

HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: HB 1071 Florida Uniform Principal & Income Act
SPONSOR(S): Representative Goodlette
TIED BILLS: **IDEN./SIM. BILLS:** SB 2450

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR
1) Banking & Securities (Sub)	6 Y, 0 N	Cutchins	Whitfield
2) Commerce	14 Y, 0 N	Cutchins	Whitfield
3) Finance & Tax			
4)			
5)			

SUMMARY ANALYSIS

Trusts are established to protect the interests of persons who own valuable property or income producing assets to assure that the benefits of those possessions are distributed in the manner that the owner desires even in the absence of direct control by the owner. (Often done in conjunction with wills.) As part of their fiduciary responsibilities, trustees and personal representatives of trusts are often required to allocate net income among beneficiaries of the trust 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. The trustee and the personal representative satisfy their obligations by making the proper allocations of assets to either principal or to income. Distinguishing income from principal is not always self-evident. Therefore, uniform laws have developed over the years to provide trustees with statutory help in this process. The latest iteration of the Uniform Principal and Income Act (UPI) was developed by the National Conference of Commissioners on Uniform State Laws in 1997. Florida adopted a majority of the provisions of this act in 1998.

One respect in which the Florida version¹ of the UPI varies from the 1997 UPI, is that Florida's version allows trustees to convert an income trust to a total return unitrust or reconvert a total return unitrust to an income trust. The provisions in Florida law are designed to give trustees the flexibility to structure the best possible distribution and income tax liability situation for all beneficiaries of a trust. This bill revises several sections in Chapter 738, Florida Statutes that impact the authority of a trustee to convert a trust to a unitrust, by:

- more clearly defining who an interested trustee is;
- providing additional clarity for when a trustee has the authority to release certain powers to adjust;
- establishing additional parameters for the 5 percent ceiling and 3 percent floor in the rates used to calculate the unitrust amount;
- clarifying to whom certain notices of power to adjust and intent to convert or reconvert will be sent;
- broadening the unitrust option by revising certain percentage calculation provisions for asset valuations; and
- clarifying provisions relating to the beginning date of the power to adjust which, as written, could prohibit a trust from exercising the ability to use the unitrust conversion provisions of the law.

This bill also clarifies the description of short- and long-term capital gains used in reference to distributions from mutual funds for the purpose of determining what receipts will be allocated from an entity to the principal of the trust.

¹ Chapter 738, Florida Statutes

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. DOES THE BILL:

- | | | | |
|--------------------------------------|---|-----------------------------|---|
| 1. Reduce government? | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |
| 2. Lower taxes? | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |
| 3. Expand individual freedom? | Yes <input checked="" type="checkbox"/> | No <input type="checkbox"/> | N/A <input type="checkbox"/> |
| 4. Increase personal responsibility? | Yes <input checked="" type="checkbox"/> | No <input type="checkbox"/> | N/A <input type="checkbox"/> |
| 5. Empower families? | Yes <input checked="" type="checkbox"/> | No <input type="checkbox"/> | N/A <input type="checkbox"/> |

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

B. EFFECT OF PROPOSED CHANGES:

Establishing a trust is a way for persons who own valuable property or income producing assets to assure that the benefits of those possessions are distributed in the manner that the owner desires even in the absence of direct control by the owner. This is usually done in conjunction with the creation of wills. 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, uniform laws have developed over the years to provide trustees with statutory help in this process. 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 was once again promulgated. Florida adopted a majority of this latest iteration of the uniform law in 2002.²

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 weigh 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.

Expenses and taxes must be paid during the administration of a trust. The trustee must make a decision as to whether the income side or the principal side of the ledger will pay the taxes. Generally, ch. 738, F.S.,

² Chapter 2002-42, Laws of Florida

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.

In general s. 738.104, F.S., 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. 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.

Since there were trusts in existence when ch. 2002-42, L.O.F., went into effect,³ paragraph (8) of s. 738.104, F.S., makes provisions for beneficiaries to object to the trustee's power to adjust and paragraph (9) requires that any trustee that qualifies for the power to adjust must provide the beneficiaries with certain information before the trustee exercises that power. However, these provisions do not give direction as to whom the notice can be sent if the person entitled to be noticed is a minor or someone otherwise under a legal disability. This bill revises s. 738.104(9), F.S., to provide that, in these circumstances, notice can be served on a legal representative or natural guardian of a beneficiary without the filing of any proceeding or approval of any court since these persons are the ones endowed with the ability to exercise an objection allowed by this section.

In certain situations, the trustee may not be able to determine whether having or exercising this power is going to cause them to adversely affect the trust's beneficiaries which the trustee is prohibited from doing according to his or her fiduciary responsibility and the prudent investor standards. Consequently, subsection (5) of s. 738.104, F.S., provides limited circumstances under which the trustee is allowed to release the entire power to adjust or may release only the power to adjust from income to principal or from principal to income. This ability to be released from the power to adjust becomes important if a trustee decides to utilize the power to convert to a new type of trust allowed under Florida law since the enactment of ch. 2002-42, L.O.F.

