



**STATE OF NEW JERSEY
NEW JERSEY LAW REVISION COMMISSION**

**Tentative Report
Relating to**

Amendments to Uniform Principal and Income Act

July 19, 2012

This Tentative Report is distributed to advise interested persons of the Commission's tentative recommendations and the opportunity to submit comments.

Comments should be submitted no later than **September 15, 2012**.

The Commission will consider these comments before making its final recommendations to the Legislature. The Commission often substantially revises tentative recommendations as a result of the comments it receives. If you approve of the report, please inform the Commission so that your approval can be considered along with other comments. Please send comments concerning this tentative report or direct any related inquiries, to:

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Introduction

Effective January 1, 2002, the New Jersey Legislature enacted a modified version of the Uniform Principal and Income Act as revised in 1997 by the Uniform Law Commission (then the National Conference of Commissioners on Uniform State Laws). The 2002 Act replaced the Revised Uniform Principal and Income Act adopted in 1991. *See, Assembly Banking and Insurance Committee Statement, N.J.S. 3B:19B-1.* The UPIA, originally prepared by the Uniform Law Commission in 1931, was revised in 1962 and adopted in 41 states. The law provides procedures for separating principal and income by trustees who are administering estates. The UPIA distinguishes between property that is principal and will be distributed to remainder beneficiaries (entitled to receive principal when an income interest ends) and property that is income and will be distributed to income beneficiaries. The UPIA serves as a default rule for allocations of such property in the absence of guidance from the trust document.

The UPIA, as adopted in New Jersey, was very similar to the NCCUSL Act, but differed in some respects. There were differences with regard to:

- the exercise of fiduciary duties (NJ eliminated the presumption that a determination in accordance with the Act is fair and reasonable);
- the trustee's power to adjust between principal and income (NJ limited the presumption of fairness and reasonability to adjustments in the distributions to income beneficiaries between 3% and 5% and required consideration of the shifting of economic interests or tax benefits between income and remainder beneficiaries before making adjustments);
- the determination and distribution of net income (NJ does not require a fiduciary to pay certain identified expenses when determine the remaining net income of an estate or a terminating income interest);
- insubstantial allocations not required (this section was not enacted in NJ);
- deferred compensation, annuities and similar payments (NJ defines "payment" differently and enacted a different requirement for the allocation of payments from a separate fund held for the benefit of the trustee to either principal or interest);
- disbursements from income (NJ has different requirements regarding the disbursements to be made from income);
- disbursements from principal (NJ has different requirements regarding the disbursements to be made from principal);
- transfers from income to reimburse principal (NJ does not permit transfers to reimburse for capital improvements to a principal asset or disbursements relating to environmental matters); and
- adjustments between principal and income because of taxes (this section was not enacted in NJ).

The Commission briefly considered the Act in March 2008, when the State Bar Association asked that the Commission support its amendments (drafted by OLS) to the Act. The proposed amendments would have modified the language pertaining to the trustee's power to adjust between principal and income. A bill introduced in the 2008-2009 session incorporating

those changes was later withdrawn and the proposed changes were not enacted. The Statement included in the bill explained the changes as follows:

Currently, the act creates a "safe harbor" for a trustee by providing that a distribution of between 3% and 5% of the value of the trust's assets is presumed to be fair and reasonable to all of the beneficiaries of the trust. However, it modifies this safe harbor by making the range of percentages dependent on possible future action by the U.S. Department of the Treasury or Internal Revenue Service. Making New Jersey law dependent upon possible future action by the Internal Revenue Service creates a degree of uncertainty that would harm the efficient administration of trusts. This bill amends current law to remove the incorporation of federal tax regulations and restores the 4% and 6% thresholds to create safe harbors within which the trustee's action is presumed to be fair and reasonable.

The current act provides that the act's provisions relating to a trustee's power to adjust principal and income shall apply to all trusts administered in New Jersey under New Jersey law unless contrary to the provisions of the trust's governing instrument. The current bill does not define the phrase "administered in New Jersey". This provision of the bill is therefore amended to establish clarity and to broaden the application of the power to adjust.

