

SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

Prepared By: Judiciary Committee

BILL: CS/SB 1688

SPONSOR: Judiciary Committee and Senator Atwater

SUBJECT: Trusts & Other Agency Relationships

DATE: April 28, 2005

REVISED: _____

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	<u>Knudson</u>	<u>Deffenbaugh</u>	<u>BI</u>	Favorable
2.	<u>Knudson</u>	<u>Maclure</u>	<u>JU</u>	Fav/CS
3.	_____	_____	_____	_____
4.	_____	_____	_____	_____
5.	_____	_____	_____	_____
6.	_____	_____	_____	_____

I. Summary:

Committee Substitute (CS) for Senate Bill 1688 amends the definition of “security account” within the Florida Uniform Transfer-on-Death Security Registration Act (ch. 711, F.S.) to allow banks and trust companies to open investment management accounts or other accounts that include transfer on death benefits.

The CS makes changes to the powers of trustees under part IV of ch. 737, F.S. The CS specifies that a trustee has the authority to use trust assets to pay compensation and costs incurred in connection with employing attorneys, auditors, investment advisers or agents to assist the trustee in performing his or her administrative duties. The CS also states that trust assets may be used to prosecute or defend a legal action and to pay compensation and costs to attorneys and other agents that assist the trustee in doing so. The CS adds “appeals” to the legal proceedings covered under this authority.

The CS also establishes the means by which a trustee may resign his or her post by creating s. 737.309, F.S. The trustee may resign:

- Upon giving at least 30 days written notice to the settler (if living), all co-trustees, and all persons entitled to a trust accounting (beneficiaries).
- With approval of the court.

The resignation of a trustee does not affect or discharge any liability the trustee or surety on the trustee’s bond may have for acts or omissions. If the resignation requires a successor trustee, the resigning trustee must continue to serve until the successor assumes the trusteeship. Notice of the

resignation must be provided to beneficiaries, and notice and all records pertaining to the resignation must be provided to a co-trustee or the successor trustee.

This CS amends various provisions of the Florida Uniform Principal and Income Act. Chapter 738, F.S., governs the identification of principal and income in or from a trust property through a trust instrument, will, or other governing instrument, the allocation of principal and income, and the apportionment of assets between income and principal. The CS makes the following changes:

- The CS provides four situations for which a trustee does not need court authorization to exercise power that may currently be considered a conflict of interest.
- The CS provides an exception to the rule that the trustee may not make an adjustment if the adjustment would benefit the trustee. Under the CS, a trustee may make an adjustment if the trustee's compensation is based upon the value of trust assets.
- The CS defines the terms "fair market value" and "unitrust amount," and amends the definition of "income trust" and "undistributed income."
- The CS provides that if a trustee or disinterested person does not act in good faith, the provisions of s. 738.105(3), F.S., apply. Thus, if a trustee of a unitrust does not act in good faith in submitting or failing to submit a unitrust plan or modification, a court will have authority to correct the trustee's actions.
- The CS makes it clear that when the administration of a trust is governed by Florida law, but the substantive provisions are governed by the laws of another state, adjustments under s. 738.104, F.S., are administrative and thus governed by Florida law.
- The CS allows the settlor of a trust to create a unitrust from the inception of the trust. This will allow settlors the option to initially draft their trust documents in unitrust form.

The CS provides guidelines for the allocation of certain types of money and property received from targeted entities and investment entities.

This committee substitute substantially amends the following sections of the Florida Statutes: 711.501, 737.402, 737.403, 738.104, 738.1041, 738.303, and 738.401.

This committee substitute creates section 737.309, Florida Statutes:

II. Present Situation:

Chapter 711, F.S., contains the Florida Uniform Transfer on Death Security Registration Act, the purpose of which is to provide a uniform means by which securities may be registered in beneficiary form. It enables the owner of a security to devise ownership of the security to another party upon the owner's death. Securities may be registered in various types of accounts, including joint accounts with a survivorship feature.

Part III of ch. 737, F.S., enumerates the duties and liabilities that a trustee has when administering a trust. A trustee is required to keep the beneficiaries of the trust reasonably informed of the trust and its administration, including providing a beneficiary with a copy of the trust document or providing the beneficiary with relevant information regarding the assets of the trust and how it is being administered, upon request. The trustee must also make an annual

accounting of the trust that details the transactions that the trust entered into over the past year. Part III is silent with regard to the means by which a trustee may resign.