One of the differences between the uniform law and that adopted by Florida is that Florida authorizes the ability of a trustee to create a total return unitrust.⁴ Under s. 738.1041, F.S., 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. To administer this type of trust, a trustee would have to release the power to adjust. However, if the trust became irrevocable after the enactment of ch. 2002-42, L.O.F., and the trustee had the power to adjust at that time, the only way that the trustee can now release that power, in order to take advantage of the unitrust option, is for the reasons stipulated in s. 738.104(5), F.S. This bill revises the provisions under s. 738.104(5), F.S., to provide that a trustee may release the entire power to adjust if the trustee desires to convert an income trust to a total return unitrust and that if the power is released for this purpose, its release is only effective for as long as the trust is administered as a unitrust. This revision expands the availability to use the unitrust option.

Because the unitrust option is not available when a trustee has the power to adjust under s. 738.104, F.S. (powers to adjust), and because the language of s. 738.104(8)(a), F.S., places conditions on the powers to

³ December 31, 2003

⁴ Section 738.1041, F.S.

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

adjust for certain existing trusts,⁶ there is some question as to when the powers to adjust begin, which impacts the availability of the unitrust option to those trusts. This bill revises s. 738.104(8)(a), F.S., to clarify that, after the written statement required in subsection (9) has been provided, the power to adjust for existing trusts will commence on the expiration of the 60-day response period if no objection has been made or when any objection which is made has been terminated. This bill further provides that an objection will be considered terminated if a super majority of the trust beneficiaries of the class that made the objection consent or the objection is resolved under the prescripts of paragraph (c) of this subsection, whichever occurs earlier. Subsection (b) is revised to provide that a consent may be executed in the same fashion as an objection.

Section 738.1041, F.S., provides certain conditions to govern the trustee's actions in controlling a unitrust. Since the enactment of the 2002 act, several issues have surfaced regarding the clarity and functionality of its provisions.

Under s. 738.1041(2), F.S., a trustee may, without court approval, convert an income trust to a total return unitrust, convert it back, or change the percentage used to calculate the unitrust amount or method used to determine the fair market value of the trust. Interested trustees and disinterested trustees are each assigned a different type of percentage methodology to use in these calculations and determinations. Interested trustees must use the percentage calculation based on 50 percent of the applicable federal rate as defined in the Internal Revenue Code, 26 U.S.C. s. 7520, (AFR) and disinterested trustees are limited to using between 3 and 5 percent. Since the unitrust percentage calculation is based on the AFR but is limited to between 3 and 5 percent⁷, if the trustee converting the trust into a unitrust is an interested person, the trustee must use a percentage fixed by statute or appoint a disinterested person to determine the appropriate unitrust percentage and the asset valuation method.⁸

An interested trustee is described in s.738.1041 (1)(d), F.S., as:

- an individual trustee to whom the net income or principal of the trust can be distributed, either currently or if the trust were to terminate and be distributed...
- any trustee who may be removed and replaced by an interested distributee, or
- an individual trustee whose legal obligation to support a beneficiary may be satisfied by distributions of income and principal of the trust.

It is unclear as to whether the second qualifier is describing who may remove and replace the trustee, or whether it is describing the type of person (an interested distributee) that is allowed to be the trustee's replacement. This bill revises the language in paragraph (d) of s. 738.1041(1), F.S., by using the qualifier to describe who may remove the trustee and by further describing the type of person who is allowed to be the trustee's replacement, as a "related or subordinate party," as defined in paragraph (c) of the subsection.⁹

In the event an interested trustee qualifies to administer the trust under sub-subsection 1. of s. 738.1041(2)(b), F.S., sub-subsection 2. requires the trustee to administer it in such a way that the percentage used to calculate the unitrust amount will be 50 percent of the AFR, and further sets the parameters for that percentage to be no more than 5 percent nor less than 3 percent; however, this section does not provide for a situation in which the first parameter may not produce the second. This bill provides that if the percentage calculation (based on 50 percent of the AFR) exceeds 5 percent, the unitrust percentage will be set at 5 percent and if that calculated percent is less than 3 percent, the unitrust percentage will be set at 3 percent.

Section 738.1041(2)(b)2., F.S., also requires the trustee to have the fair market value of the trust determined at least annually on an asset-by-asset basis in accordance with the provisions of s. 738.202(5), F.S., (with exceptions). The language in s. 738.202(5), F.S., establishing the time frame for appraisals on which asset

⁶ Trustees of trusts existing on January 1, 2003, have no power to adjust until notice is sent and the objection period has passed, or have the power to adjust, subject to losing the power if notice is sent and proper objection is made.

⁷ Section 738.1041(2)(b)2., F.S.

⁸ Section 738.1041(2)(b)1., F.S.