Finally, subdivision (8) of subsection (c) of the current act's "savings clause" prevents the trustee from exercising a power to adjust if the effect of the adjustment would be to satisfy the trustee's obligation of support or other legal obligation. It is difficult to envision a circumstance where this provision might apply. To determine whether it applies would require an analysis of the trustee's obligations of support "and other legal obligations" and such an analysis would be unduly cumbersome. Thirteen states that have adopted a power to adjust provision within the Uniform Principal and Income Act have deleted the Uniform Act's savings clause provision prohibiting an adjustment that would benefit a trustee directly or indirectly. In accordance with the other states who have adopted a power to adjust provision, this bill is amended to eliminate subdivision (8) of subsection (c) in its entirety as it has the potential to be too broad.

In 2009, the ULC recommended changes to the two different sections of the Act dealing with deferred compensation, annuities, and similar payments as well as income taxes and the adoption of a new section that includes transitional provisions. This project is a priority for the ULC and is recommended for adoption for the following reasons:

- To update the traditional income and allocation rules to reflect the modernization of the law of trust investment.
- To provide a mechanism for the transition to an investment regime based on the principles embodied in the Uniform Prudent Investor Act, particularly the principle of investing for total return, rather than for a certain level of income.
- To clarify the allocations of acquired assets, like those from corporate distributions.
- To include the concept of an "unincorporated entity" to deal with businesses operated by a trustee, including things like farming and livestock operations and investments in rental real estate, natural resources and timber.
- To include provisions for investment modalities that did not exist in 1962, such as derivatives, options, deferred payment obligations and synthetic financial assets.
- To address the problem of disbursements made as a result of environmental laws.

- To deal with imbalances as a result of tax laws and make adjustments between principal and income to correct inequalities caused by tax elections or peculiarities in the manner in which fiduciary income tax rules apply.

The amending document described the proposed changes as follows:

Marital deduction requirements. When an IRA or other retirement arrangement (a “plan”) is payable to a marital deduction trust, the IRS treats the plan as a separate property interest that itself must qualify for the marital deduction. IRS Revenue Ruling 2006-26 said that, as written, Section 409 does not cause a trust to qualify for the IRS’ safe harbors. Revenue Ruling 2006-26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans. Without necessarily agreeing with the IRS’ position in that ruling, the revision to this section is designed to satisfy the IRS’ safe harbor and to address concerns that might be raised for similar assets. No IRS pronouncements have addressed the scope of Code § 2056(b)(7)(C).

Subsection (f) requires the trustee to demand certain distributions if the surviving spouse so requests. The safe harbor of Revenue Ruling 2006-26 requires that the surviving spouse be separately entitled to demand the fund’s income (without regard to the income from the trust’s other assets) and the income from the other assets (without regard to the fund’s income). In any event, the surviving spouse is not required to demand that the trustee distribute all of the fund’s income from the fund or from other trust assets. Treas. Reg. § 20.2056(b)-5(f)(8).

Subsection (f) also recognizes that the trustee might not control the payments that the trustee receives and provides a remedy to the surviving spouse if the distributions under subsection (d)(1) are insufficient.

Subsection (g) addresses situations where, due to lack of information provided by the fund’s administrator, the trustee is unable to determine the fund’s actual income. The bracketed language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)-1. In determining the value for purposes of applying the unitrust percentage, the trustee would seek to obtain the value of the assets as of the most recent statement of value immediately preceding the beginning of the year. For example, suppose a trust’s accounting period is January 1 through December 31. If a retirement plan administrator furnishes information annually each September 30 and declines to provide information as of December 31, then the trustee may rely on the September 30 value to determine the distribution for the following year. For funds whose values are not readily available, subsection (g) relies on Code section 7520 valuation methods because many funds described in Section 409 are annuities, and one consistent set of valuation principles should apply whether or not the fund is, in fact, an annuity.

