

The Florida Senate
BILL ANALYSIS AND FISCAL IMPACT STATEMENT

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

Prepared By: The Professional Staff of the Banking and Insurance Committee

BILL: SB 1222

INTRODUCER: Senator Richter

SUBJECT: Florida Uniform Principal and Income Act

DATE: March 15, 2009 REVISED: _____

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Messer	Burgess	BI	Favorable
2.	_____	_____	JU	_____
3.	_____	_____	WPSC	_____
4.	_____	_____	_____	_____
5.	_____	_____	_____	_____
6.	_____	_____	_____	_____

I. Summary:

This bill rewrites s. 738.602, F.S., which codified Florida’s Principal and Income Act. This section defines how a trustee is to characterize payments as either principal or income from deferred compensation plans, annuities, retirement plans or other similar arrangements to trusts named as beneficiaries of the payments. The impetus to rewrite s. 738.602, F.S., was a recent Internal Revenue Service (IRS) revenue ruling.¹ The revenue ruling rejected the allocation provisions in s. 738.602, F.S., as they apply to marital trusts, for failing to entitle the surviving spouse to all of an Individual Retirement Account’s (IRA) income. This failure could prevent the IRA and its beneficiary-trust from qualifying for the estate tax marital deduction. This bill amends the allocation provisions in s. 738.602, F.S., for payments from deferred compensation plans, annuities, and retirement plans or accounts in order to allow marital deduction trusts to continue to receive favorable federal estate tax treatment.

A surviving spouse has a qualifying income interest for life in an IRA or similar retirement plan, and in a marital trust named as the beneficiary of that retirement plan, if the spouse has the power to compel the trustee to withdraw the income earned on the retirement fund’s assets and to distribute that income.² Thus, a necessary requirement to determine whether a surviving spouse has a qualifying income interest in such a fund is to calculate the fund’s income. This bill conforms Florida Statutes to comply with a recent IRS ruling that rejected a portion of Florida’s current statutory income and principal calculation. The IRS made it clear that the 10 percent rule, an income and principal calculation currently in s. 738.602, F.S., was too arbitrary for purposes

¹ See Rev. Rul. 2006-26.

² See Rev. Rul. 2000-2, 2000-1 C.B. 305, citing IRC § 2056(b)(7)(B)(ii).

of the marital deduction. For this reason, the proposed changes to s. 738.602, F.S., disallow the arbitrary 10 percent rule for trusts receiving marital deductions.

This bill substantially amends the following section of the Florida Statutes: 738.602.

II. Present Situation:

Section 738.602 F.S., currently provides three methods for allocating a payment from a retirement plan to a trust as either principal or income. Under the first method the plan (IRA, deferred compensation, or otherwise as defined in the statute) characterizes a payment as interest, dividends, or their equivalent.³ The second method under s. 738.602(2)(a)2., F.S., authorizes the trustee of the receiving trust to allocate reasonably and in good faith all other payments as interest, dividends, or their equivalent.

If neither of the first two methods applies, s. 738.602(3), F.S., characterizes the payment. For required payments, such as IRA required minimum distributions, s. 738.602(3), F.S., allocates 90 percent of the payment to principal and 10 percent to income. If a payment is a non-required payment, then it is completely allocated to principal. This method of determining principal and income was rejected in an IRS revenue ruling;⁴ as a consequence, use of this method could cause both the IRA and the trust named as beneficiary to not qualify for an estate tax marital deduction.

In 2002, the Florida Legislature substantially revised the principal and income laws in ch. 738, F.S.⁵ Section 738.602, F.S., provides a means for classifying payments into trusts from retirement plans, deferred compensation plans, annuities, IRAs and other types of retirement plans as either trust accounting income or trust accounting principal. The statutory language describes the default rules that are activated when a trust does not explicitly address a relevant area. Accordingly, trust language is often drafted to address terms such that the statutory default provisions are not activated. However, there is a possibility that trusts that do not contain language overriding the default definitions provided in s. 738.602, F.S., may not qualify for Qualified Terminable Interest Property (QTIP) treatment as intended for federal estate tax purposes.

III. Effect of Proposed Changes:

Section 1 amends and expands s. 738.602, F.S., with respect to the classification of payments from a retirement fund to a trust as either principal or income.

Section 2 provides that the act shall take effect on July 1, 2009.

This bill amends s. 738.602, F.S., to provide for favorable federal tax treatment of marital deduction (QTIP) trusts. The allocation of a payment is either by the general rule in subsection (4), or the special rule applicable to marital trusts in subsection (5). The general rule for allocation of payments is similar to the allocation found currently in s. 738.602, F.S. Where the fund, such as an IRA or other retirement fund, designates the portions of a payment as income

³ See s. 738.602(2)(a)1., F.S.

