GETTING A GRIP ON FIDUCIARY ACCOUNTING UNDER THE FLORIDA UNIFORM PRINCIPAL AND INCOME ACT, CHAPTER 738, FLORIDA STATUTES

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I. <u>Why Should You Care About This Topic</u>?

A. The Florida Trust Code requires trustees to provide annual accountings to all "qualified beneficiaries" of the trust. Accountings are also required when the trust terminates or when there has been a change in trustees.

(1) The "qualified beneficiaries" are (a) those persons who are entitled to share in the income or principal of the trust right now, whether on a mandatory or discretionary basis; and (b) those persons who would receive or have the benefit of the trust assets if all of the persons described in (1) were no longer beneficiaries.

(2) **The trust agreement cannot waive or restrict the trustee's duty to account**.

(3) Beneficiaries can waive their rights to receive trust accountings. They often don't.

B. A probate estate cannot be closed unless the personal representative provides an accounting of the estate administration (or all of the beneficiaries waive their rights to the final accounting…and at least one beneficiary often won't). Estate accountings disclose the same information in the same format as a trust accounting.

C. An "accounting" must be "a reasonably understandable report from the date of the last trust accounting, or, if none, from the date the trustee became accountable" that adequately discloses the information set forth in F.S.[*] Section 736.08135(2) a copy of which is attached as ***Exhibit A.***

D. Florida Probate Rule 5.346 provides a model format for an accounting for use in estate accountings, a copy of which is attached as ***Exhibit B.*** The model format can, and frequently is, easily be adapted for use in trust accountings.

E. Trustees can get sued, surcharged and removed from office if they don't account. A failure to account also keeps open the statute of limitations for beneficiaries to sue for breach of trust, sometimes for up to 40 years if the trustee is a Very Bad Person. On the other hand, if the trustee accounts to the beneficiaries in a manner that rises to the level of a trust accounting under F. S. 736.08135(2) **and** if the accounting contains a limitation notice, the trustee's liability for matters adequately disclosed on the accounting is limited to six months. A "limitation notice" should slavishly follow the form of limitation notice in F.S. 736.1008(4)(c), as follows:

[*]In this outline, F.S. refers to the Florida Statutes.

> An action for breach of trust based on matters disclosed in a trust accounting or other written report of the trustee may be subject to a 6-month statute of limitations from the receipt of the trust accounting or other report. If you have questions, please consult your attorney.

F. The trustee will probably see the trust's CPA much more frequently than the trustee will see his or her lawyer, if the trustee has one.

G. A trustee who accounts when and as required has a happy lawyer and, whether the trustee knows it or not, happy beneficiaries. A CPA who assists the trustee to fulfill his or her accounting duties has a happy trustee. Or not.

II. The Florida Uniform Principal and Income Act ("FPIA"): A High-Altitude View

A. Where to Find It. Chapter 738, Florida Statutes. Parts of FPIA have recently been amended, but the amendments take effect only on January 1, 2013. Many of the amendments will be referred to in this outline, flagged by "NEW LAW". The amendments are attached as ***Exhibit C.***

B. When it applies.

(1) FPIA applies in the administration of all Florida trusts and estates. However, when the trust or will contains a provision that directs the fiduciary to something different from what is provided for in FPIA, the contrary provision in the will or trust agreement controls.

(2) If the will or trust gives the fiduciary a discretionary power of administration, the fiduciary can exercise the discretionary power to achieve a result different from that provided in FPIA. The fiduciary's discretion is bounded by all applicable fiduciary duties. Further, F. S. 738.103 (2) requires a fiduciary with a discretionary administrative power to "administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary may favor one or more of the beneficiaries."

(3) F. S. 738.801 makes the portions of FPIA dealing with apportionment of expenses (*See* III.B below) applicable to life tenant / remainderman relationships, e.g., common law or statutory life estates. NEW LAW: F. S. 738.801 (1) is now much more specific in the apportionment of expenses to life tenants and remaindermen. The statutory provisions that deal with apportionment of improvements to the property that can reasonably be expected to outlast the life tenant's interest are now explicitly based on

the present value of the life estate using the rates in Code Section 7520. The life tenant is responsible for paying a portion of the improvement based on the actuarial value of the life estate, and the remaindermen pay the rest.

C. What it Does.

(1) Certain trust beneficiaries may be entitled to "income" and others to "principal." During the administration of an estate, some beneficiaries will be entitled to "income" from the residuary estate assets and others will not. If the income and principal beneficiaries are exactly the same, neither the fiduciary nor the beneficiaries would care what is "income" and what is "principal": the same person gets all the money. But if the income beneficiaries and principal beneficiaries are different, it matters a great deal to the fiduciary and to the beneficiaries to differentiate between receipts that are "income" and those that are "principal."

(2) Trusts and estates incur administrative expenses that must be paid from fiduciary funds. If the income and principal beneficiaries are exactly the same, neither the fiduciary nor the beneficiaries would care what expenses are allocated to "income" and what expenses are allocated to "principal": the same person bears the economic effect of the payment of the expense. But if the income beneficiaries and principal beneficiaries are different, it matters a great deal to the fiduciary and to the beneficiaries whether expenses are allocated to "income" or "principal."

