

## HOUSE OF REPRESENTATIVES STAFF ANALYSIS

**BILL #:** PCS for HB 823 Florida Uniform Principal and Income Act

**SPONSOR(S):** Civil Justice Subcommittee

**TIED BILLS:** None **IDEN./SIM. BILLS:** SB 978

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
Orig. Comm.: Civil Justice Subcommittee		Cary	Bond

### SUMMARY ANALYSIS

Florida law governs the creation of wills and trusts and the administration of such instruments. Drafters of wills and trusts have broad authority to create parameters for administering the instrument within the documents, but the Florida statutes serve to provide default guidelines where the instrument is silent.

The Florida Uniform Principal and Income Act is modeled after the Uniform Principal and Income Act as drafted by the National Conference of Commissioners on Uniform State Laws. The Florida act is similar to the model act.

Practitioners have identified several issues with the act, including some misuse of the terms "fiduciary" and "trustee". Trustees are always fiduciaries, but fiduciaries are not always trustees. In some cases, the word "trustee" was used in a context where the provision should apply to all fiduciaries.

Furthermore, fluctuations in the stock market make it difficult to evaluate assets and can lead to a wide variance in distributions from year to year. This bill implements a "smoothing rule" where fiduciaries calculate the average fair market value of the current year assets and the two preceding years' assets. The bill also provides clarification for allocating assets between principal and income, including providing a new definition for "carrying value," which is the fair market value at the time the assets are received by the fiduciary.

The bill also modifies the default guidelines for several other aspects, including unitrusts, distribution of income, the partial liquidation rule, marital deductions, liquidating assets, income taxes, and property improvements.

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

# FULL ANALYSIS

## I. SUBSTANTIVE ANALYSIS

### A. EFFECT OF PROPOSED CHANGES:

#### **Background**

In 2002, a modified version of the Uniform Principal and Income Act, as developed by the National Commissioners on Uniform State Laws in 1997, was enacted.<sup>1</sup> The act provides procedures for trustees administering an estate in differentiating principal from income and ensuring that the intention of the trust creator is the guiding principal for trustees.<sup>2</sup> The act provides default rules to trustees and fiduciaries where the will or trust instrument is silent.

The act defines principal as property held in trust for distribution to a remainder beneficiary when the trust terminates.<sup>3</sup> Income is money or property that a fiduciary receives as current return from a principal asset.<sup>4</sup>

#### **Effects of the Bill**

##### Trustee and Fiduciary

Trustees and fiduciaries both have the responsibility to act primarily for another's benefit.<sup>5</sup> However, a trustee is the owner of the legal title to the property of the trust.<sup>6</sup> Current law defines a trustee to include an original, additional, or successor trustee, whether or not appointed or confirmed by a court.<sup>7</sup> A fiduciary is a personal representative or a trustee. The term includes an executor, administrator, successor personal representative, special administrator, or a person performing substantially the same function.<sup>8</sup> A trustee is always a fiduciary, but a fiduciary is not always a trustee.

The bill changes "trustee" to "fiduciary" throughout wherever the word "trustee" should also apply to fiduciaries that are not specifically designated as trustees. Furthermore, the bill amends s. 738.103, F.S., to provide that the chapter pertains to the administration of trusts administered in this state or under its law, and to any estate that is administered in this state unless the provision is limited in application to a trustee, rather than a fiduciary.

##### Carrying Value

The bill amends s. 738.102, F.S., to provide a new standard for valuing assets. The term "carrying value" is defined as the fair market value at the time the assets are received by the fiduciary, and a change in fiduciaries allows the majority of continuing fiduciaries to elect to adjust the carrying values to reflect the fair market value of the assets at the beginning of their administration. The bill amends s. 738.202, F.S. and s. 738.602(2), F.S., to apply the carrying value, which will simplify administration of trusts by not requiring the fiduciary to revalue the assets on each distribution date unless there is a

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<sup>1</sup> Chapter 2002-42, L.O.F.

<sup>2</sup> The National Conference of Commissioners on Uniform State Laws, [http://www.nccusl.org/Narrative.aspx?title=Why States Should Adopt UPIA](http://www.nccusl.org/Narrative.aspx?title=Why%20States%20Should%20Adopt%20UPIA) (last checked Jan. 4, 2012).

<sup>3</sup> Section 738.102(10), F.S.

<sup>4</sup> Section 738.102(4), F.S.

<sup>5</sup> See, e.g., *Black's Law Dictionary, which defines a fiduciary as* ". . . a person holding the character of a trustee, or a character analogous to that of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires. A person having duty, created by his undertaking, to act primarily for another's benefit in matters connected with such undertaking." 5th Ed., at 563.

<sup>6</sup> See, e.g., *Black's Law Dictionary, which defines a trustee as a* "Person holding property in trust. The person appointed, or required by law, to execute a trust; one in whom an estate, interest, or power is vested, under an express or implied agreement to administer or exercise it for the benefit or to the use of another called the cestui que trust. Person who holds title to res and administers it for others' benefit." 5th Ed., at 1357.

<sup>7</sup> Section 738.102(13), F.S.

