

Wealth Management
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The Surprising Effects of a 'Principal
and Income' Statute

In 2002, the Florida Legislature adopted the Florida Uniform Principal and Income Act, effective on January 1, 2003 (the act). The act, which is found in F.S. Ch. 738, is a modified version of the Uniform Principal and Income Act (1997). The statutory sections of the act allocate trust and estate receipts and disbursements between income and principal. Additionally, the act contains provisions that allow a trustee to make adjustments between income and principal (§ 738.104) and to convert a trust to a unitrust (§738.1041).

It is significant to note that the statutory sections of the act are “default” sections, meaning that the provisions of Ch. 738 only apply if the terms of the trust or will do not contain a different provision or do not give the fiduciary a discretionary power or administration. It is critically important that attorneys and financial advisors practicing in the trusts and estates area or providing investment advice for trusts and estates have a working knowledge of the act. We will explore the inner workings of some of the more significant provisions of the act. These examples assume that the will or trust is silent as to allocating the receipt or disbursement at issue to either income or principal, and does not give the fiduciary a discretionary power of administration.

Example 1: Specifically Devised Real Estate

Mom's will specifically devises rental real estate to Son. The residue of the estate passes to Daughter. The will is silent as to who receives and/or pays the rental real estate receipts and expenses. Mom died on December 31. One year after Mom's death rental real estate gets distributed to Son. During the probate administration, the estate has the following receipts and disbursements.

- Rent received on rental real estate: \$12,000 (\$1,000 per month).
- Property taxes on rental real estate: \$2,000.
- Estate administrative expenses (\$200,000).

Section 738.201(1) provides that the net income and principal receipts on property specifically devised to a beneficiary shall be distributed to the beneficiary.

Section 738.201(1) specifically refers to and incorporates the provisions of §738.301 through § 738.706 in determining the net income and principal receipts. Pursuant to § 738.502, the \$12,000 of rent constitutes income and under § 738.701(3), the \$2,000 of property taxes is charged against income. Therefore, in addition to the distribution of the rental real estate, Son also receives \$10,000 of net rental income (i.e., \$12,000 of rent less \$2,000 of property taxes).

Example 2: Rental Real Estate

Example 2a: Trust owns rental real estate and provides for the mandatory payment of net income to the beneficiary. Pursuant to § 738.403(1), the trustee may elect to maintain accounting records for this rental activity separate from the trust's accounting records. In such a case, the trustee has the flexibility to retain a portion of the rental receipts for the rental real estate's working capital needs, to make renovations to the property, and to pay the principal portion of any monthly mortgage payment.

Without § 738.403, all rent receipts, except for those used to pay expenses chargeable to income, need to be distributed to the beneficiary under the terms of the trust. For instance, principal payments on a mortgage secured by the rental real estate are principal charges; thus, the income beneficiary would receive the rental income without reductions for these expenses. The trustee, in maintaining a separate set of books under § 738.403, can pay these expenses out of rental receipts, thereby decreasing income but maintaining principal (real estate) and its mortgage obligations.

Example 2b: Assume the facts in Example 2a, but with the further assumption that the trustee contributes rental real estate to a Florida limited liability company (LLC) naming the trustee as manager of the LLC. With this Example 2b, § 738.401 would apply, and not § 738.403. As manager of the LLC, pursuant to §§ 608.422(3) and 608.426, the trustee has the power to retain receipts for the LLC's working capital and other needs. As manager of the LLC, the trustee also has the authority to determine the timing of distributions from the LLC to the trust. Section 738.401 determines the character of the receipts from the LLC to trust, as either principal or income.

Example 3: Distributions Received by a Private Trustee from Investment Entity and a Target Entity

Section 738.501(2), generally, provides that capital gains are allocated to principal. However, § 738.401(2) may change that result and allocate capital gain cash receipts from an entity, such as an LLC, to income.

