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HOUSE OF REPRESENTATIVES
COMMITTEE ON
JUDICIAL OVERSIGHT
ANALYSIS

BILL #: HB 585

RELATING TO: Fla. Uniform Principal & Income Act

SPONSOR(S): Representative Goodlette

TIED BILL(S): none

ORIGINATING COMMITTEE(S)/COUNCIL(S)/COMMITTEE(S) OF REFERENCE:

(1) JUDICIAL OVERSIGHT YEAS 11 NAYS 0
(2) COUNCIL FOR SMARTER GOVERNMENT
(3)
(4)
(5)

I. SUMMARY:

THIS DOCUMENT IS NOT INTENDED TO BE USED FOR THE PURPOSE OF CONSTRUING STATUTES, OR TO BE CONSTRUED AS AFFECTING, DEFINING, LIMITING, CONTROLLING, SPECIFYING, CLARIFYING, OR MODIFYING ANY LEGISLATION OR STATUTE.

A trustee of a trust and the personal representative of a decedent's estate are fiduciaries that have special duties toward those who benefit from their administration. The trustee and the personal representative satisfy their obligations in part by making the proper allocations of assets to either principal or to income. Generally, assets allocated to principal serve the interests of remainder beneficiaries of a trust, and the interests of the final distributees of the assets in an estate. Assets allocated to income meet the requirements of income beneficiaries during the life of a trust, and those beneficiaries who must be paid out of the income derived during administration of an estate.

The identification of principal and income, its allocation, and apportionment of assets between income and principal have always been a very tricky business. Distinguishing income from principal is not always self-evident. Therefore, the law has provided trustees with statutory help for a very long period of time. The Uniform Law Commissioners promulgated the first Uniform Principal and Income Act in 1931. A revision was promulgated in 1962, which Florida subsequently adopted. In 1997, a new revision once again has been promulgated by the Uniform Law Commissioners.

This bill enacts the 1997 Uniform Principal and Income Act, with Florida modifications. This bill is an agreed-upon work product of the Real Property, Probate and Trust Law Section of The Florida Bar, the Florida Bankers Association, and the Florida Institute of Certified Public Accountants.

This bill does not appear to have a fiscal impact on state or local government.

II. SUBSTANTIVE ANALYSIS:

A. DOES THE BILL SUPPORT THE FOLLOWING PRINCIPLES:

1. Less Government Yes [] No [] N/A [x]
2. Lower Taxes Yes [] No [] N/A [x]
3. Individual Freedom Yes [] No [] N/A [x]
4. Personal Responsibility Yes [] No [] N/A [x]
5. Family Empowerment Yes [] No [] N/A [x]

For any principle that received a "no" above, please explain:

B. PRESENT SITUATION:

"Principal" is defined by s. 738.03(2), F.S., as generally "the property that has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainderman, while the return or use of the principal is in the meantime taken or received by, or held for accumulation for, an income beneficiary." "Interest" is defined by s. 738.03(1), F.S., as generally "the return in money or property derived from the use of principal . . . ."

There is a natural conflict in the management of any trust between the current beneficiaries and the future beneficiaries. In general, the current beneficiaries want the largest possible payout given to them. The future beneficiaries want as little as possible being paid to the present beneficiaries, in order to maximize the amount that the future beneficiary is to receive. The settlor of a trust, in the document creating the trust, generally provides for a distribution plan that the settlor deems appropriate. There are many situations, however, where the terms of a trust do not clearly specify a distribution. Those situations include:

- Estate or insurance distributions to minors where no trust language was specified.
- Court settlements or judgments benefiting a minor or incompetent.
- Poor trust drafting.
- Intentionally vague trust drafting intended to give discretion to the trustee.
- Unanticipated change in circumstances.

In these situations, ch. 738, F.S., entitled "Principal and Income", is utilized to determine the correct distribution.

This is a simple explanation of a very complicated subject. Many factors come into play in drafting a statute on this subject. For instance, there are numerous forms and types of trusts, and numerous forms and types of property held by trusts. The age and type of beneficiaries may warrant different distributions, and federal and state tax consequences must be considered. Determining the proper balance between current beneficiaries, and future beneficiaries, necessarily entails policy considerations.