<sup>8</sup> Section 738.102(3), F.S.

non pro-rata distribution to one or more beneficiaries, in which case the bill provides guidelines on how to make the distribution.

### Unitrusts

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."<sup>9</sup> The value of assets in a unitrust are calculated by the "fair market value" method, which is the fair market value of assets held by the trust as otherwise determined under this chapter, reduced by all known noncontingent liabilities.<sup>10</sup>

The bill provides new rules for valuing assets for unitrusts. The bill amends s. 738.1041(1)(a), F.S., to add a definition for "average fair market value" which includes what is commonly referred to as the "smoothing rule." This rule is intended to reduce the large differences in amounts distributable to a beneficiary from year to year depending on large market fluctuations by using the average fair market value over the past three years to value assets. The bill then implements the smoothing rule in the definition of "unitrust amount" in s. 738.1041(1)(f), F.S.

### Determination and Distribution of Net Income

Current law requires a fiduciary, in certain situations, to distribute to the beneficiary who receives a pecuniary amount outright the interest provided by will, the terms of the trust, or applicable law. However, this was model act language and there are no situations where this law applies in Florida. Current law also contains language from the model act that implies that there is a statutory right to income on an outright pecuniary device in Florida, where such a right does not exist.<sup>11</sup>

The bill amends s. 738.201(3), F.S., to remove unnecessary language referencing "applicable law" where there is no applicable law and to remove model act language pertaining to a statutory right to income on an outright pecuniary device, which is not a right in Florida.

### Character of Receipts

Current law provides a default provision for determining whether assets should be allocated to principal or income: payments in excess of 20% of the entities' assets are presumed to be liquidating distributions which are allocated to principal (the 20% partial liquidation rule). However, certain entities pay large dividends that may exceed this limit despite not being liquidating assets.<sup>12</sup>

The bill amends s. 738.401, F.S., to retain the 20% partial liquidation rule for non-publicly-traded entities, but only after the trust or estate has received a cumulative minimum return of 3% annually. The bill provides a framework for allocating dividends and other stock payments which exceed 10% of fair market value of the trust's interest in that entity, and provides rules for different types of entities, such as publicly-traded companies, partnerships, subchapter S corporations, and other entities.

### Marital Trusts and Deductions

Current law contains one method of computing income from assets held in marital trusts and another more complex method of computing the allocation of principal and income for non-marital trusts.<sup>13</sup>

The bill amends s. 738.602(4), F.S., to simplify the method for computing income held in non-marital trusts. The bill also amends s. 738.602(5), F.S., to ensure that the estate or gift tax marital deduction applies to not only federal tax laws, but tax laws of other states where the trust is administered in

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<sup>9</sup> Black's Law Dictionary, 5th Ed., at 1376.

<sup>10</sup> Section 738.1041(1)(b), F.S.

<sup>11</sup> Section 738.201, F.S.

<sup>12</sup> Section 738.401, F.S.

<sup>13</sup> Compare s. 738.602(4) and (5), F.S.

Florida. The bill also amends s. 738.606(1), F.S., to clarify that the marital deduction in that section can apply to the IRS or a comparable law of any state.

### Liquidating Asset

Assets in a trust that are expected to produce receipts for a limited period of time are allocated such that 10% of the payments go to income and the rest is applied to principal. The Internal Revenue Service (IRS) recently ruled that the safe harbor was between 3 % and 5% to income, putting Florida trusts at risk for additional tax liabilities.

The bill amends s. 738.603(2), F.S., to change the percentage of limited-duration assets applied to income from 10% to 5% to comply with an IRS ruling that 5% is the maximum safe harbor for such an allocation.

### Disbursements from Income

Current law requires fiduciaries to make certain disbursements from income, providing that the disbursements are not income from property used to discharge liabilities or disbursements paying from principal which were incurred in connection with the settlement of a decedent's estate or the winding up of a terminating income interest.<sup>14</sup>

The bill amends s. 738.701, F.S., to add an additional exclusion from disbursements from income, payments from income or principal including, at the fiduciary's discretion, attorney, accountant, or fiduciary fees, court costs, other administration expenses, and interest on death taxes.

### Income Taxes

Current law provides guidelines for paying income taxes out of a trust, including guidelines specifically for paying taxes on an entity's taxable income. Current law also requires payment from income to the extent receipts from the entity are allocated to income and from principal to the extent that receipts from the entity are allocated to principal and the trust's share of the entity's taxable income exceeds the total of such receipts. Receipts allocated to principal or income are reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.<sup>15</sup>

The bill amends s. 738.705, F.S., to provide new guidelines for paying income taxes out of a trust. The bill provides that an income tax required to be paid on the trust or estate's share of an entity's taxable income is to be paid proportionally from income to the extent the receipts from the entity are allocated to income, from principal to the extent the receipts from the entity are allocated to principal, and from principal to the extent that the income taxes payable by the trust or estate exceed the total distributions from the entity. Then, the fiduciary is to adjust income or principal receipts to the extent that the trust or estate's income taxes are reduced, but not eliminated, because the trust or estate receives a deduction for payments made to a beneficiary, with additional guidelines to provide clarity to the fiduciary.

