

# Principal & Income Act Updated

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Over the years, the Florida Principal and Income Act (the “Act”) has undergone significant changes. The initial adoption of the Act occurred in 1974 with the passage of the then 12 year old 1962 Uniform Principal and Income Act (the “1974 Act”). In 2002, Florida adopted its version of the National Conference of Commissioners on Uniform State Laws (“NCCUSL”) 2000 Uniform Principal and Income Act, which was codified in Chapter § 738 of the Florida Statutes, effective January 1, 2003 (the “2002 Act”). Since the adoption of the 2002 Act, there have been three separate “Glitch Bills” to fix various problems with the Act.<sup>1</sup>

During the 2012 Legislative Session, Florida adopted its fourth “Glitch Bill” as part of Chapter 2012-49, Laws of Florida, effective January 1, 2013 (the “2012 Revisions”). This article focuses on some of the more important 2012 Revisions.

## Fiduciary Duties; General Principals

While most of Florida’s Principal and Income Act is intended to apply to all fiduciaries, including trustees and personal representatives,<sup>2</sup> certain sections of the Act that were intended to apply to all fiduciaries contained the word “trustee.” Additionally, the word “fiduciary(ies)” was used in certain sections that were only intended to apply to “trustee(s).” The 2012 Revisions clarify some of these inconsistencies by using the word “trustee” rather than “fiduciary” in all sections intended to apply only to trusts. Additionally, the 2012 Revisions added a specific provision that states that, “All provisions of this chapter also apply to any estate that is administered in Florida, unless the provision is limited to a trustee rather than a fiduciary.”<sup>3</sup>

## Addition of “Carrying Value”

The 1974 Act included a definition of “Inventory Value.”<sup>4</sup> Although a defined term, “inventory value” was only used in one statute within the 1974 Act, which was former F.S. § 738.11

entitled, “Other property subject to depletion.” The 2002 Act removed this definition because the replacement statute – F.S. § 738.603 – referenced payment based on a percentage of the receipts from a liquidating asset rather than a calculation based on the inventory value. The 2002 Act made no reference to inventory value. Until the 2012 Revisions, the closest use of this phrase in the trusts and estates statutes was outside of Chapter 738 in F.S. § 736.08135(2)(b), which used the phrase “carrying value” and provided that trust accountings were required to present a “carrying value” for each asset owned by the trust. The only other related use of “carrying value” within the probate and trust context is found in Florida Probate Rule 5.346, Appendix B(IV), when referencing the inclusion of “carrying values” in the preparation of a fiduciary accounting.

The 2012 Revisions re-introduce the concept of “inventory value” by instead adopting the phrase “carrying value.” In addition to harmonizing the cited provisions of F.S. § 736.08135(2)(b) with Florida Probate Rule 5.346, Appendix B(IV), several statutes within the 2002 Act were revised to reference “carrying value” within the context of income and principal allocations.<sup>5</sup>

“Carrying value” is defined in F.S. § 738.102(c) as “the fair market value at the time the assets are received by the fiduciary.” This is different from “cost basis,” which is defined in the Internal Revenue Code. For the estates of decedents, and trusts described in F.S. § 733.707(3) after the grantor’s death (i.e., revocable trusts), the carrying value of assets received upon the grantor’s death is the value as determined for federal estate tax purposes (or date of death if no estate tax return is required). For assets acquired during the administration of the estate or trust, the carrying value is equal to the acquisition cost of the asset. If there is a change in fiduciaries, a majority of the continuing fiduciaries may elect to adjust the car-

rying values to reflect the fair market value of the assets at the beginning of their administration. If such an election is made, it must be reflected on the first accounting filed after the election.<sup>6</sup>

## Changes to Unitrust Provisions

When the 2002 Act was adopted, it included a “unitrust provision” that was not included in the NCCUSL version of the Uniform Principal and Income Act.<sup>7</sup> Under Florida’s unitrust provision, unitrusts can be created in one of two ways – either an existing trust can be converted to a unitrust, or a grantor may provide for an “express unitrust” when drafting the governing instrument. The ease of administration aspect of a unitrust has caused it to gain wide acceptance. Typically, the annual unitrust amount is based on the valuation of the trust as of a specific date.<sup>8</sup> Recent market fluctuations, however, have impacted the value of trust assets, resulting in significant variations in the annual calculation of the unitrust amounts. In an effort to minimize these fluctuations, the 2012 Revisions incorporate a “smoothing rule” to be used when computing the fair market value of the unitrust. The smoothing rule incorporates an “Average Fair Market Value” concept,<sup>9</sup> which requires that fair market value for purposes of the unitrust computation be computed using the average of the fair market value of the trust’s assets at the beginning of the current year and each of the prior two years. Additionally, any principal additions to the unitrust during the periods used in computing the “Average Fair Market Value” are taken into account, as illustrated in the following examples.<sup>10</sup> (See examples #1 and #2, next page).