(3) FPIA, to the extent it is not superseded by a contrary term in the trust or will, is the fiduciary's road map for allocating receipts and disbursements. A fiduciary who does what FPIA says to do (again, subject to a contrary term on the governing instrument and to a discretionary power of the fiduciary to depart from the statute) is by statute presumed to be acting in a fair and reasonable manner towards all beneficiaries. F. S. 738.103(2).

III. FPIA Up Close

A. Receipts

(1) What is "Income"?

a. Income for purposes of FPIA is NOT the same thing as income for federal tax purposes. For example, capital gains from a sale of trust or estate assets is taxable income but it is not fiduciary accounting income (*but see* A.(1)c. below).

b. That being said, consider Code Section 643(b), which defines "income" for purposes of Subchapter J (other than the grantor trust provisions), when the term is not modified by "taxable" or "distributable net" or "gross," to be "the income of the estate or trust for the taxable year *determined under the terms of the governing instrument and applicable local law."* (emphasis added). This is a rare instance of the Internal Revenue Code explicitly deferring the substance of federal tax law to state law.

c. As suggested by the portion of Code Section 643(b) quoted above, and as provided in FPIA, the governing instrument can define what is "income." For example, Treas. Regs. Section 1.643(a)-3 provides that capital gains are included in DNI if the governing instrument provides that capital gains are to be FPIA income, or gives the trustee discretion to allocate capital gains to income and the trustee does that. DNI is, generally speaking, the measure to determine which part of the trust's *taxable* income is taxed to the beneficiaries who receive trust assets. Thus, classification of a receipt as "income" or principal" for *state law*, *FPIA purposes* necessarily affects the classification of that receipt as income to the beneficiaries, or to the trust or estate, for *federal tax law purposes*.

d. F. S. 738.102(4) gives the general definition of "income." Under the statute, FPIA income is "money or property that a fiduciary receives as current return from a principal asset." Interest and stock dividends are easy examples.

e. There are special rules that govern a fiduciary's receipt of "money" from an "entity;" these are contained in F. S. 738.401. "Money" is cash, and an "entity" is a partnership, LLC, corporation, REIT or other organization in which the trustee has an interest. An "entity" does not include a business conducted by the trust as a sole proprietorship that the trustee is accounting for separately from the rest of the trust assets (in which case F. S. 738.403 applies to give the trustee great leeway to allocate receipts as between income and principal).

i. In general, money received from an entity is allocated to *income*.

ii. Also in general, the following receipts from an entity are added to *principal*:

1. Property other than money;

2. Money received in exchange for part or all of the trust's interest in the entity, whether all at once or in a series of related payments.

3. Money received in total or partial liquidation of the entity. <u>NEW LAW</u>: Money will be treated as being received in partial liquidation of the entity that is *not* publicly traded if it exceeds 20% of the trust's or estate's pro rata share of the entity's gross assets. However, money cannot be considered in determining whether there is an excess unless the amount exceeds the *greater* of (a) a cumulative

annual return equal to 3% of the entity's carrying value (*see* C.(2)b.i. below for definition of "carrying value"); and (b) if the entity is a pass-through or disregarded entity, the cumulative annual amount of income tax attributable to the trust's or estate's pro rata share of the taxable income of the entity that distributes the money, calculated as if the tax was incurred by the fiduciary. The statutory changes are intended to avoid unduly favoring the principal beneficiaries with regard to liquidating payments.

4. <u>NEW LAW</u>: Money received from an entity that *is* publicly-traded entity that exceeds 10% of the FMV of the trust's or estate's interest in the entity is allocated to principal. However, the fiduciary has to reduce the amount allocated to principal to the extent that the cumulative distributions from the entity to the trust or estate do not exceed a cumulative annual return of 3% of the FMV of the interest in the entity in each year in which the trust owned the interest in the entity. This is an income catch-up provision, and is reminiscent of the now-repealed underproductive property statute.

5. <u>NEW LAW</u>: The special provisions in F. S. 738.401(7) that apply to money received by a "private trustee" (e.g., not a bank) as a distribution from an "investment entity" have been completely re-done. As before, the purposes of these provisions is to prevent a Very Naughty Trustee from playing games with a trust's investment assets (e.g., by putting the trust's income-producing investment portfolio into an entity the trustee could increase the amount of payments that are FPIA income under F. S. 738.401(7)). The re-draft of the statue is to tighten up perceived abuses and to make things easier for private trustees who invest in publicly-traded partnerships.

f. There are also special rules that govern payments received from deferred compensation plans, annuities, and IRAs and other retirement accounts; these are set forth in F. S. 738.602.