Part IV of ch. 737, F.S., enumerates the powers that a trustee has in administering a trust. Trustees are given various powers, including the collection, retention and distribution of assets from a settlor (the creator of the trust). The trustee may also reinvest trust assets as allowed by the terms of the trust or provided by law, and take a variety of actions as permitted in the trust instrument or by law. The trustee has all the powers contained in this part, unless such powers are limited by the trust instrument.

Chapter 738, F.S., governs the identification of principal and income in or from a trust property through a trust instrument, will, or other governing instrument, the allocation of principal and income, and the apportionment of assets between income and principal. The Florida Legislature enacted the Florida Uniform Principal and Income Act during the 2002 legislative session.¹ The legislation substantially revised ch. 738, F.S., by repealing the existing provisions of ch. 738, F.S., and enacting the Uniform Principal and Income Act, as modified.² The intent of the Act was to:

- Provide more precise procedures for trustees and personal representatives in the administration of a trust or an estate, respectively.
- Specify more clearly what constitutes income and principal and the formulas for allocation of assets to principal and income.
- Ensure proper distribution to beneficiaries, heirs and devisees.
- Reflect changes in principal and allocation rules consistent with modern trust investment principles and practices.

¹ Chapter 2002-42, L.O.F.

² This Act is based on the Uniform Principal and Income Act (1997) promulgated by the National Conference of Commissioners on Uniform State Laws. Florida's Act also includes a number of provisions not found in the NCCUSL version of the uniform act. For example, ch. 738, F.S., provides that: 1) There is no express or implied duty to exercise a power to adjust between principal and income or vice versa (s. 738.104(7), F.S.); 2) Beneficiaries, by a super majority, have a right to object to a trustee's discretionary power to adjust between principal and income (s. 738.104(8), F.S.); 3) A trustee has the discretionary power to convert an income trust to a total return unitrust or reconvert a total return unitrust to an income trust (s.738.1041, F.S.); 4) Value of trust assets is to be determined on an asset-by-asset basis and a challenge to such valuation must be made within 6 months of notice of such valuation (s. 738.202(5), F.S.); 5) State law on the apportionment of estate taxes controls over any apportionment provision in ch. 738, F.S. (s. 738.302(4),F.S.); 6) New shares of stock purchased from reinvested dividends retain their character as income (s. 738.401(4), F.S.); 7) provisions governing the sale and collection of interest from bonds and other obligations to pay were expanded (s. 738.503(3), F.S.); 8) A trustee must allocate to income payments received in the nature of interest or dividends under specified circumstances (s. 738.602(2)(a)2., F.S.); 9) An additional category of expenses for extraordinary repairs or expenses in capital improvements may be charged against the principal (s. 738.702(1)(h), F.S.); 10) The amount of depreciation taken for tax purposes is presumptively the correct depreciation for allocating between principal and income (s. 738.703(3), F.S.); 11) A formula for appointing expenses between a life tenant and the remainder interests is provided. See s. 738.801, F.S. The following provisions were originally found in the Uniform Principal and Income Act (1997) but altered in Florida's version of the uniform act: 1) Section 738.503(2), F.S., does not include 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. However, subsection (3) of this section expands upon the provisions regarding the sale of a bond. 2) Section 738.704(2), F.S., does not include the ability of a trustee to "borrow" principal to pay certain expenses chargeable against income, namely extraordinary repairs and capital improvements. Subsection (4) is added to provide that the principal may only be advanced for mortgage payments if necessary to avoid a default.

The guiding principle under ch. 738, F.S., is to ensure that the trust's creator's intent governs the interpretation and construction of the trust or other governing instrument. Therefore, the default rules of ch. 738, F.S., are only operative in the event a trust document, will, or other governing instrument is silent.

Section 738.1041, F.S., governs the creation of a total return unitrust and provides rules for the trustee in operating the unitrust. Traditionally, most trusts were known as income rule trusts in which the trustee holds the principal of the trust and makes distributions of income. A total return trust allows not only the distribution of trust income, but also capital appreciation. A total return unitrust pays a set percentage of trust assets (income and capital appreciation) in each distribution.³

III. Effect of Proposed Changes:

Section 1. Amends definition of "security account" in s. 711.501(10), F.S., to allow banks and trust companies to open investment management accounts or other accounts that include transfer on death benefits. Under the committee substitute (CS), a "security account" includes an investment management, investment advisory, investment agency, custody, or other account with a bank or trust company, including the securities in the account, the cash balance, all cash equivalents, and interest, earnings, or dividends earned or declared on a security in the account, whether or not credited to the account before the owner's death. The purpose of the change is to include investment accounts at banks and trust companies within the definition of "security account." The current definition only permits a securities broker to hold such accounts, and proponents of the CS state there is no good reason to exclude banks and trust companies, which could benefit from the ability to open accounts that include transfer on death benefits.