## Distributions To Residuary And Remainder Beneficiaries

The 2002 Act required that distributions of income to pecuniary devisees in trust and remainder beneficiaries be

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**Example #1**

The trustee of a unitrust wants to compute the unitrust distribution for calendar year 2013. This computation will involve averaging the market values of 2011-2013. On July 1, 2012, the trustee receives an addition to principal in the amount of \$1,000,000. Average Fair Market Value would be computed as shown. (For illustration purposes, market fluctuation has not been reflected).

	2011	2012	2013
Beginning Market Value	\$1,000,000	\$1,000,000	\$2,000,000
Principal Addition 07/01/12	<u>1,000,000</u>	<u>1,000,000</u>	
Total FMV	\$2,000,000	\$2,000,000	\$2,000,000

Average FMV for unitrust calculation purposes = \$2,000,000.  
In 2014, assuming no further additions to principal:

	2012	2013	2014
Beginning Market Value	\$1,000,000	\$2,000,000	\$2,000,000
Principal Addition 07/01/12	<u>1,000,000</u>		
Total FMV	\$2,000,000	\$2,000,000	\$2,000,000

Average FMV for unitrust calculation purposes = \$2,000,000

Because the principal addition occurred on July 1, 2012, its value is added to the 2012 asset balance as well as the asset balance for all prior periods used in the computation (limited to 2011 in this example). No prospective adjustment for future years is required because the addition will comprise part of the principal of the trust.

**Example #2**

Same facts as Example #1, except that during 2012, the beneficiary receives a \$500,000 principal distribution.

	2011	2012	2013
Beginning Market Value	\$1,000,000	\$1,000,000	\$1,500,000
Principal Distribution	(500,000)	(500,000)	
Principal Addition 07/01/12	<u>1,000,000</u>	<u>1,000,000</u>	
Total FMV	\$1,500,000	\$1,500,000	\$1,500,000

Average FMV for unitrust calculation purposes = \$1,500,000

Computation for 2014, assuming no further principal contributions or withdrawals, and assuming principal appreciation in 2014:

	2012	2013	2014
Beginning Market Value	\$1,000,000	\$1,500,000	\$2,000,000
Principal Distribution	(500,000)		
Principal Addition 07/01/12	<u>1,000,000</u>		
Total FMV	\$1,500,000	\$1,500,000	\$2,000,000

Average FMV for unitrust calculation purposes = \$1,666,667

Changes to F.S. § 738.1041 clarify that the smoothing rules apply to express unitrusts unless another method is directed in the governing instrument. To avoid the default rules for computing "Average Fair Market Value," the grantor must provide that a unitrust approach is desired, how the fair market value will be computed, what percentage (which must be between 3% and 5% for Internal Revenue Service reasons) is to be used to calculate the unitrust amount and which, if any, assets are to be excluded from the computation.<sup>11</sup>

computed in proportion to their respective interests in the trust principal. This was determined by using fair market values as of date of distribution. This was cumbersome because it required revaluing all assets when each income distribution was made to a pecuniary devisee. This also caused the allocation of income to be different from the taxation of distributable net income. The Internal Revenue Code requires that distributable net income be allocated to beneficiaries based upon the lesser of fair market value or carrying values.<sup>12</sup>

As was the case under the 1974 Act, the 2012 Revisions now require that accounting income be allocated to beneficiaries based upon carrying values, except in cases where disproportionate distributions are made. This greatly simplifies trust administration by not requiring valuation of trust assets each time a distribution is made--unless disproportionate distributions are made.<sup>13</sup> Examples #3 and #4 illustrate the application of this revision when disproportionate distributions are made.<sup>1</sup> (See Examples #3 and #4, next page).

**Distributions From Entities**

The 2002 Act provided that cash distributions from entities not in liquidation were allocated to income.<sup>15</sup> In determining if a distribution was in liquidation, absent a representation from the entity, a default rule existed that provided that any distributions made by the entity in excess of 20% of the entity's gross assets (as shown on the entity's year end financial statements immediately preceding the initial receipt) was deemed to be made in liquidation.<sup>16</sup> This posed a problem for service entities, which have a very small investment in infrastructure, because they regularly distribute in excess of 20% of their gross assets. A similar problem arose when Microsoft declared its very first dividend, which exceeded 20% of the company's gross assets. While it was clear that the distribution was from accumulated earnings and profits, it was nevertheless treated as a liquidating distribution under the default rule.

Additionally, the 2002 Act contained

**Example #3**

The total principal of a trust remaining after all debts and expenses is \$12,000,000. A pecuniary devise of \$7,000,000 is to be held in further trust for the benefit of Beneficiary A with the residue left outright to Beneficiary B. From the onset, the trust for Beneficiary A is entitled to 7/12 of all income earned during administration and Beneficiary B is entitled to 5/12.