Chapter 738, F.S., is based on the 1962 Revised Uniform Principal and Income Act, developed by the National Conference of Commissioners on Uniform State Laws. In 1997, the National Conference of Commissioners on Uniform State Laws published a new version of the Uniform

Principal and Income Act. The National Conference of Commissioners on Uniform State Laws gives this explanation of the subject:[1]

> A trustee of a trust and the personal representative of a decedent's estate are called fiduciaries. They have special duties toward those who benefit from their administration. A trustee of a trust has a fiduciary obligation to satisfy both the interests of the trust's income beneficiaries during the life of the trust, and the interests of the remainder beneficiaries at the trust's termination. A personal representative may be required to allocate net income to certain individuals during the administration of the estate and to assure that certain expenses are paid out of an appropriate category of interests before finally distributing the assets of the decedent's estate to the heirs or devisees (heirs if there is no will, devisees if there is a will).
>
> The trustee and the personal representative satisfy their obligations by making the proper allocations of assets to either principal or to income. Generally, assets allocated to principal serve the interests of remainder beneficiaries of a trust, and the interests of the final distributees of the assets in an estate. Assets allocated to income meet the requirements of income beneficiaries during the life of a trust, and those beneficiaries who must be paid out of the income derived during administration of an estate.
>
> But the identification of principal and income, its allocation, and apportionment of assets between income and principal have always been a very tricky business. Distinguishing income from principal is not always self-evident. Therefore, the law has provided trustees with statutory help for a very long period of time. The Uniform Law Commissioners promulgated the first Uniform Principal and Income Act in 1931. A revision was promulgated in 1962. Almost all of the states in the United States have adopted one or the other of these earlier acts by 1997, when a new revision once again has been promulgated.
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> In 1997, 35 years after the 1962 revision, the Uniform Law Commissioners have promulgated the Uniform Principal and Income Act (1997) (UPIA 1997). Obsolescence over time is not the only stimulus for promulgating UPIA 1997. In the 1990's and especially since the promulgation of the Uniform Prudent Investor Act in 1994, a trustee's obligation to invest the assets of a trust as a prudent investor would invest them, has substantially altered the fiduciary obligations of a trustee. There is a strong relationship between the obligation to invest as a prudent investor and the obligation to satisfy income and remainder beneficiaries. The earlier Uniform Principal and Income Acts do not accommodate prudent investor rules. UPIA 1997 does, as will be discussed a little later in this summary.
>
> UPIA 1997 provides some basic answers to questions that any trustee must ask in dealing with trust assets, and that personal representatives need to ask in the administration of an estate. The first question is whether an asset that becomes a trust or estate asset is either principal or income? Once established as either principal or income, the next question is, when is a beneficiary entitled to receive that asset?
>
> The answers to these questions are strongly affected by the time at which the question is asked. There are three relevant times to consider -- the time before creation of an income interest, the time during which an income interest is current and the time after the income interest ends (an income interest is merely the interest of the income beneficiary -- the right to receive current payment). The time influences allocation of assets to principal or to income, and ultimately the rights of income and remainder beneficiaries.

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[1] http://www.nccusl.org/nccusl/uniformact_summaries/uniformacts-s-upaia1997.asp

The beginning and the end of the income interest are key, because (1) sometimes assets that would otherwise be income are allocated to principal if there is no current income interest; and (2) even if assets are allocated to income, when there is no current income interest, remainder beneficiaries will be entitled to a share of that income.

INITIAL RULE

The express language of the trust instrument, will or other applicable document will govern, notwithstanding conflict with any statutory rule. UPIA 1997 is entirely a default statute that operates only when the governing instrument is silent.

ALLOCATION TO PRINCIPAL OR INCOME

Principal is fundamentally defined as the property held in trust for distribution to a remainder beneficiary when the trust terminates. Income is the current return that any fiduciary receives from an asset that is principal. It has never been sufficient to provide a bare general definition in any of the Uniform Principal and Income Acts. There is, therefore, a group of rules that establish what is principal and what is income with respect to specific kinds of assets.

UPIA 1997 refines old rules and provides specific rules for assets that are not accounted for in the earlier acts. An example of the refinement of old rules concerns receipts from an entity. The earlier uniform acts provide for corporate distributions, generally allocating ordinary dividends to income and any other distribution in the form of additional equity to principal. UPIA 1997 addresses the broader category of receipts from an entity. A corporation is an entity, but so is a partnership, a limited liability company, a regulated investment company and a real estate investment trust. UPIA 1997 allocates the receipts from all entities in the same manner.

