

starts at the date of death and not the date a representative is appointed. If there is a known or potential claim against a decedent's estate, it may be diligent for an estate representative to wait until six months after the date of death to open the estate. By doing so, the estate may seek to avoid any claims and ultimately reject any claims submitted for failure to comply with R.C. 2117.06(B).

If the decedent has probate assets and the decedent's family has, for whatever reason, not opened an Estate, counsel may find themselves in a position to open the estate in order to preserve a claim. Counsel may need to open the case themselves or enlist the services of another attorney, a "strawman" to seek appointment as Administrator. If such action is taken, the hope is that the decedent's family will request to step in and take over administration. The problem is that if the family does not seek to step in, counsel or his/her strawman is forced to become the fiduciary of an estate he/she wants to pursue. Such practice puts counsel in a position of direct conflict to violate the Rules of Professional Conduct while he/she has a fiduciary responsibility to the estate (including accepting/rejecting claims); however, the only purpose of opening the estate was to pursue a claim against it.¹⁰

To avoid such circumstances, the Ohio Probate courts should utilize the newly enacted R.C. §§ 2113.15 through 2113.17, which provide that when there is a delay in granting Letters of Authority appointing an estate fiduciary, or there is a delay in opening an estate, the Probate Court may appoint a special administrator for the decedent's estate:

1. To collect and preserve the effects of the decedent and grant such other authority as the Court considers appropriate;
2. To receive the debts of the decedent; and
3. To complete such other duties as the

Court authorizes and considers appropriate.

CONCLUSION

When the General and Probate Divisions of the Common Pleas Court collide, make sure you take the time review R.C. 2117 and be aware of the time limitations contained within so that you make the best determination to preserve and pursue your client's claims and provide for the best chance at recovery.

ENDNOTES:

¹*Heuser v. Crum*, 31 Ohio St.2d 90, 285 N.E.2d 340 (1972).

²*Heuser v. Crum*, 31 Ohio St.2d 90, 95, 285 N.E.2d 340, 343 (1972).

³*Heuser v. Crum*, 31 Ohio St.2d 90, 94, 285 N.E.2d 340, 343 (1972).

⁴*Children's Med. Ctr. v. Ward*, 87 Ohio App.3d 504, 622 N.E.2d 692 (Ohio Ct. App. 2d Dist. Montgomery County 1993).

⁵*Children's Med. Ctr. v. Ward*, 87 Ohio App.3d 504, 622 N.E.2d 692 (Ohio Ct. App. 2d Dist. Montgomery County 1993).

⁶*Pierce v. Johnson*, 136 Ohio St. 95, 23 N.E.2d 993 (1939).

⁷The Ohio General Code required a Notice of Claim be filed within four months from date of Executor/Administrator's appointment. The current law under the Ohio Probate Code is that a Notice of Claim be filed within six months from date of death.

⁸The current probate code section 2117.06 does not distinguish between an unliquidated or contingent claim. A review of *Pierce* under the Ohio Probate Code is a prime issue for review by the Supreme Court of Ohio.

⁹*Pierce v. Johnson*, 136 Ohio St. 95, 23 N.E.2d 993 (1939).

¹⁰Ohio Rules of Professional Conduct 1.7.

CHANGES TO THE UNIFORM PRINCIPAL AND INCOME ACT CURRENTLY UNDER CONSIDERATION FOR ADOPTION IN OHIO

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The Ohio Principal and Income Act Committee (the “Committee”) of the Ohio State Bar Association Estate Planning, Trust and Probate Law Section Council (the “Section Council”) is currently considering amendments to the Uniform Principal and Income Act (“UPIA”) adopted by the Uniform Law Commission (formerly known as the National Conference of Commissioners of Uniform State Laws or NCCUSL) in 2008 (the “2008 Amendments”) for adoption in Ohio. The 2008 Amendments amend UPIA §§ 409 and 505 and provide a new transitional § 606 to facilitate technical implementation of amended § 409. The 2008 Amendments are included, with official comments, as an Appendix to this article.

AMENDMENT OF SECTION 409

UPIA § 409, the unamended version of which corresponds to R.C. 5812.32, deals with payments to trusts from annuities, IRAs, pension plans, profit sharing plans and other similar funds.