Prior to the funding of Beneficiary's A's trust, Beneficiary B receives a principal distribution of \$1,000,000. As of the date of this principal distribution, but prior to the actual distribution, the fair market value of the trust assets is \$20,000,000. The fractional interests are recomputed as follows:

	<b>Beneficiary A</b>	<b>Beneficiary B</b>
Date of death values	\$7,000,000	\$ 5,000,000
Fair Market Value Adjusted as of Date of Disproportionate Principal Distribution	7,000,000	13,000,000
Disproportionate Principal Distribution	<u>                    </u>	<u>(1,000,000)</u>
Remaining Principal	7,000,000	12,000,000
Recomputed Fractions	7/19	12/19

**Example #4**

	<b>Beneficiary A</b>	<b>Beneficiary B</b>
Date of death values	\$ 6,000,000	\$ 6,000,000
Fair Market Value Adjusted as of Date of Disproportionate Principal Distribution	10,000,000	10,000,000
Disproportionate Principal Distribution	<u>                    </u>	<u>(1,000,000)</u>
Remaining Principal	10,000,000	9,000,000
Recomputed Fractions	10/19	9/19

on the entity's year-end financial statements immediately preceding the initial receipt, the distribution will be allocated to income to the extent that total distributions received from the entity – for the number of years or portions thereof while it was subject to the trust – have not equaled a cumulative annual return of 3% of the entity's carrying value, computed at the beginning of each period included in the measuring period. Distributions in excess of this amount are treated as principal.<sup>18</sup>

For publicly traded entities, cash distributions are treated as income unless they are determined to have been made in liquidation. The 20% default rule is replaced by 10% of the entity's fair market value as of the beginning of the measuring period. If total distributions exceed this 10% threshold, such distributions will be income to the extent that amounts allocated to income for the number of years (or portion of years) that the trust held an interest in the entity have not equaled a cumulative return of 3% of the entity's fair market value at the beginning of each measuring period.<sup>19</sup>

**Conclusion**

This article covered some but not all of the 2012 Revisions. Changes were also made to F.S. § 738.602 – payments from deferred compensation plans, annuities, and retirement plans or accounts; F.S. § 738.603 – liquidating assets; F.S. § 738.705 – Income Taxes and; F.S. § 738.801 – application with respect to apportionment of expenses. The complete text of the revised Act can be found at myflorida.com and should be reviewed in its entirety by all practitioners handling issues covered by the Act. ■

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separate rules for tax “pass through” entities by creating two classes of pass through entities.<sup>17</sup> “Targeted Entities” were defined as pass through entities that were not “investment entities.” “Investment Entities” were defined as pass through entities that derived in excess of 50% of their annual cumulative net income from passive sources (i.e. dividends, interest, rents, royalties, etc.).

Distributions from Targeted Entities were treated as income only to the extent of cumulative undistributed income earned by the Targeted Entity while the trust held an interest in the entity. Distributions from Investment Entities were treated as income to the extent that the cumulative undistributed income earned by the entity represented traditional

income items (i.e. interest, dividends, rents & royalties) and as principal to the extent that the accumulated undistributed income represented traditional principal items (i.e. long and short term capital gains). The allocation was made in the same proportion of the income and principal items included in the cumulative undistributed income of the entity.

The 2012 Revisions attempt to simplify these computations and clarify the application of the 20% rule used in determining liquidating distributions. For non- publicly traded entities, cash distributions are treated as income unless they are determined to have been received in liquidation. If the total distributions by the entity exceed 20% of the entity's gross assets as shown



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**Endnotes:**

- 1 Chapter 2003-43, Laws of Florida, effective 05/23/03; Chapter 2005-85, Laws of Florida, effective 07/01/05 and Chapter 2006-217, Laws of Florida, effective 07/01/07.
- 2 "Fiduciary" is defined as meaning a personal representative or trustee. The term includes an executor, administrator, successor personal representative, special administrator, or a person performing substantially the same function. [F.S. § 738.102(4)]
- 3 F.S. § 738.103(3)
- 4 F.S. § 738.01(2) [Applied prior to 01/01/03]
- 5 F.S. § 738.202, F.S. § 738.401(6), and F.S. § 738.603
- 6 F.S. § 738.102(3)

- 7 F.S. § 738.1041
- 8 See generally F.S. § 738.1041(2)(b)2.b.
- 9 F.S. § 738.1041(1)(a)
- 10 Example #1 and #2 are excerpted from the White Paper written for the 2012 changes.
- 11 F.S. § 738.1041(10). Also note that a trust that otherwise qualifies for the federal estate tax marital deduction under I.R.C. § 2056(b)(7) (a "QTIP Trust") may be a total return unitrust as Treas. Reg. § 1.643(b)-1 provides that the unitrust amount is a reasonable apportionment of the total return of a trust and therefore, the unitrust amount is considered to be "income." Several Internal Revenue Service Private Letter Rulings have approved a conversion of the "income only" requirement of a QTIP Trust to a unitrust, but have done so within the guidelines of the applicable state statute as to the unitrust percentage. See, for example, Priv. Ltr. Rul. 201148001.
- 12 IRC §643(e)(2)
- 13 F.S. § 738.202
- 14 Examples #3 and #4 are excerpted from the White Paper written for the 2012 changes.
- 15 F.S. § 738.401(2)
- 16 F.S. § 738.401(5)(b)
- 17 F.S. § 738.401(7)
- 18 F.S. § 738.401(5)(b)
- 19 F.S. § 738.401(e)



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