i. In general, if the trust owns a garden-variety annuity, IRA or retirement account (the statute calls each of these a "fund"), the income of the fund is either (a) the income attributable to the assets in the fund, as if the fund were a trust subject to FPIA; in other words, the trustee looks through the fund to determine the income; or (b) a unitrust amount selected by the trustee as to the fund, in the manner provided by and subject to the procedures of F. S. 738.1041 (*see* D.(2) and following below).

ii. Having determined the income from the assets in a fund, the trustee then allocates a receipt from the fund as follows: An amount equal to the *lesser* of (a) the payment received by the trustee from the fund; or (b) the income from the fund as determined under f.i above is *income*, and the rest of the payment, if any, is *principal*. <u>NEW LAW</u>: The portions of F. S. 738.602(4) that formerly provided guidance to the trustee when the trustee could not tell what was the income of the fund have been struck. Now, a trustee who cannot figure out the income on a "see through" basis will need to use the unitrust amount approach as the only other available option.

iii. Trusts that qualify for the gift or estate tax marital or charitable deduction are subject to specialized rules of F. S. 738.602(5), which are in the nature of savings provisions.

(2) <u>What is "Principal"</u>?

a. In general, principal is "property held in trust for distribution to a remainder beneficiary when the trust terminates." F. S. 738.102(10).

b. Also in general, pursuant to F. S. 738.501, a trustee must allocate to principal:

i. To the extent not allocated to income under some other provisions of FPIA (*see* d below), assets received from the trust grantor during lifetime, assets received by the trustee from an estate or from another trust upon its termination, and assets received by the trustee as a beneficiary under a contract.

ii. Money received from a sale or exchange of a principal asset.

iii. Eminent domain awards.

iv. Income when there is no trust beneficiary who can receive it (for example, if the trustee directs the trustee to accumulate income for a certain period of time).

c. Proceeds of insurance that insures the trust against damage, loss or destruction of trust assets are allocated to *principal*, but to the extent that the policy inures the trustee against loss of occupancy or other use by the income beneficiary, the proceeds are allocated to *income.* Dividends on any policy of insurance are allocated to principal or income based upon how the premium payment as allocated. F. S. 738.504.

d. A distribution from a trust or estate is income or principal depending upon its classification as income or principal by the distributing entity. F. S. 738.402.

B. <u>Disbursements</u>

(1) <u>What is charged to Income</u>? Under the general rule, as set forth in F. S. 738.701, the following are charged to income:

a. One-half of the trustee’s regular compensation, and one-half of fees paid for investment advice or custodial services;

b. One-half of all charges for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;

c. All other “ordinary expenses” incurred in connection with the management, administration or preservation of trust assets and the distribution of income, including interest; ordinary repairs; regularly recurring taxes assessed against principal (e.g., property taxes); and expenses or anything that “primarily” concerns the income interest.

d. Recurring premiums on insurance covering the loss of a principal asset or the loss of income or use of the asset.

(2) What is Charged to Principal? Under the general rule as set forth in F. S. 738.701, the following are charged to principal:

a. The other half of trustee’s regular compensation, fees paid for investment advice or custodial services, charges for accountings, judicial proceedings, or other matters that involve both the income and remainder interests.

b. Payments on the principal of a trust debt.

c. Expenses of a proceeding that primarily concerns trust principal, including a proceeding to construe the trust or to protect the trust or its property.

d. Estate and other transfer taxes including penalties and interest.

e. Payments for environmental matters.

f. Payments for extraordinary repairs or capital improvements.

(3) Special Rules for Estates and “Administrative Trusts”. The general rules as set forth in (1) and (2) above don’t apply in the case of estates or a decedent’s revocable trust in the period of administration after the trust grantor dies (an “administrative trust”). Instead, the rules in F. S. 738.201 apply. Pursuant to those rules:

i. The PR or the trustee has discretion to charge against *income* or *principal* fees for accountants, attorneys and fiduciaries; court costs and other expenses of administration, and interest in death taxes, but the fiduciary can pay the expenses from income allocable to property passing to a trust for which an estate tax marital or charitable deduction is claimed only to the extent that the deduction is not reduced.

ii. The PR pays from *principal* "all other disbursements made or incurred in connection with the settlement of the decedent's estate or [the administrative trust], including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or [the administrative trust]…."

(4) Income Taxes. Under F. S. 738.705:

a. A tax payable on receipts allocated to income is payable from income.

b. A tax payable on receipts allocated to principal is payable from principal.

c. In the case of a tax payable attributable to a pass-though entity such as an LLC or partnership, payment is charged to income to the extent receipts from the pass-through entity were allocated to income, and to principal to the extent the receipts were allocated to principal. If the amount of the tax due exceeds the trust's or estate's receipts from the pass-through entity, the excess is allocated to principal.

d. NEW LAW: Under F. S. 738.705(4) as revised, to the extent that the estate's or trust's income tax liability is reduced (but not eliminated) because the estate or trust got a deduction for making a payment of amounts paid by the entity, the fiduciary has to adjust income and principal receipts. The amount distributable as income as result of the adjustment can be expressed as the following formula:

$$D = [C-(R \times K)] / (1 - R)$$

D = the distribution to the beneficiary
C + cash paid by the entity to the trust or estate
R = Tax rate on income
K = Entity's K-1 taxable income

Here is an example, cribbed from materials by Edward F. Koren, Esq., and F. Gordon Spoor, CPA, presented at the 2012 RPPTL Section Legislative and Case Law Update Seminar (July 27, 2012):

Example. ABC Trust receives a K-1 from Partnership reflecting taxable income of $1 million. Partnership distributes $500,000 to the trust, which it represents to be income. The trust is in the 35 percent tax bracket.