* * *

Taxes on Undistributed Entity Taxable Income. When a trust owns an interest in a pass-through entity, such as a partnership or S corporation, it must report its share of the entity’s taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust’s tax on its share of the entity’s taxable income, the trust must pay the taxes and allocate them between income and principal.

Subsection (c) requires the trust to pay the taxes on its share of an entity’s taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each.

This assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection 505(d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries.

* * *

While the proposed ULC changes are small (in comparison to the size of the Act as a whole), they are recommended as important since they are designed to address tax problems caused by the version of the law currently in effect. The changes have been enacted in 33 states and Washington, D.C. and were introduced in Michigan in 2012. The states that have *not* yet enacted the changes are: Alaska, Florida, Georgia, Hawaii, Illinois, Louisiana, Massachusetts, Minnesota, New Hampshire, New York, Ohio, Pennsylvania, Rhode Island, Wisconsin, Wyoming, and New Jersey.

Draft language that modifies New Jersey's current statute to reflect the earlier Bar Association proposed changes and the 2009 ULC proposed changes is shown below. Staff has made inquiries to determine whether the changes proposed by the State Bar Association in 2008 are still viable and should be incorporated in to this project but, in the interim, they are shown in the first draft statutory section below.

Draft

3B:19B-4. Power of trustee to adjust between principle and income [this section represents the change supported by the State Bar Association in 2008 and is not included in the ULC recommendation – it is included here for completeness and for a determination of continued relevance]

a. A trustee may adjust between principal and income if the terms of the trust describe the amount that may or shall be distributed to a beneficiary by referring to the trust's income and the trustee determines, after applying the rules in subsection a. of section 3 of this act, that the trustee is unable to comply with subsection b. of section 3 of this act. A decision by a trustee to adjust increase the distribution to the income beneficiary or beneficiaries in any accounting period to an amount not less than three not in excess of four percent not more, or to decrease that period's distributions to not less than five six percent, or in accordance with such other percentages as may be approved for trust distribution adjustment purposes from time to time by the United States Department of Treasury or the Internal Revenue Service, of the net fair market value of the trust assets on the first business day of that accounting period shall be presumed to be fair and reasonable to all of the beneficiaries. Any adjustment by a trustee between income and

principal with respect to any accounting period shall be made during that accounting period or within 65 days after the end of that period.

~~This subsection shall apply to a trust that is administered in New Jersey under New Jersey law unless contrary to the provisions of the governing instrument. This section shall be construed as pertaining to the administration of a trust and shall be available to any trust that is administered in New Jersey under New Jersey law or to any trust, regardless of its place of administration, whose governing instrument provides that New Jersey law governs matters of administration, unless the application of this section is contrary to the provisions of the governing instrument.~~

b. In deciding whether and to what extent to exercise the power conferred by subsection a. of this section, a trustee shall consider all factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant:

- (1) the nature, purpose and expected duration of the trust;
- (2) the intent of the settlor;
- (3) the identity and circumstances of the beneficiaries;
- (4) the needs for liquidity, regularity of income and preservation and appreciation of capital;
- (5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;
- (6) the net amount allocated to income under the other sections of this act and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;
- (7) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;
- (8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation;
- (9) the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries that arise from elections and decisions regarding tax matters, the imposition of an income or other tax on the fiduciary or a beneficiary as a result of a transaction involving a distribution from the estate or trust, or the ownership of an

interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust or a beneficiary; and

(10) the anticipated tax consequences of an adjustment.

c. A trustee shall not make an adjustment:

(1) 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, in whole or in part, if the trustee did not have the power to make the adjustment;

(2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

(3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;

(4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;

(5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment;

(6) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment;

(7) if the trustee is a beneficiary of the trust ~~or~~;

~~(8) that satisfies the trustee's obligation of support or other legal obligation.~~

d. If paragraph (5), (6), or (7) ~~or (8)~~ of subsection c. of this section applies to a trustee and there is more than one trustee, a co-trustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the terms of the trust.

e. A trustee may release the entire power conferred by subsection a. of this section or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or exercising the power will cause a result described in paragraphs (1) through (6) ~~or (8)~~ of subsection c. of this section, or if the trustee determines that possessing or exercising the power will or may deprive the trust

of a tax benefit or impose a tax burden not described in subsection c. of this section. The release may be permanent or for a specified period, including a period measured by the life of an individual.

f. Terms of a trust that limit the power of a trustee to make an adjustment between principal and income do not affect the application of this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment conferred by subsection a. of this section.