UPIA 1997 then simplifies the allocation question. Any money received by a fiduciary is regarded as income, unless it fits certain categories. For example, if money is received as part of a liquidation of the entity, it is principal. If money is received from an investment company (mutual fund) that labels a distribution as capital gain, the receipt is principal. All property received that is not money, i.e., a stock distribution, is principal. In addition, UPIA 1997 establishes what qualifies as a partial or complete liquidation of an entity. Fiduciaries will, thus, be better able to make judgments about receipts that are part of a liquidation. This is a more precise and logical set of rules for making allocations than exists in the earlier uniform acts, making fiduciaries' decisions easier and more certain.

There are certain kinds of assets that UPIA 1997 provides for that are just not within the scope of consideration in the earlier acts. One of them is derivatives. Another is asset-based securities. Receipts from derivatives, unless a trustee exercises powers available in the conduct of a business held in trust, are principal. Receipts from asset-based securities are either income or principal, depending upon the categorization of the asset backed security's payor.

APPORTIONMENT ISSUES

The beginning point and the ending point of an income interest in an estate or a trust provide particular problems, even though the incoming assets would clearly be income under the rules applied during the life of the income interest. Depending upon the time of receipt, an asset that is otherwise classified as income may have to be apportioned at least in part to principal to balance beneficiary interests. UPIA 1997 more precisely and simply provides for that apportionment than the earlier acts did.

UPIA 1997 provides, generally, that an income receipt is principal if it is due before a decedent dies in the case of an estate or before an income interest begins in the case of a trust. After death or after an income interest begins, it is classified as income. If there is income that is not distributed at the time the income interest ends, generally it is paid to income beneficiaries. But if the trust is revocable by an income beneficiary at an amount more than five percent of the trust's corpus immediately before the income interest ends, the undistributed income allocable to the revocable part, must be added to principal.

RIGHT TO PAYMENT

UPIA 1997 expressly requires distribution of net income and principal receipts to the appropriate beneficiaries when a decedent dies or when an income interest ends. There is discretion given to pay certain expenses out of either principal or income unless there is an adverse effect on estate tax marital deductions or income tax charitable deductions. General expenses of an estate are paid from principal. A specific pecuniary amount required to be paid, is paid from income unless insufficient. The deficiency is paid from principal. If there is any net income after the fact, it is distributed to remainder beneficiaries according to share in principal.

These rules assure orderly distribution of income when the decedent dies or an income interest ends. The earlier uniform acts make no attempt to deal with this distribution problem.

ADJUSTMENT POWERS

For Prudent Investment

A trustee must use prudent investment rules in any state that has adopted the Uniform Prudent Investor Act or equivalent statute, and in any case governed by the Restatement of the Law of Trusts III. The investment policy governing a trust's assets depends upon making the appropriate risk/return analysis and investing accordingly. Asset growth can be as significant an objective as income in setting the investment policy for a specific trust. Because a trustee may weight either growth or income significantly in making investment decisions, and because either may be greater or less than anticipated, the trustee may have to rebalance the interests of remainder and income beneficiaries as a result.

UPIA 1997 allows the trustee to adjust principal and income to the extent made necessary by prudent investment when a trust provides for a fixed income for the income beneficiary. This must be a careful decision before which a trustee shall consider all of the factors relevant to the trust and its beneficiaries. The express list of factors includes the nature, purpose, and expected duration of the trust; and the intent of the settlor. This is not a decision to be taken lightly -- the list of express factors to consider is long. Adjustments are forbidden in certain circumstances, such as when they diminish the income interest in a trust that requires all of the income to be paid at least annually to a surviving spouse and for which an estate tax or gift tax marital deduction would be allowed..., or if the trustee is a beneficiary of the trust... This list of forbidden situations, also, must be read with some care before a trustee decides to adjust allocations.

The earlier Uniform Acts did not deal with adjustment as a result of prudent investment. The whole notion of prudent investment, modern portfolio theory and total return came later than either of the two earlier acts. UPIA 1997 is absolutely necessary to making prudent investment work to its full capacity.

For Disbursements during the Administration of a Trust

Expenses and taxes must be paid during the administration of a trust. From which side of the ledger are they to be paid? Generally, UPIA 1997 provides for payment of ordinary expenses out of income, for payment of compensation to the trustee and legal proceedings from principal and income, dividing expenses in two, and payment of expenses peculiar to the remainder interest to principal. A trustee may transfer income to principal to make up for depreciation of an asset or to reimburse principal for disbursements that enhance income, i.e., repairs to assets that are necessary to maintain income. A trustee may make adjustments to principal and income to offset shifting of economic interests or tax benefits between income and remainder beneficiaries in certain instances.