In the example above, the partnership distribution exceeds the trust's $350,000 tax on the K-1 income by $150,000 ($500,000 - $350,000 = $150,000) allowing it to distribute the remaining $150,000 to the beneficiary. But because the trust can deduct the $150,000 paid to the beneficiary in computing the trust's income tax liability, it must apply the algebraic formula above to derive the amount owed the beneficiary. After deducting the payment, the trust should have exactly enough to pay its tax on the remaining share of entity taxable income.

Taxable Income per K-1	$1,000,000
Payment to Beneficiary	(230,769)
Trust taxable Income	$ 769,231
Trust tax-35%	269,231
Partnership distribution	$ 500,000
Trust tax	(269,231)
Payable to the beneficiary	$ 230,769

C. <u>Paying the Income: Who, How Much and When</u>?

(1) <u>Who</u>? The question of "who gets the income?" is easy to answer in a trust that is fully funded and up and running. It's not so easy in the case of estates or administrative trusts. In these instances, F. S. 738.201 supplies the answers in the form of a priority order of payments:

a. *First*, the fiduciary pays the net income from any property specifically devised to the specific devisee (and if the specifically-devised property is sold by the fiduciary, the specific devisee receives the net principal receipts). F. S. 738.201(1).

b. *Second*, the fiduciary pays expenses from income or principal as described in B (3) above.

c. *Third*, in the case of an outright (e.g., not in trust) pecuniary devise under a will (and *not* a distribution of a pecuniary amount under a trust), the PR pays the devise from net income and from principal if the net income is insufficient. NEW LAW: The statute makes clear that no interest is payable on a specific devise unless the will requires. This was already the common law. F. S. 738.201(3).

d. Finally, the fiduciary pays the balance of the net income as provided in F. S. 738.202 to the residuary and remainder beneficiaries, including a beneficiary who receives a pecuniary amount in trust.

(2) <u>How Much</u>? The question of "how much income do the beneficiaries get?" is easy to answer in a trust that is fully funded and up and running. It's not so easy in the case of estates or administrative trusts. This is where 738.202 comes in, *after* the fiduciary has paid those entitled to specific and outright pecuniary devises.

a. The general rule is that the residual beneficiaries share in the remainder of the estate's or trust's net income proportionately to their "respective fractional interests in the undistributed principal," using "carrying values" as of the date of distribution.

b. So, to figure out the "how much" question, you need to know two things: What is the appropriate "carrying value" to use? How do you calculate the beneficiaries' "fractional interests in the undistributed principal?" These concepts are <u>NEW LAW</u>.

i. F. S. 738. 102(3) adds a new definition of carrying value, as follows:

> "Carrying value" means the fair market value of the assets received by the fiduciary. For the estates of decedents and [revocable trusts], after the grantor's death, the assets are considered received as of date of death. If there is a change of fiduciaries, a majority of the continuing fiduciaries may elect to adjust the carrying value 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. For assets acquired during the administration of the estate of trust, the carrying value is equal to the acquisition costs of the asset.

ii. Carrying value and FMV is determined on an asset-by-asset basis. Determinations of value based on appraisals done within two years before or after the valuation date are presumed to be reasonable. The fiduciary's good faith determination of carrying value and FMV is presumed reasonable unless proven otherwise in court.

iii. The concept of "carrying value" is also relevant in connection with F. S 738.401(6) (*see* A.(1)e. above) and F. S. 738.603 (which deals with liquidating assets and is not addressed in this outline).

iv. F. S. 728.202(2) (reminder, this is NEW LAW) governs the calculation of the beneficiaries' fractional interests in undistributed principal:

1. Each residual beneficiary is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in the carrying value of the undistributed principal assets immediately before the distribution date. In making the calculation, the following are *excluded*: (a) liabilities owed by the estate or trust; and (b) specifically-devised property and property used to pay a pecuniary amount not in trust.

2. If there has been a disproportionate distribution of principal to any beneficiary, the fractional interests of the beneficiaries in the remaining assets must be recomputed, as follows:

a. The carrying value in the remaining assets is adjusted to FMV immediately before the distribution;

b. The fractional interest of the beneficiary who received the disproportionate distribution is reduced by an amount equal to the FMV of the assets that the beneficiary received in the disproportionate distribution, determined as of the date of distribution; and

c. The fractional interests of the beneficiaries in the remaining principal assets is readjusted based on the now-restated carrying values.

v. The following examples, again cribbed form the Koren and Spoor materials, may help:

Example #1: 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 any income earned during administration and beneficiary B is entitled to 5/12.