COMMENT

The bill statement explained that the bill amends the "Uniform Principal and Income Act of 2001" (the "act") as follows:

...to revise the extent to which a trustee may adjust between principal and income in making distributions from a trust to an income beneficiary and still retain a presumption that the distribution is fair and reasonable to the remainder beneficiaries of the trust.

Currently, the act creates a "safe harbor" for a trustee by providing that a distribution of between 3% and 5% of the value of the trust's assets is presumed to be fair and reasonable to all of the beneficiaries of the trust. However, it modifies this safe harbor by making the range of percentages dependent on possible future action by the U.S. Department of the Treasury or Internal Revenue Service. Making New Jersey law dependent upon possible future action by the Internal Revenue Service creates a degree of uncertainty that would harm the efficient administration of trusts. This bill amends current law to remove the incorporation of federal tax regulations and restores the 4% and 6% thresholds to create safe harbors within which the trustee's action is presumed to be fair and reasonable.

The current act provides that the act's provisions relating to a trustee's power to adjust principal and income shall apply to all trusts administered in New Jersey under New Jersey law unless contrary to the provisions of the trust's governing instrument. The current bill does not define the phrase "administered in New Jersey". This provision of the bill is therefore amended to establish clarity and to broaden the application of the power to adjust.

Finally, subdivision (8) of subsection (c) of the current act's "savings clause" prevents the trustee from exercising a power to adjust if the effect of the adjustment would be to satisfy the trustee's obligation of support or other legal obligation. It is difficult to envision a circumstance where this provision might apply. To determine whether it applies would require an analysis of the trustee's obligations of support "and other legal obligations" and such an analysis would be unduly cumbersome. Thirteen states that have adopted a power to adjust provision within the Uniform Principal and Income Act have deleted the Uniform Act's savings clause provision prohibiting an adjustment that would benefit a trustee directly or indirectly. In accordance with the other states who have adopted a power to adjust provision, this bill is amended to eliminate subdivision (8) of subsection (c) in its entirety as it has the potential to be too broad.

3B:19B-17. Payments from annuities, individual retirement accounts, and pension, profit-sharing, stock-bonus, or stock-ownership plans

a. As used in this section:

(1) "Payment" means a payment that a trustee may receive over a fixed period of time or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer or by another. For purposes of subsections d., e., f. and g. of

this section, “payment” includes any payment from any separate fund, regardless of the reason for the payment.

(2) “Separate fund” includes a private or commercial annuity, an individual retirement account and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

b. To the extent that a trustee can readily ascertain the part of a payment from a separate fund held for the benefit of the trust that represents the then undistributed net income of the fund realized since the trust acquired its interest in the fund, a trustee shall allocate that part to income. The trustee shall allocate to principal the balance of the payment.

c. If no part of a payment is allocated to income under subsection b. of this section, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not “required to be made” to the extent that it is made because the trustee exercises a right of withdrawal.