During the Conduct of a Business Held in Trust

Under UPIA 1997, a trustee who conducts a business held in a trust may separate out the accounting for the business from that for other trust assets. The trustee, also, has the power to allocate net cash receipts to working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records.

The earlier uniform acts treated net profit from a business as income, and losses as principal. There is no flexibility.

For Tax Purposes

UPIA 1997 allows a fiduciary to make adjustments between principal and income for tax purposes. Tax liabilities may accrue to either income or remainder beneficiaries. A fiduciary may have to make elections under the tax laws. Imbalances of interests that arise because of taxes can be remedied by the fiduciary.

The earlier uniform acts did not provide such discretion to the fiduciary.

C. EFFECT OF PROPOSED CHANGES:

This bill adopts the Uniform Principal And Income Act (1997), promulgated by the National Conference of Commissioners on Uniform State Laws. The purpose of the Act "is to provide procedures for trustees administering trusts and personal representatives administering estates in allocating assets to principal and income, and to govern their proper distribution to beneficiaries, heirs and devisees."[2] The Uniform Principal and Income Act (1997), has been adopted in 24 states, and is currently filed in the legislatures of 6.[3] "The purpose of the new act, like its predecessors, is to provide procedures for trustees administering an estate in separating principal from income, and to ensure that the intention of the trust creator is the guiding principle for trustees. A revision is necessary so that principal and income allocation rules can function with modern trust investment practices."[4]

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2 http://www.nccusl.org/nccusl/pubndrafts.asp
3 http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-upia.asp
4 *Id*.

This bill adds the following provisions not found in the Uniform Principal and Income Act (1997):

- 738.104(7), which provides that nothing in ch. 738, F.S., is intended to create or imply a duty to make a discretionary adjustment between principal and income, and no inference of impropriety can be made as a result of a trustee not exercising the power of adjustment.

- 738.104(8), which provides a method by which a supermajority of the beneficiaries of a trust in existence on the date of enactment of this bill may elect, under certain conditions, to opt out of the new provisions regarding a trustee's discretionary power of adjustment between principal and income. The following subsection (9) requires a trustee to notify beneficiaries of their right to make this election.

- 738.1041, which provides that a trustee has the discretion to convert an income trust to a total return unitrust, and may reconvert the total return unitrust back to an income trust. A "unitrust" is a "trust from which a fixed percentage of the net fair market value of the trust's assets, valued annually, is paid each year to the beneficiary."[5] A total return trust is a trust that directs or allows the trustee to distribute the net income of the trust to one or more persons, either in fixed proportions or in amounts or proportions determined by the trustee. A trustee may, without court approval, convert a trust to or from a total return unitrust. If the trustee converting the trust into a unitrust is in an interested person, the trustee must appoint a disinterested person to determine the appropriate unitrust percentage and the asset valuation method. The trustee must give written notice to the beneficiaries of the decision. The trustee may petition the circuit court to determine the appropriate unitrust percentage. In determining the terms of the unitrust, the trustee or the court must must take into account the federal income tax consequences regarding the marital deduction and the generation skipping tax. A trustee acting in good faith may not be sued for failure to act to convert an income trust to a unitrust. A beneficiary may seek an order compelling a trustee to convert an income trust to a unitrust. If a majority in interest of the beneficiaries object to the unitrust percentage, and such objection is not resolved by the trustee after 6 months, those beneficiaries may petition the circuit court for a determination of the appropriate percentage. This section is available to any trust in existence, including those created prior to the effective date of this bill; unless the trust is not an income trust, the trust is one of several special types cited, the grantor of the trust specifically prohibited conversion in the trust instrument, or the trustee has the power of adjustment at s. 738.104.

- 738.202(5), which provides that the value of trust assets is determined on an asset-by-asset basis, and will be conclusive if reasonable and determined in good faith. An appraisal less than 2 years old is presumed correct. A valuation challenge must be commenced within 6 months of when the interested party is notified of the valuation.

- 738.302(4), which provides that s. 733.817, F.S. (Florida law on the apportionment of estate taxes), controls over any apportionment provision in the Uniform Principal and Income Act in conflict.