Prior to the funding of the trust or payment of any of the residue, 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:

	Beneficiary A	*Beneficiary B*
Date of death values	$7,000,000	$ 5,000,000
Adjusted Carrying values	$7,000,000	$13,000,000
Principal Distribution		(1,000,000)
Remaining principal	$7,000,000	$12,000,000
Recomputed Fraction	7/19	12/19

Example #2: The total principal of a trust remaining after all debts and expenses is $12,000,000. The residue is to be split equally between beneficiary A and B. From the onset, both beneficiary A and B are entitled to 50% of any income earned during administration. Prior to the disbursement of the residual devises, beneficiary B receives a principal distribution of $1,000,000. As of the date of the principal distribution, but prior to the distribution, the fair market value of the trust assets is $20,000,000. The fractional interests are recomputed as follows:

	Beneficiary A	*Beneficiary B*
Date of death values	$ 6,000,000	$ 6,000,000
Adjusted Carrying values	$10,000,000	$10,000,000
Principal Distribution		($ 1,000,000)
Remaining principal	$10,000,000	$ 9,000,000
Recomputed Fraction	10/19	9/19

vi. Why this New Law? Use of the carrying value concept relieves the fiduciary of the obligation to re-value assets every time there has been a distribution, other than a disproportionate distribution.

(3) When? In general, an income beneficiary is entitled to net income on the date that the income interest begins. F. S. 738.301.

a. An income interest *begins* when trust instrument says it does or, in the absence of a specified start date, either when the asset is first subject to the trust or when a prior income interest ends (e.g., the death of the grantor of a revocable trust).

b. Assets are first subject to a trust when the trustee receives them (for an inter vivos trust) or, in the case of an asset received by the trustee by reason of the grantor's death, when the trust grantor dies. The intervening period of estate administration is disregarded. Any period of intervening administration between the termination of a prior income interest and the trustee's actual receipt of the asst is also disregarded.

c. An income interest *ends* on the day before an income beneficiary dies or another terminating event occurs.

D. Total Return Unitrust.

(1) NEW LAW: There are revisions to F. S. 738.1041 that apply to express and elected total return unitrusts.

a. The purpose of the revisions to F. S. 738.1041 are to ameliorate the fluctuations in the amount of unitrust distributions that can occur as a result of annual market fluctuations the provisions also moderately the Unitrust amount to account for principal distributions. In general, the new provisions are a "smoothing rule."

b. F. S. 738.1041(1)(h) as revised now defines a "unitrust amount" with reference to an *average* fair market value of assets.

c. F. S. 738.1041(1)(a) adds a new definition for "average fair market value," as follows:

> (a) "Average fair market value" means the average of the fair market values of assets held by the trust at the beginning of the current and each of the two preceding years, or for the entire term of the trust is there are less than 2 preceding years, and adjusted as follows:
>
> 1. If assets have been added to the trust during the years used to determine the average, the amount of each addition is added to all years in which such addition was not included.
>
> 2. If assets have been distributed from the trust during the years used to determine the average, other than in satisfaction of the unitrust amount, the amount of each distribution is subtracted from all years in which such distribution was not included.

d. F. S. 738.1041(10) makes the new smoothing rule applicable to all express total return unitrust unless the governing instrument provides otherwise.

e. Here are two examples:

<u>Example #1</u>: (for illustration purposes, market fluctuation has not been reflected) The trustee of a Unitrust wants to compute the Unitrust distribution of 2013. This computation will involve averaging the market values of 2011-2013. The initial funding of the trust of $1,000,000 occurred sometime during 2011, which is the beginning of the 2011 period; because the purpose of smoothing is to minimize fluctuations due solely to investment performance, $1,000,000 is the Beginning Market Value for 2011, which would be used in determining the unitrust amount. (Under the provisions of F.S. 738.1041(6)(b), the trustee would likely exercise its discretion to prorate the payment over the remaining portion of the year).

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 follows:

	2011	*2012*	*2013*
Beginning Market Value	$1,000,000	$1,000,000	$2,000,000
Principal addition	1,000,000	1,000,000	
Total FMV	$2,000,000	$2,000,000	$2,000,000

Average FMV = $2,000,000

In 2014, the computation would be as follows:

	2011	*2012*	*2013*
Beginning Market Value	$1,000,000	$2,000,000	$2,000,000
Principal addition	1,000,000		
Total FMV	$2,000,000	$2,000,000	$2,000,000

Average FMV = $2,000,000

The principal addition in 2012 was added to the 2012 balance, as well as the balance in all prior periods used in the computation. (i.e. because the addition occurred after 01/01/12, the addition would be to both 2011 and 2012 balances, but in the computation for 2014, it is only included in the 2012 balance, because it is already actually included in the 2013 and 2014 balances).

Example #2: Same facts as Example #1 with the addition of a principal distribution to a beneficiary of $500,000 in 2012.