### Improvements

Under the common law, when a tenant of a property had a life estate, the tenant was generally responsible for the maintenance of the property while the holder of the remainder interest, or the remainderman, was responsible for capital improvements. The original adoption of the act attempted to codify the common law rule, but the wording of the act could lead to different conclusion for the apportionment of expenses because the act used terms common in trust law, which did not exist at common law.

The bill amends s. 738.801, F.S., to provide definitions and additional guidelines for apportioning expenses between the life tenant and the remainderman. Life tenants are responsible for paying

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<sup>14</sup> Section 738.701, F.S.

<sup>15</sup> Section 738.705, F.S.

ordinary expenses and maintenance, recurring insurance premiums, and other expenses which are the result of the property's use by the tenant. The remainderman is responsible for paying mortgage debt not allocated to the tenant, expenses due to title other than the tenant's estate, environmental expenses, and extraordinary repairs. If either party incurs an expense for personal benefit without the consent of the other, that party bears the expense in full. For improvements that add value to the property forming part of the principal, the expense is split between the tenant and the remainderman, with the tenant paying to the extent that the improvement increases the value of the tenant's estate.

#### Effective Date

The bill provides an effective date of January 1, 2013, in order to provide practitioners enough lead time to prepare for the changes in the law.

#### B. SECTION DIRECTORY:

Section 1 amends s. 738.102, F.S., providing an additional definition.

Section 2 amends s. 738.103, F.S., relating to fiduciary duties.

Section 3 amends s. 738.104, F.S., relating to the trustee's power to adjust between principal and income.

Section 4 amends s. 738.1041, F.S., relating to total return unitrusts.

Section 5 amends s. 738.105, F.S., relating to judicial control of discretionary powers.

Section 6 amends s. 738.201, F.S., relating to determination and distribution of net income.

Section 7 amends s. 738.202, F.S., relating to distribution to residuary and remainder beneficiaries.

Section 8 amends s. 738.301, F.S., relating to right to income.

Section 9 amends s. 738.302, F.S., relating to apportionment of receipts and disbursements.

Section 10 amends s. 738.303, F.S., relating to apportionment when income interest ends.

Section 11 amends s. 738.401, F.S., relating to the character of receipts.

Section 12 amends s. 738.402, F.S., relating to distribution from trust or estate.

Section 13 amends s. 738.403, F.S., relating to business and other activities conducted by fiduciaries.

Section 14 amends s. 738.501, F.S., relating to principal receipts.

Section 15 amends s. 738.502, F.S., relating to rental property.

Section 16 amends s. 738.503, F.S., relating to the obligation to pay money.

Section 17 amends s. 738.504, F.S., relating to insurance policies and similar contracts.

Section 18 amends s. 738.601, F.S., relating to insubstantial allocations.

Section 19 amends s. 738.602, F.S., relating to payments from deferred compensation plans, annuities, and retirement plans or accounts.

Section 20 amends s. 738.603, F.S., relating to liquidating assets.

Section 21 amends s. 738.604, F.S., relating to minerals, water, and other natural resources.

Section 22 amends s. 738.605, F.S., relating to timber.

Section 23 amends s. 738.606, F.S., relating to property not productive of income.

Section 24 amends s. 738.607, F.S., relating to derivatives and options.

Section 25 amends s. 738.608, F.S., relating to asset-backed securities.

Section 26 amends s. 738.701, F.S., relating to disbursements from income.

Section 27 amends s. 738.702, F.S., relating to disbursements from principal.

Section 28 amends s. 738.703, F.S., relating to transfers from income to principal for depreciation.

Section 29 amends s. 738.704, F.S., relating to transfers from income to reimburse principal.

Section 30 amends s. 738.705, F.S., relating to income taxes.

Section 31 amends s. 738.801, F.S., relating to apportionment of expenses for improvements.

Section 32 provides an effective date of January 1, 2013.

## **II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT**

### **A. FISCAL IMPACT ON STATE GOVERNMENT:**

#### **1. Revenues:**

The bill does not appear to have any impact on state revenues.

#### **2. Expenditures:**

The bill does not appear to have any impact on state expenditures.

### **B. FISCAL IMPACT ON LOCAL GOVERNMENTS:**

#### **1. Revenues:**

The bill does not appear to have any impact on local government revenues.

#### **2. Expenditures:**

The bill does not appear to have any impact on local government expenditures.

### **C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:**

None.

### **D. FISCAL COMMENTS:**

None.

### **III. COMMENTS**

#### **A. CONSTITUTIONAL ISSUES:**

##### **1. Applicability of Municipality/County Mandates Provision:**

The bill does not appear to require counties or municipalities to take an action require the expenditure of funds, reduce the authority that counties or municipalities have to raise revenue in the aggregate, nor reduce the percentage of state tax shared with counties or municipalities.

##### **2. Other:**

None.

#### **B. RULE-MAKING AUTHORITY:**

The bill does not appear to create a need for rulemaking or rulemaking authority.

#### **C. DRAFTING ISSUES OR OTHER COMMENTS:**

None.

### **IV. AMENDMENTS/ COMMITTEE SUBSTITUTE CHANGES**

n/a