated as income to obtain a marital deduction, then the larger amount must be so treated. If a lump sum payment is received, it is treated entirely as principal.

b. **Leases, Copyrights, Patents, Royalties, Options, Puts and Calls; Mineral Interests; GNMA Contracts.** Amounts paid under a leasehold (such as a ground lease), patent, copyright, royalty right, or an arrangement paying amounts where no part is stated as interest, will be treated as 10% income and 90% principal.

Other special rules are provided for timber, mineral royalties, options (such as puts and calls) and "asset-based securities" (like GNMA contracts.)

9. **Environmental Remediation.** Environmental remediation costs are principal.

10. **Income Assigned to Repay Creditor.** If a creditor is assigned the income from an asset, then the Trustee must allocate principal to income in amount equal to the reduction in the principal of the creditor's obligation. Section 16371(b).

11. **Depreciation.** A trustee may set up depreciation reserves based on generally accepted accounting principles, except that no reserve can be established for a residence, or tangible personal property, used by a beneficiary, nor during the administration of a decedent's estate, or if the "business entity" provision is used. Section 16372.

12. **Reserves.** If a trustee plans to make a large, unusual expenditure, such as replacing a roof on a building, making a capital improvement, incurring expenses in connection with renting out a property (such as fix-up, tenant allowances, leasehold improvements and broker's fees), where mortgage payments are not covered by depreciation, and paying environmental remediation expenses, then the trustee can reduce income in order to reimburse principal or establish a reserve. Section 16373