	2011	*2012*	*2013*
Beginning Market Value	$1,000,000	$1,000,000	$1,500,000
Principal addition	1,000,000	1,000,000	
Principal distribution	(500,000)	(500,000)	
Total FMV	$1,500,000	$1,500,000	$1,500,000

Average FMV = $1,500,000

Computations for 2014

	2011	*2012*	*2013*
Beginning Market Value	$1,000,000	$1,500,000	$1,500,000
Principal addition	1,000,000		
Principal distribution	(500,000)		
Total FMV	$1,500,000	$1,500,000	$1,500,000

Average FMV = $1,500,000

Example #3: Assume the same facts as Example #2 except allow for market fluctuations – showing an increase of $200,000 during 2011, and an increase of $300,000 during 2012.

	2011	*2012*	*2013*
Beginning Market Value	$1,000,000	$1,200,000	$2,000,000
Principal addition	1,000,000	1,000,000	
Principal distribution	(500,000)	(500,000)	
Total FMV	$1,500,000	$1,700,000	$2,000,000

Average FMV = ($1,500,000 + $1,700,000 + $2,000,000)/3 = $1,733,333

(2) F. S. 738.1041 permits a trustee to convert a “regular” trust to a “total return unitrust,” and vice versa, without court approval. The limits within which the trustee must operate in doing so can vary depending upon whether the trustee is an “interested trustee” or a “disinterested trustee.” The statute applies even if the trust was irrevocable before the change in the law. F. S. 738.1041(10).

(3) Under F. S. 738.1041((1)(e), an “interested trustee” is:

a. an individual trustee to whom the net income or principal can be distributed, or who is a first-line remainder beneficiary;

b. any trustee whom an “interested distributee” (defined by the statute as a current income or principal beneficiary who can remove a trustee and replace the removed trustee with someone who is related or subordinate to the distributee under IRC §672(c)) has the power to remove and replace; or

c. a trustee whose legal obligations of support to a beneficiary can be satisfied via distributions from the trust.

A “disinterested trustee” is a trustee other than an interested trustee.

(4) Under F. S. 738.1041(10), a trust cannot be converted to a total return unitrust if:

a. The trust instrument reflects an intention that current beneficiaries are to receive an amount other than reasonable current return;

b. The trust is a pooled income fund, a CRT or CLT, a QSST, a trust under IRC § 2702 (i.e., a QPRT, GRAT or GRUT).

c. The trust has at least one income beneficiary who has a power to withdraw that is not subject to ascertainable standard, or that can be exercised to discharge a support obligation;

d. The trust expressly prohibits the use of F. S. 738.1041 *by specific reference to that section*; or

e. The trustee currently has the power to adjust the trust asset under F. S. 738.104 (*see* E. below).

(5) To convert to a total return unitrust without court approval, the trustee must:

a. Adopt a written statement regarding trust distributions providing that future distributions will be unitrust amounts rather than net income, and that describes the manner in which the unitrust amount will be calculated; and the method in which fair market value of the trust will be determined.

b. Determine the terms of the unitrust amount under either of the following two alternatives:

i. The *disinterested* trustee, if there is one, otherwise a "disinterested person" (one not related or subordinate to interested trustee) appointed by the interested trustee, but not the interested trustee himself or herself:

1. selects a unitrust provision that is not less than 3% or greater than 5%;

2. arrives at a method of determining the fair market value of the trust assets for purposes of determining the unitrust amount; and determines which assets, if any, are to be excluded from the calculations.

ii. The *interested* trustee (although a disinterested trustee can also use this approach if desired):

1. administers the trust so that the unitrust percentage is 50% of the Section 7520 AFR rate as in effect for the month of the conversion. However, F. S. 738.1041(2)(b)2.a requires that the unitrust amount under this approach cannot be less than be 3% (or exceed 5%); and

2. provides that the fair market value of the trust assets will be determined at least annually on an asset-by-asset basis; assets such as use property and specifically devised assets are excluded by statute from the calculation.

c. Under F. S. 738.1041(2)(c), the trustee must serve notice of its intent to convert to a total return unitrust on:

i. The trust grantor, if living;

ii. All living beneficiaries who are currently receiving or who are eligible to receive trust income;

iii. All living beneficiaries who would receive principal if trust were to terminate on that date (without regard to a power of appointment) or if no termination is specified, to all living beneficiaries who would (or could) receive distributions of income or principal if all income beneficiaries were deceased; and

iv. All trust protectors or advisors.

d. The notice of the trustee's intent to convert to a total return unitrust must be accompanied by copies of the written statement referred to above, and a photocopy of F. S. 738.1041. The notice is served informally, in the manner of provided in the Florida Rules of Civil Procedure relating to service of pleadings subsequent to the initial pleading." For non-litigators, this means via regular mail. At least one person receiving notice must be legally competent. F. S. 738.1041(2)(d).

e. If any person served objects within 60 days, the conversion to a unitrust cannot take place without prior court approval.