⁴ Rev. Rul. 2006-26, 2006-22 I.R.B.

⁵ 2002 Fla. Laws ch. 42.

and principal, that designation controls. If the fund does not make such a designation upon disbursement of the payment, but the trustee can reasonably determine income and principal, then the trustee's determination controls. If neither of these provisions apply, then a required payment is allocated 10 percent to income and the remainder to principal; a non-required payment is 100 percent principal. However, when the trust at issue is a marital deduction trust, the bill provides that the general rule does not apply and instead the trustee must pay the spouse all of the income of the trust. The assets of the trust are broken into funds, which are defined as being either separate or nonseparate.

Under s. 738.602(1)(c), F.S., a non-separate account means that a participant or account holder's benefit can be determined only at retirement or at death. Under proposed s. 738.602(1)(e), F.S., a separate account is a type of fund that holds assets exclusively for an individual and either has a readily ascertainable fair market value or is arranged so that the administrator of the fund maintains records that show receipts and disbursements associated with such assets.

The trustee of a trust may elect one of two methods of determining the income of a separate account.

- Method 1 under s. 738.602(5)(a)1, F.S. Unless the surviving spouse directs the trustee to leave the income in the fund, the trustee shall withdraw and pay to the surviving spouse, no less frequently than annually, the income of the fund as determined by the trust provisions of ss. 738.401-738.706. In other words, the trust rules for determining income and principal will be applied to the fund.
- Method 2 under s. 738.602(5)(a)2, F.S. Unless the surviving spouse directs the trustee to leave the income in the fund, the trustee must withdraw and pay to the surviving spouse, no less frequently than annually, all of the fund's income as determined under proposed s. 738.602(1)(e)1.b., F.S. This permits the trustee to treat a separate account as a unitrust and withdraw an amount based on a fixed percentage of a fund's fair market value. The trustee has no discretion in determining the percentage and must calculate it by taking fifty percent of the interest rate determined under the Internal Revenue Code section 7520, as described in s. 738.1041(2)(a)2.b., F.S.

The bill imposes a duty on the trustee to provide the trust's beneficiaries with information about the election, under method 2, to treat a fund as a unitrust. The trustee fulfills this duty by preparing a trust disclosure document in accordance with s. 736.1008(4)(a), F.S. The disclosure shall contain sufficient information to describe the operation of the unitrust method, including, but not limited to, the unitrust percentage, the determination of the percentage, a description of the assets held in the fund, the fair market value of those assets, and the method for calculating the unitrust amount. If the trustee terminates an election, the trustee must also disclose this decision in a trust disclosure document.

For non-separate accounts, which the revenue ruling did not address, this bill provides that the trustee shall pay the surviving spouse all the income of the fund determined as a unitrust amount in s. 738.602(1)(e)2., F.S. Thus, for non-separate accounts, the bill does not afford the trustee with an option as to which method will be used to determine principal and income.

In either the separate account or non-separate account scenario, this bill eliminates the arbitrary 10 percent income allocation provision as it applies to marital deduction trusts in s. 738.602(5), F.S.

Section 738.602(5), F.S., also encompasses lifetime transfers to trusts in which the transferor's spouse is entitled to all of the fund's income. An example of this would be an annuity payment. In the event the trust's language does not provide the transferor's spouse with the right to all of the fund's income, s. 738.602(5)(b), F.S., operates to create this entitlement. The trust would then qualify for the gift tax marital deduction.

Section 738.602(6), F.S., provides that the section shall not apply to liquidating assets, as defined in s. 738.603, F.S.

The bill imposes a duty on the trustee to provide the trust's beneficiaries with information about the election to treat a fund as a unitrust. The trustee fulfills this duty by preparing a trust disclosure document in accordance with s. 736.1008(4)(a), F.S., of the trust code. The disclosure shall contain sufficient information to describe the operation of the unitrust method, including, but not limited to, the unitrust percentage, the determination of the percentage, a description of the assets held in the fund, the fair market value of those assets, and the method for calculating the unitrust amount. If the trustee terminates an election, the trustee must also disclose this decision in a trust disclosure document.

The provision in s. 738.602(2)(b), F.S., gives the trustee full discretion to elect which method to choose when calculating principal and income in a separate account scenario. Additionally, the trustee may change the method of determining the income of the fund for any future accounting period.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Fiscal Impact Statement:

A. Tax/Fee Issues:

This bill may assist in estate tax avoidance.

B. Private Sector Impact:

This bill will aid in preventing widowed spouses from failing to benefit from the estate tax marital deduction.

C. Government Sector Impact:

None.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Additional Information:

A. Committee Substitute – Statement of Substantial Changes:

(Summarizing differences between the Committee Substitute and the prior version of the bill.)

None.

B. Amendments:

None.