⁹ Section 738.1041(1)(c), F.S., references the definition for related or subordinate party found in the Internal Revenue Code, 26 U.S.C. s. 672(c).

value determinations will be made indicates that they will be made within 2 years *after* the valuation date. This appears to indicate current decisions will be made on information in future appraisals. This bill revises that language to say that appraisals performed within 2 years *before or after* the valuation date will be presumed reasonable. While this does allow for appraisals to be done before the valuation, it still appears to allow determinations to be made on information in future appraisals. The uniform text for this section relies on the phrase *within 2 years* to indicate the expectation of timeliness.

Certain notification requirements are made of trustees who opt to use the unitrust conversion or reconversion or change the percentage used to calculate the unitrust amount or method used to determine the fair market value of the trust. However, as in the situation where notice is required for existing trusts relative to the power to adjust, no direction is given in s. 738.1041(2)(c), F.S., as to whom the notice can be sent if the person entitled to be noticed is a minor or someone otherwise under a legal disability. This bill revises that section to provide that, in these circumstances, notice can be served on a legal representative or natural guardian of a beneficiary without the filing of any proceeding or approval of any court since these persons are the ones endowed with the ability to exercise an objection allowed by this section.

Beneficiaries can withdraw funds from a trust, but the law limits that power so that the withdrawal power does not cause the entire trust amount to be taxed to the estate of the person holding the power. There are two traditional methods to limit a beneficiary's power to withdraw funds. The first is to limit it to an "ascertainable standard." The second is to limit the withdrawal power to the greater of 5% of the trust value or \$5,000. The second method is also known as a 5X5 power. Both methods are effective under the Federal tax code in protecting the beneficiary's tax status.¹⁰ In the event a trust limits its beneficiaries' withdrawal powers by using another method, it would be precluded from exercising the unitrust option under this section. This bill revises the section to provide in order for the exclusion to apply, the beneficiary's power to withdraw would not only have to not be limited by an ascertainable standard, but it would also have to exceed, in any calendar year, the amount set forth in the Internal Revenue Code, 26 U.S.C. s. 2041(b)(2) or s. 2514(e). These amounts correspond to the 5X5 power. Consequently, the revision of this section would expand the option to choose a unitrust to trusts that limit the power to withdraw by using the 5X5 power method.

Section 738.401(3)(d), F.S., currently refers to "a distribution of short-term or long-term capital gains for federal income tax purposes," when referring to distributions from regulated investment companies (mutual funds). Since short term capital gains from a mutual fund are taxed as ordinary income dividends referring to them as capital gains for federal income tax purposes has caused some confusion as to the ability under this section to allocate gains, realized within the entity, to a trust's principal account. This bill revises the language to clarify the description of short and long-term capital gains used in reference to distributions from mutual funds for the purpose of determining what receipts will be allocated from an entity to the principal of the trust.

C. SECTION DIRECTORY:

Section 1 amends subsections (5), (8), and (9) of s. 738.104, F.S., relating to a trustee's power to adjust, revising the conditions for release of the power to adjust between the principal and interest of a trust, and providing direction for whom required notices of intent to adjust are to be sent.

Section 2 amends paragraphs (1), (2), and (12) of s. 738.1041, F.S., relating to total return unitrusts, revising the definition for interested trustee and the parameters for percentage calculations of unitrust amounts; providing direction for whom required notices of intent to convert to or reconvert from a unitrust are to be sent; and revising in the provisions which exclude a trust from having the ability to use the unitrust conversion provisions based on certain beneficiaries' power to withdraw from the trust, by expanding the ascertainable standard basis for determining a beneficiary's power to withdraw to include the use of the "5X5" power as well, thereby broadening the availability of the unitrust option.

¹⁰ Section 738.1041(12), F.S., excludes trusts from the availability of the unitrust under the Internal Revenue Code, 26 U.S.C. s. 2041 or s. 2514.

Section 3 amends subsection (5) of s. 738.202(5), F.S., relating to the valuation of trust assets and revising the allowable time frame for asset appraisals.

Section 4 amends paragraph (3) of s. 738.401, F.S., clarifying the description of short and long-term capital gains used in reference to distributions from mutual funds for the purpose of determining what receipts will be allocated from an entity to the principal of the trust.

Section 5 provides that this act will be effective upon becoming law and will apply retroactively to January 1, 2003, the date the main body of Florida's uniform principal and income act took effect.

II. 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:

The ability to take advantage of more flexible trusting provisions could result in more equitable trust distributions and better tax situations for trust beneficiaries.

D. FISCAL COMMENTS:

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

This bill does not require counties or municipalities to spend funds or to take an action requiring the expenditure of funds, does not reduce a county's authority to raise revenue and does not reduce the percentage of a state tax shared with counties or municipalities.

2. Other:

None.

B. RULE-MAKING AUTHORITY:

N/A

C. DRAFTING ISSUES OR OTHER COMMENTS:

IV. AMENDMENTS/COMMITTEE SUBSTITUTE CHANGES