~~d. If, to obtain an estate tax or gift tax marital deduction for a trust, the trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction. Except as otherwise provided in subsection e., subsections f. and g. apply, and subsections b. and c. do not apply, in determining the allocation of a payment made from a separate fund to:~~

~~(1) a trust to which an election to qualify for a marital deduction under 26 U.S.C. Section 2056(b)(7), as amended, has been made; or~~

~~(2) a trust that qualifies for the marital deduction under 26 U.S.C. Section 2056(b)(5), as amended.~~

~~e. Subsections d., f., and g. do not apply if and to the extent that the series of payments would, without the application of subsection d., qualify for the marital deduction under 26 U.S.C. Section 2056(b)(7)(C), as amended.~~

f. A trustee shall determine the internal income of each separate fund for the accounting period as if the separate fund were a trust subject to this act. Upon request of the surviving spouse, the trustee shall demand that the person administering the separate fund distribute the internal income to the trust. The trustee shall allocate a payment from the separate fund to income to the extent of the internal income of the separate fund and distribute that amount to the surviving spouse. The trustee shall allocate the balance of the payment to principal. Upon request of the surviving spouse, the trustee shall allocate principal to income to the extent the internal income of the separate fund exceeds payments made from the separate fund to the trust during the accounting period.

g. If a trustee cannot determine the internal income of a separate fund but can determine the value of the separate fund, the internal income of the separate fund is deemed to equal [insert number at least three percent and not more than five percent] of the fund’s value, according to the most recent statement of value preceding the beginning of the accounting period. If the trustee can determine neither the internal income of the separate fund nor the fund’s value, the internal income of the fund is deemed to equal the product of the interest rate and the present

value of the expected future payments, as determined under 26 U.S.C. Section 7520, as amended, for the month preceding the accounting period for which the computation is made.

e. h. This section does not apply to payments to which section 18 of this act applies.

COMMENT

The ULC's amending document described the proposed changes as follows:

When an IRA or other retirement arrangement (a "plan") is payable to a marital deduction trust, the IRS treats the plan as a separate property interest that itself must qualify for the marital deduction. IRS Revenue Ruling 2006-26 said that, as written, Section 409 does not cause a trust to qualify for the IRS' safe harbors. Revenue Ruling 2006-26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans. Without necessarily agreeing with the IRS' position in that ruling, the revision to this section is designed to satisfy the IRS' safe harbor and to address concerns that might be raised for similar assets. No IRS pronouncements have addressed the scope of Code § 2056(b)(7)(C).

Subsection f. requires the trustee to demand certain distributions if the surviving spouse so requests. The safe harbor of Revenue Ruling 2006-26 requires that the surviving spouse be separately entitled to demand the fund's income (without regard to the income from the trust's other assets) and the income from the other assets (without regard to the fund's income). In any event, the surviving spouse is not required to demand that the trustee distribute all of the fund's income from the fund or from other trust assets. Treas. Reg. § 20.2056(b)-5(f)(8).

Subsection f. also recognizes that the trustee might not control the payments that the trustee receives and provides a remedy to the surviving spouse if the distributions under subsection d.(1) are insufficient.

Subsection g. addresses situations where, due to lack of information provided by the fund's administrator, the trustee is unable to determine the fund's actual income. The bracketed language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)-1. In determining the value for purposes of applying the unitrust percentage, the trustee would seek to obtain the value of the assets as of the most recent statement of value immediately preceding the beginning of the year. For example, suppose a trust's accounting period is January 1 through December 31. If a retirement plan administrator furnishes information annually each September 30 and declines to provide information as of December 31, then the trustee may rely on the September 30 value to determine the distribution for the following year. For funds whose values are not readily available, subsection (g) relies on Code section 7520 valuation methods because many funds described in Section 409 are annuities, and one consistent set of valuation principles should apply whether or not the fund is, in fact, an annuity.

In making the changes shown above, it was noted that current law, in subsection d., refers to an estate tax or gift tax marital deduction. The ULC language refers only to an estate tax marital deduction. Staff will review this issue to determine whether additional modification to the proposed language is required.

In addition, subsection g. calls for the selection of a number between 3% and 5% and Staff seeks comment regarding the selection of a number to fill in that blank.