- 738.401(4), which provides that if a trustee elects, or continues an election made by its predecessor, to reinvest dividends in shares of stock of a distributing corporation or fund, whether evidenced by new certificates or entries on the books of the distributing entity, the new shares retain their character as income.

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[5] Black's Law Dictionary, Sixth Edition, at 1534.

- 738.503(3), which provides expanded provisions regarding the sale of, and collection of interest from, bonds.
- 738.602(2)(a)2., which provides that a trustee must allocate to interest payments received that are in the nature of interest or dividends, even if not characterized as such by the payor.
- 738.702(1)(h), which provides an additional category of expense charged against principal, for any expense representing extraordinary repairs or expenses incurred in making a capital improvement to principal.
- 738.703(3), which provides that the amount of depreciation taken for tax purposes is presumptively the correct depreciation for allocating between principal and income.
- 738.801, which provides a formula for apportioning expenses between a life tenant and the remainder interests.

This bill does not adopt, or substantially changes, the following provisions found in the Uniform Principal and Income Act (1997):

- At 738.503(2), this bill deletes the provision in the uniform act which provides that the profit on the sale by a trustee of a note maturing within one year must be allocated to income. But see 738.503(3) above, regarding expanded provisions regarding the sale of a bond.
- At 738.704(2), this bill deletes the ability of a trustee to "borrow" principal to pay certain expenses chargeable against income, namely extraordinary repairs and capital improvements. This bill also adds a subsection (4) providing that the principal may only be advanced for mortgage payments if necessary to avoid a default.

D. SECTION-BY-SECTION ANALYSIS:

Section 1. Adopts the Uniform Principal and Income Act (1997), with Florida modifications (as described herein).

Section 2. Repeals all of current ch. 738, F.S., the current version of the Uniform Principal and Income Act, as applied in Florida

Section 3. Provides an effective date of January 1. 2003.

III. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT:

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

   None.

2. Expenditures:

   None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

None.

2. Expenditures:

None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

None.

D. FISCAL COMMENTS:

None.

IV. CONSEQUENCES OF ARTICLE VII, SECTION 18 OF THE FLORIDA CONSTITUTION:

A. APPLICABILITY OF THE MANDATES PROVISION:

This bill does not require counties or municipalities to spend funds or to take an action requiring the expenditure of funds.

B. REDUCTION OF REVENUE RAISING AUTHORITY:

This bill does not reduce the authority that municipalities or counties have to raise revenues in the aggregate.

C. REDUCTION OF STATE TAX SHARED WITH COUNTIES AND MUNICIPALITIES:

This bill does not reduce the percentage of a state tax shared with counties or municipalities.

V. COMMENTS:

A. CONSTITUTIONAL ISSUES:

None.

B. RULE-MAKING AUTHORITY:

None.

C. OTHER COMMENTS:

This bill is an agreed-upon work product of the Real Property, Probate and Trust Law Section of The Florida Bar, the Florida Bankers Association, and the Florida Institute of Certified Public Accountants.

The National Conference of Commissioners on Uniform State Laws states:[6]

> There are many reasons why every state should adopt the Revised Uniform Principal and Income Act (1997).
>
> - The law of trust investment has been modernized. It is now time to update the traditional income and allocation rules so that it can work with the doctrine of modern investment theory.
> - The new act provides a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle for investing for total return instead of for a certain level of income.
> - The new act better clarifies allocations of acquired assets, such as those from corporate distributions.
> - An "unincorporated entity" concept has been introduced to deal with businesses operated by a trustee, including farming and livestock operations, and investment activities in rental real estate, natural resources, and timber.
> - The new act provides for investment modalities that were not in existence in 1962, such as derivatives, options, deferred payment obligations, and synthetic financial assets.
> - There is a new provision which deals with the problem of disbursements made because of environmental laws.
> - New provisions which deal with the imbalances as a result of tax laws are also included. The act provides the power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in the way the fiduciary income tax rules apply.

VI. AMENDMENTS OR COMMITTEE SUBSTITUTE CHANGES:

On January 30, 2002, the Committee on Judicial Oversight adopted one amendment to this bill, correcting cross-references to the Internal Revenue Code. The bill was then reported favorably, as amended.

VII. SIGNATURES:

COMMITTEE ON JUDICIAL OVERSIGHT:

Prepared by:	Staff Director:
Nathan L. Bond, J.D.	Nathan L. Bond, J.D.

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[6] http://www.nccusl.org/nccusl/uniformact_why/uniformacts-why-upia97.asp