(6) The trustee is not liable for any action or inaction to convert or not to convert undertaken in good faith. F. S. 738.1041(8). However, if a majority in interest of either income or remainder beneficiaries objects in writing to the trustee as to the amount of income distributions, and if the beneficiaries' objections are not resolved by the trustee to the satisfaction of the objecting beneficiaries within 6 months after the trustee's receipt of the written objection, the objecting beneficiaries may petition the court for conversion, reconversion or change of unitrust amount in the same manner as the trustee. F. S. 738.1041(9).

(7) Helpful guidance from the IRS! In PLR 200702013, the IRS gave positive guidance on several questions that arise in the context of a conversion to a total return unitrust.

In the ruling, the trustee converted two "regular" trusts for the benefit of the surviving spouse – one a "Family Trust" and the other a QTIP trust – into total return unitrusts under a statute that sounds a lot like F. S. §738.1041. The trusts were in existence after September 25, 1985 (i.e., not grandfathered for GST purposes), but, as of the modification, both of the trusts had zero inclusion ratios for GST purposes.

The IRS ruled that:

- The conversion of the trusts did not shift any beneficial interests in the trusts to a lower generation, and would not extend the time for vesting of a beneficial interest. Thus, the inclusion ratios of the trust would remain at zero. The IRS used the same analysis applicable to trust modifications that do, or do not, affect grandfathered status for GST purposes.

- The conversion did not disqualify the QTIP for the marital deduction. The ruling references the regulations under IRC §2056(b)(7), which provide that the surviving spouse's income interest will satisfy QTIP requirements if the spouse is entitled to income as determined by applicable law that provides for a "reasonable apportionment between income and remainder beneficiaries of the total return of the trust" and meets the IRC §643 regulations (which the statute in question did).

Because the trustee had the authority to convert the two trusts to total return unitrusts, the mere exercise of the power will not result in a sale or disposition of an interest in the trust by any beneficiary. Thus, the conversion was not an income tax recognition event under IRS §643.

E. The Power to Adjust Between Principal and Income.

(1) FPIA is a compliment to the Prudent Investor Act, Florida Statutes §518.11. It responds to the trustee's need to evaluate a trust's investments on a "total return" basis, rather than evaluating the benefits for trust beneficiaries on the traditional, and often divisive, basis of net income, on the one hand, and principal appreciation, on the other. In furtherance of the "total return" approach, F.S. §738.104 now gives trustees of Florida trusts the important power to adjust between income and principal. The power of adjustment involves crediting between income and principal when necessary to invest the trust assets on a total return basis.

(2) Examples of when a power to adjust might be considered:

a. Principal to Income. Investment advisors convince the trustee to shift to a total return investment policy that involves solely growth stocks. This change results in a reduction of dividend and interest receipts from $100,000 in the prior year (and the average of the past five years) to $10,000. As a result of the portfolio change, principal value increased $300,000. These results indicate to the trustee that it should exercise its power to adjust by transferring $90,000 from principal to income. Accordingly, the income beneficiary receives $100,000, after the adjustment is reflected. UPIA Section 104, Example 1.

b. Income to Principal. Inflation increases. A trustee has invested $1 million in U.S. government bonds with a 14% coupon. The inflation rate is 8%. Inflation causes the principal to decrease in value. So, the trustee decides to adjust by transferring $80,000 from income to principal, an amount the trustee considers an appropriate adjustment (other fiduciaries may choose a larger or smaller adjustment) to make up for the loss in value due to inflation. The trustee distributes $60,000 ($140,000 income less $80,000 added to principal) to the beneficiary as the year's income. UPIA Section 104, Example 2.

c. Outmoded Trust Instrument. When the irrevocable trust was formed and funded, state law did not contain the prudent investor rule. The trust document required all income to be distributed to a named beneficiary. The trustee was provided very narrow principal invasion powers "for dire emergencies only," and, over the term of the trust, the aggregate principal invasion was limited to 6% of the trust's initial value. The state of situs then changed its law by adding the prudent investor rule. As a result, the trustee changed the asset allocation from 50/50 percentages for stock and bonds to 90/10 percentages for stock and bonds. This change in the portfolio reduced the annual income from dividends and interest, but it significantly increased the total return. The example concludes that the trustee may adjust by a transfer from principal to income, *but only if the transfer is exclusively from the capital appreciation* resulting from the switch in asset allocation. Even so, the adjustment will be prohibited if the trustee cannot determine, or inadequate records exist to assist the trustee in ascertaining, the application of the 6% invasion cap. UPIA Section 104, Example 4.

(3) The following three conditions must be present in order for the trustee to adjust under F. S. 738.104 :

a. The trustee must administer the trust under the Prudent Investor Rule as found in Florida Statutes Section 518.11;

b. The trust document must provide for distributions to beneficiaries of "income"; and

c. The trustee must be unable to administer the trust impartially, based on what is reasonable and fair to all beneficiaries. F. S. 738.104(1).