3B:19B-28. Payment of income taxes

a. A tax required to be paid by a trustee based on receipts allocated to income shall be paid from income.

b. A tax required to be paid by a trustee based on receipts allocated to principal shall be paid from principal, even if the tax is called an income tax by the taxing authority.

c. A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid ~~proportionately~~:

(1) from income to the extent that receipts from the entity are allocated only to income; and

(2) from principal to the extent that:

~~(A) receipts from the entity are allocated only to principal; and~~

~~(B) the trust's share of the entity's taxable income exceeds the total receipts described in paragraphs (1) and (2)(A).~~

(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and

(4) from principal to the extent that the tax exceeds the total receipts from the entity.

~~d. For purposes of this section, receipts allocated to principal or income shall be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax. After applying subsections a. through c. of this section, the trustee shall adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary.~~

COMMENT

The ULC's amending document described the proposed changes as follows:

When a trust owns an interest in a pass-through entity, such as a partnership or S corporation, it must report its share of the entity's taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust's tax on its share of the entity's taxable income, the trust must pay the taxes and allocate them between income and principal.

Subsection (c) requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection 505(d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries.

Example (1) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of \$1 million. Partnership P distributes \$100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.

Trust T's tax on \$1 million of taxable income is \$350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire \$100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

Example (2) - Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of \$1 million. Partnership P distributes \$500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.

Trust T's tax on \$1 million of taxable income is \$350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses \$350,000 of the \$500,000 to pay its taxes and distributes the remaining \$150,000 to B. The \$150,000

payment to B reduces T's taxes by \$52,500, which it must pay to B. But the \$52,500 further reduces T's taxes by \$18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

Alternatively, T can apply the following algebraic formula to determine the amount payable to B:

$$D = (C - R * K) / (1 - R)$$

D = Distribution to income beneficiary

C = Cash paid by the entity to the trust

R = tax rate on income

K = entity's K-1 taxable income

Applying the formula to Example (2) above, Trust T must pay \$230,769 to B so that after deducting the payment, T has exactly enough to pay its tax on the remaining taxable income from P.

Taxable Income per K-1	1,000,000
Payment to beneficiary	230,769 ¹
Trust Taxable Income	\$ 769,231
35 percent tax	269,231
Partnership Distribution	\$ 500,000
Fiduciary's Tax Liability	(269,231)
Payable to the Beneficiary	\$ 230,769

In addition, B will report \$230,769 on his or her own personal income tax return, paying taxes of \$80,769. Because Trust T withheld \$269,231 to pay its taxes and B paid \$80,769 taxes of its own, B bore the entire \$350,000 tax burden on the \$1 million of entity taxable income, including the \$500,000 that the entity retained that presumably increased the value of the trust's investment entity.

If a trustee determines that it is appropriate to so, it should consider exercising the discretion granted in UPIA section 506 to adjust between income and principal. Alternatively, the trustee may exercise the power to adjust under UPIA section 104 to the extent it is available and appropriate under the circumstances, including whether a future distribution from the entity that would be allocated to principal should be reallocated to income because the income beneficiary already bore the burden of taxes on the reinvested income. In exercising the power, the trust should consider the impact that future distributions will have on any current adjustments.

Staff has incorporated the NCCUSL changes to this section and additional research will be done to determine whether modification of the language is required.

3B:19B-32. Transitional matters

Section 17, as amended by this [amendment], applies to a trust described in Section 17d. on and after the following dates:

¹ $D = (C - R * K) / (1 - R) = (500,000 - 350,000) / (1 - .35) = \$230,769$. (D is the amount payable to the income beneficiary, K is the entity's K-1 taxable income, R is the trust ordinary tax rate, and C is the cash distributed by the entity).

a. If the trust is not funded as of [the effective date of this [amendment]], the date of the decedent's death.

b. If the trust is initially funded in the calendar year beginning January 1, _____ [insert year in which this [amendment] takes effect], the date of the decedent's death.

c. If the trust is not described in paragraph (1) or (2), January 1, _____ [insert year in which this [amendment] takes effect].

Source: New.

COMMENT

In the interest of clarity, it may be advisable to include this language in the section to which it refers, rather than inserting it as a stand-alone section.