Section 2. The CS amends paragraphs (y) and (z) of s. 737.402(2), F.S. The section expands the powers of a trustee to spend trust funds. It specifies that a trustee has the authority to use trust assets to pay compensation and costs incurred in connection with employing attorneys, auditors, investment advisers or agents to assist the trustee in performing his or her administrative duties. The CS also states that trust assets may be used to prosecute or defend a legal action and to pay compensation and costs to attorneys and other agents that assist the trustee in doing so. The CS adds "appeals" to the legal proceedings covered under this authority.

Section 3. Amends s. 737.403(2), F.S., to expand the situations in which a trustee may exercise power without court authorization. Generally, if a trustee's personal interests conflict with an exercise of trust power, the trustee can only exercise that power with court authorization. The CS provides four situations for which a trustee does not need court authorization to exercise power:

- When the trust document acknowledges the conflict of interest and expressly authorizes the exercise of that power.
- The trustee may also exercise any power consented to in writing by a settlor of the trust while the settlor holds a right of revocation for the trust.
- When the exercise of power is consented to in writing by each of the beneficiaries to whom the trustee is required to provide annual or periodic accounting. Consent may be

³ Thomas Begley, Jr., *Total Return Trusts: Why Didn't We Think of That*, 74-APR Fla. Bar Journal 74 (2000).

given by a person who represents the beneficiary under s.731.303, F.S., or the legal or natural guardian of the beneficiary.

- The trustee may use trust assets to pay costs or attorney's fees incurred in a trust proceeding without court order unless an action is pending against the trustee for breach of trust, the trustee withdraws or dismisses the case, or if the trustee is found by the court to have committed a breach of trust.

Section 4. Amends s. 738.104, F.S. This section sets forth the powers of a trustee to make adjustments between principal and income. Generally, a trustee may make an adjustment to the trust that is in accordance with the purpose of the trust. Subsection (3) details the types of adjustments that a trustee cannot make. The CS eliminates the prohibition in paragraph (3)(a) against an adjustment that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed if the trustee did not have the power to adjust. This provision is eliminated because regulations adopted by the Internal Revenue Service have made the provision unnecessary in order to protect trusts from adverse tax consequences.

The CS also provides an exception to the rule that the trustee may not make an adjustment if the adjustment would benefit the trustee. Under the CS, the exception would be provided for a trustee whose compensation is based upon the value of trust assets.

The CS also creates subsection (11) of s. 738.104, F.S., which states that the section applies to the administration of a trust and is available to any trust administered in this state or under Florida law. This will allow trustees to use the power of adjustment contained in the Uniform Principal and Income Act (UPIA) in trusts administered in Florida, even if the trust is governed by the laws of a state that has not adopted the UPIA.

Section 5. Amends s. 738.1041, F.S., relating to total return unitrusts. The CS defines "fair market value" for purposes of this section to mean the fair market value of assets held by the trust as determined under ch. 738, F.S., reduced by all known non-contingent liabilities. The definition provides guidance on how to treat liabilities in calculating fair market value. The definition of "income trust" is amended to clarify that the issue of whether the trust directs or permits the trustee to distribute the principal of the trust to one or more persons. It also eliminates the requirement that a trust cannot qualify as an income trust if it may be subject to taxation under the Internal Revenue Code 26 U.S.C. s. 2001 or s. 2501 until the expiration of the period for filing a tax return, including extensions. The CS defines "unitrust amount" as the fair market value of trust assets multiplied by the percentage to be distributed. The definition provides guidance on how to calculate the unitrust amount to be distributed.

The CS permits a disinterested trustee to use either means of creating a unitrust under s. 738.1041(2)(b), F.S. The CS also reduces the time a grantor, beneficiary, advisor or protector of the trust has to object to its conversion into a total return unitrust. A unitrust plan goes into effect unless an interested person objects. The objection period under the CS is 60 days after service of such notice, instead of 60 days after notice has been received.

The CS eliminates the requirement in subsection (5) that the unitrust amount cannot be less than the net income of the trust for trusts for which a marital deduction has been taken, or for trusts to

which the generation skipping transfer tax under the Internal Revenue Code does not apply by reason of an effective date or transition rule. Under the deleted language, the rules did not apply to a total return unitrust recognized for tax purposes under the Internal Revenue Code, 26 U.S.C. s. 2056 or s. 2523. The CS also eliminates the requirement in subsection (9) that if a marital deduction has been taken for a trust, the spouse has the right to reconvert the trust from a total return unitrust to an income trust. These sections may be eliminated according to proponents of the legislation, because regulation adopted by the Internal Revenue Service have made the provision unnecessary in order to protect trusts from adverse tax consequences.