(4) The statute (F. S. 738.104(2)) contains a non-exclusive list of factors that the trustee is to consider in deciding to exercise the power to adjust, "to the extent they are relevant." Inception assets: If the trustee is directed by the grantor to retain certain assets in the trust, thereby overcoming the normally applicable duty to diversify under F.S. 518.11(1)(c), "the trustee may take these circumstances into account in determining whether and to what extent the power to adjust should be exercised to change the results produced by [the remainder of Ch. 738] that apply to the retained assets." *Joint Principal and Income Committee White Paper on proposed changes to Chapter 738, Florida Statutes.*

(5) The power of the trustee to adjust between principal and income meant that the underproductive property statute in former F.S. 738.12(1)(a), which required the trustee to distribute a minimum of 3% of the value of a trust annually to income beneficiaries, could be (and was) repealed. There is no more underproductive property statute in Florida.

(6) The trustee cannot exercise a power to adjust if:

a. the trustee is also a beneficiary of the trust, or would otherwise directly or indirectly benefit from the adjustment;

b. the exercise or possession of the power would constitute a general power of appointment as to the trustee;

c. the exercise or possession of the power would cause the trustee to be a grantor of any portion of the trust under the grantor trust rules of Code Sections 671 – 679;

d. the effect would be to reduce the income payable from a marital deduction trust requiring all income annually to spouse;

e. the effect would be to reduce the actuarial value of income interest in a trust intended to qualify for the gift tax exclusion;

f. the adjustment would change an annuity or unitrust amount, whether charitable or otherwise; or

g. the power relates to an amount permanently held in trust for charitable purposes, unless both the income and remainder are held for charitable purposes.

If there is a disinterested co-trustee, that co-trustee may exercise the prohibited power to adjust. F.S. 728.104(4).

(7) Language contained in a trust that attempts to limit a trustee's power to adjust between principal and income will not be sufficient to disengage the statute "unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power to adjust conferred by subsection (1)." F.S. 738.401(6).

(8) A trustee has no duty to exercise the power to adjust. F.S. 738.401(7).

(9) If the trustee of a trust that was in existence and irrevocable prior to January 1, 2003 intends to exercise a power to adjust, the trustee must provide notice before acting. F. S. 738.104(8).

a. Under F.S. §738.104(9), the notice must:

i. be provided to (i) all current income or principal beneficiaries, whether mandatory or discretionary; and (ii) all reasonably ascertainable remainder beneficiaries who would take if all prior interests terminated.

ii. contain the name, telephone number, street address and mailing address of the trustee, and of any other persons that may be contacted for further information (i.e., the trustee's attorney).

iii. provide that, unless a super majority (two-thirds in interest) of either the current beneficiaries or first-line remainder beneficiaries object within 60 days of service of the notice, the trustee has the power to adjust.

iv. state that the power to adjust between income and principal may have an effect on trust distributions to beneficiaries.

b. The notice is served informally, in the manner of provided in the Florida Rules of Civil procedure relating to service of pleadings subsequent to the initial pleading." For non-litigators, this means via regular mail.

c. If a beneficiary has been omitted despite a good faith attempt to identify and serve all reasonably ascertainable beneficiaries, the power to adjust, if acquired (*see* (d) immediately below), is not affected. However, once the trustee received actual notice that a beneficiary has not received the required notice, the power is suspended until notice is served on the omitted beneficiary *and* re-served on the originally noticed beneficiaries.

d. The trustee may not exercise the power to adjust if either a super majority (two-thirds in interest) of the beneficiaries currently entitled or eligible for distributions or a super majority (two-thirds in interest) of the first-line remainder beneficiaries object in writing to the proposed exercise of the power to adjust within 60 days after date of required notice. An objection is deemed delivered on the date of mailing

e. The trustee may obtain a court order to quash objection if the trustee still wants to proceed. In such a proceeding, the burden is on the objecting beneficiaries to prove that the power to adjust would be inequitable, illegal, or otherwise in contravention of the grantor's intent. The court may award fees and costs, and may direct from which part of the trust they shall be paid.

f. If the trustee is unsuccessful in quashing the objection, or decides not to proceed after receiving the objection, the trustee can wait one year after notice to try again with a new notice procedure.

(10) The trustee can release the power to adjust from income to principal, and vice versa, in whole or in part. The release can be permanent or for a specified period of time measured by the life of an individual. F. S. 738.104(5). This is extremely important in the context of a conversion to a total return unitrust.

(11) It is said that "the power to adjust also controls tax consequences." The tax effects of the power to adjust will generally be respected by the IRS if statutes permit reasonable apportionment between income and remainder beneficiaries. *See* Treasury

Regulations Section 1.643(b)-1 ("…a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust.").

(12) *The power to adjust is not needs based. A trustee may only adjust to achieve impartiality in administration for the benefit of the income and remainder beneficiaries.* This differs from the discretionary power to distribute principal. Although the existence and parameters of a discretionary power to invade trust principal is one of the factors to be considered when the trustee determines whether or not to exercise the power to adjust, the decision as to whether to exercise such a discretionary invasion power is likely subject to different standards than the power to adjust. The purpose of the power to adjust is solely to achieve fairness between income and remainder beneficiaries.