Example 3a: Mom, prior to her death, was the sole member of LLC. At Mom's death, LLC was used to fund a testamentary trust. Mom's second husband (Stepdad) is lifetime income beneficiary of the trust and Son is the remainder beneficiary. The trust is Trust Company. Trust Company, as manager of LLC, sells five percent of LLC's assets, realizing a \$100,000 capital gain, and the \$100,000 is distributed from LLC to the trust. Under § 738.401(2), the LLC distribution to the trust constitutes income to be distributed to Stepdad, net of trust expenses allocable to income. Under § 738.501(2), if there were no LLC and the \$100,000 gain were incurred directly by the trust, it would constitute principal (and would not be distributed to Stepdad).

Example 3b: Assume Mom's will creates a trust naming Stepdad as trustee and lifetime income beneficiary and Son as the sole remainder beneficiary. In 2007, Stepdad, as trustee, contributes 100 percent of the trust's marketable securities portfolio to a newly established LLC. The trust is the sole member of the LLC and the marketable securities are its only assets. During 2007, LLC received \$50,000 of dividends and \$40,000 of interest. Also, during 2007, LLC sold securities and realized \$100,000 of capital gains. In 2007, \$250,000 of cash is distributed from the LLC to the trust. Does this \$250,000 cash receipt constitute trust income provided in §738.401(2), to be distributed to Stepdad as the income beneficiary?

Example 4: Death of an Income Beneficiary

Husband's trust is funded solely with rental real estate. Tenant pays monthly rent of \$100,000 on the first of each month. The income beneficiary of the trust is Surviving Spouse, and Husband's Son from a prior marriage is the remainder beneficiary. Surviving Spouse dies on June 2, 2007, and her will provides that her entire estate passes to Daughter. Tenant falls behind in rental payments but pays the \$100,000 February rent on June 1, 2007, and the March through June rent (\$400,000) on June 5, 2007.

Example 5: Pecuniary Amounts

Mom has two children, Daughter and Son. Daughter is financially responsible and Son is a spendthrift. Mom's will gives \$2,000,000 outright to Daughter and puts \$2,000,000 into a trust which provides Son with income for life. Mom's will leaves the residue to charity. Distributions to Daughter and Son's trust occurred six months after Mom's death. Prior to these distributions, the estate received \$1,000,000 of income, net of expenses properly charged against income.

Sections 738.201(4) and 738.202, read together, require that the testamentary trust established for Son and charity will share the \$1,000,000 of net estate income. The statute does not allocate any portion of this net income to Daughter, who received \$2,000,000 outright pecuniary bequest.

Example 6: Life Estate in Real Property

Decedent's will devises a vacation condominium (subject to a mortgage) to Spouse for life with the remainder to Child. In the first year after death, the condominium has the following expenses: monthly mortgage payment of \$1,000; quarterly (regular) condominium association maintenance assessments of \$400; real property taxes of \$2,500; and routine repairs of \$2,000. Also, as a result of hurricane damage to the building, each unit is specially assessed \$30,000 for repairs.

Section 738.801 provides that the provisions of §§ 738.701 through 738.705 shall govern the apportionment of expenses between tenants and remainder beneficiaries when no trust has been created. A tenant (i.e., the holder of the life estate) must pay the income charges and the remainder beneficiary pays the principal charges. In this example, no trust was created. Accordingly, as required by §738.701(3), Spouse pays the interest portion of the mortgage payments, the quarterly association maintenance assessments, the property taxes, and the routine repairs. Under § 738.702(1)(c), Child pays the principal portion of mortgage payments.

Assuming the hurricane damage repairs are reasonably expected to outlast Spouse's actuarial life expectancy, the cost of the special assessment is allocated between Spouse and Child based on an actuarial formula set forth in §738.801(2). If the special assessment repairs are not reasonably expected to last beyond Spouse's life expectancy, § 738.801(2) charges this expense to Spouse. Significantly, under § 738.701(4), homeowner's and windstorm insurance premiums must be paid by the life tenant.

Example Seven: Mutual Fund Capital Gain Distributions

A trustee purchases 20,000 units in QZ mutual fund for \$200,000. Shortly after the purchase, QZ mutual fund makes a \$1 per unit (\$20,000) distribution to the trust, representing short-term and long-term capital gains realized within the mutual fund. Pursuant to § 738.401(3)(d), the distribution constitutes principal.

THE END.

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