The CS applies the trustee liability provisions of s. 738.105(3), F.S., to a trustee who acts in bad faith and submits or fails to submit a unitrust plan or modification to a unitrust plan. Section 738.105(3), F.S., requires the trustee to use his own assets to make beneficiaries or the trust whole if the court is unable to restore the beneficiaries or trust by adjusting the disbursements from the trust.

The CS amends subsection (12) as new subsection (10) and permits a trust to be converted into a total return unitrust if it is administered in Florida or under Florida law (but located elsewhere). Currently, the trust must be administered in Florida in order to be converted.

The CS creates a new subsection (11) that allows the settler of a trust to create a unitrust from the inception of the trust. This will allow settlers the option to initially draft their trust documents in unitrust form.

Section 6. Amends s. 738.303(1), F.S., to state that “undistributed income” in a trust includes not only income received before the date on which an income interest ends (the beneficiary dies), but also income received on the date on which an income interest ends. The change corrects a technical problem in the statutes that had the effect of restricting undistributed income to income received two days before the income interest ends. The CS also defines “undistributed income” in a unitrust as being the prorated unitrust amount computed on a daily basis through the date on which the income interest ends.

Section 7. Amends s. 738.401, F.S., which provides rules on whether a trustee is to allocate property from an “entity” (a corporation, LLC, partnership; etc) to income or principal. Generally, cash is allocated to income, though there are exceptions. One such exception is that money received in the total or partial liquidation of that entity is to be allocated to the principal of the unitrust. Property other than cash is allocated to principle, as is cash that is exempt from being allocated to income.

The CS provides rules in a new subsection (7) that applies to moneys or property received by a private trustee from an entity in certain circumstances. Money or property received from a targeted entity⁴ that is not an investment entity⁵ that does not exceed the trust’s pro-rata share of the undistributed cumulative net income⁶ of the targeted entity during the time an ownership

⁴ A partnership, subchapter S corporation, or disregarded entity not described in s. 738.403, F.S.

⁵ A targeted entity that normally derives 50 percent or more of its annual cumulative net income from interest, dividends, and other passive instruments.

⁶ The trust’s pro-rata share of cumulative net income minus all prior distributions to the trust from the targeted entity that were allocated to income

interest in the entity was held by the trust is allocated to income. The balance of money or property received from that entity is allocated to principal. If trust assets include any interest in an investment entity, the designated amount of money or property received shall be treated in the same manner as if the trustee had directly held the trust's pro-rata share of the assets of the investment entity attributable to the distribution of such designated amount. Thereafter, distributions must be treated as principal. The CS also states that a trustee may rely upon an entity's statement regarding the amount of profits of a targeted entity.

Section 8. Creates s. 737.309, F.S., and states that a trustee may resign in one of the following two ways:

- After giving at least 30-days written notice to the settlor (if living), any co-trustees, and all persons entitled to a trust accounting (beneficiaries) under s. 737.303, F.S., and s. 731.303, F.S.
- Upon court approval. The court has the authority to issue order and impose conditions necessary to preserve the trust property.

The resignation of a trustee is subject to the following conditions:

- Any liability the resigning trustee has for acts or omissions on the trustee's part is not discharged or affected by the resignation. This also applies to surety on the trustee's bond.
- If the trustee's resignation requires the vacancy to be filled by a successor trustee, the resigning trustee must continue to serve until the successor takes the position. The resigning trustee must deliver copies of all notices and records pertaining to his or her resignation to the successor trustee, or a co-trustee if there is no successor.
- Notice of resignation must be served in the same way as service of pleadings is made under the Florida Rules of Civil Procedure (Rule 1.080, et seq.). Such notice may be served on the legal representative or natural guardian of a beneficiary without the filing of any proceeding or approval of a court.

The rules for resignation contained in this section appear likely will override any provisions in currently existing trusts that provide criteria for when and how a trustee may resign.

Section 9. The act is effective upon becoming law.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

The CS makes corrections that should make the administration of trusts more efficient and clarifies ambiguous portions of the law, which may have the effect of reducing costs.

C. Government Sector Impact:

None.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

This Senate staff analysis does not reflect the intent or official position of the bill's sponsor or the Florida Senate.

VIII. Summary of Amendments:

None.

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