For various planning reasons, trusts for the benefit of a surviving spouse are sometimes designated as the beneficiary of a decedent’s IRA or other similar retirement plan instead of designating the surviving spouse directly. The Internal Revenue Service (“IRS”) has been concerned about whether IRAs and defined contribution retirement plans (IRAs and defined contribution retirement plans hereinafter referred to collectively as “Retirement Plans” and each individually as a “Retirement Plan”) qualify for the federal estate tax marital deduction (the “marital deduction”) when they are left to a Marital Trust.¹

In 2006, the IRS issued Revenue Ruling 2006-26² (the “Ruling”) to clarify its opinion on when a Retirement Plan payable to a Marital Trust qualifies for the marital deduction. The

Ruling includes safe harbors in the context of different state law definitions of income which, if followed, guarantee the marital deduction for such Retirement Plans. The Ruling found fault with how the UPIA of 1997 (the version in effect prior to the 2008 Amendments and which is currently the law in Ohio) defined “income” in the context of Retirement Plans payable to trusts indicating that in UPIA compliant states, Retirement Plans payable to Marital Trusts may not qualify for its safe harbor for a marital deduction unless the terms of the trust specifically address the various concerns raised in the Ruling.

The Ruling requires that the Retirement Plan itself must qualify for the marital deduction under the same rules as any Marital Trust. It includes a safe harbor for qualification with two basic requirements. First, that the Retirement Plan’s income must be determined as if the Retirement Plan itself were a Marital Trust, and second, that the surviving spouse must have the right to receive this income without regard to the income of the trust to which the Retirement Plan is payable. The IRS suggested that, in states such as Ohio with the version of UPIA § 409 included in the UPIA of 1997 (“Old § 409”), the requirements of the marital deduction may not be met unless the trust instrument has specific provisions that meet the requirements. This because Old § 409 provides generally for an allocation of receipts from Retirement Plans 90% to principal and 10% to income³ and such an allocation does not necessarily correspond to a Retirement Plan’s internal income, nor does it provide for a reasonable apportionment of the total return of the trust between the income and remainder beneficiaries of the trust. Although Old § 409 also includes a savings provision requiring the trustee to allocate more of the receipts from a Retirement Plan to income to the extent necessary to obtain the marital deduction⁴, the Ruling concluded that Old § 409, standing alone, may not satisfy the

requirements for the marital deduction. Old § 409 also does not address the requirements present in the Ruling's safe harbor that the Retirement Plan's income be computed independently of the trust's other income and that the surviving spouse have the right to receive all of the income from the Retirement Plan if less than all of its income is distributed to the trust with the required minimum distribution.

As previously suggested in this article, the trust instrument can specifically address the concerns raised in the Ruling with respect to Old § 409. However, after the Ruling was issued, concern arose within the estate planning community that, if the draftsman of a trust instrument were to rely upon the savings provision in Old § 409(d) to protect the marital deduction that the Ruling states may not be sufficient, the trust instrument might inadvertently fail to qualify for the marital deduction. NCCUSL responded by adopting amendments to Old § 409 in 2008 to bring it more clearly in line with the Ruling safe harbor requirements (Old § 409 as so amended hereinafter "Amended § 409").

Amended § 409 brings UPIA § 409 within the safe harbor requirements of the Ruling by requiring the determination of the income earned within a Retirement Plan payable to a Marital Trust as though the Retirement Plan were a separate trust subject to the UPIA and providing for the benefits received by the Marital Trust from the Retirement Plan to be allocated to income up to the amount determined as the internal income of the Retirement Plan. Further, in the event amounts distributed to the Marital Trust from the Retirement Plan fall short of the income allocation, Amended § 409 provides that, upon the request of the surviving spouse, the Trustee shall allocate other trust principal to income to the extent of the shortfall. This feature will make it possible to avoid making withdrawals from a Retirement Plan to the extent that the income from the Retirement Plan exceeds the required

minimum distribution. While the Ruling does not apply to assets other than Retirement Plans payable to Marital Trusts, Amended § 409 is broader and also applies to similar assets such as annuities and defined benefit plans that are payable to Marital Trusts. Accordingly, Amended § 409 includes alternative mechanisms for the determination of the internal income which the trustee can employ for such assets for which the trustee may not otherwise be able to calculate the internal income.

AMENDMENT OF SECTION 505

The 2008 Amendments also include needed amendments to UPIA § 505. UPIA § 505 deals with the allocation of a trust's income tax liability between the income and principal of the trust. The amendments to § 505 address and clarify an ambiguity that has existed under the prior version of the Section ("Old § 505") when a mandatory income trust owns an interest in a pass-through entity. Old § 505 corresponds to Ohio Revised Code 5812.46.

The problem arises from the fact that trusts owning an interest in a pass-through entity are taxed on their allocable share of the entity's income, but the entity does not always distribute all of that income to the trust. In this context, the question becomes how much of the distribution from the entity should the trustee of the trust pay to the mandatory income beneficiary?

If the trustee pays the full amount of the distribution it receives from the entity to the beneficiary, the trust receives an income tax deduction for the amount distributed to the beneficiary, but it still has a tax liability with respect to the trust's share of the entity's taxable income that the entity retained and no funds from the distribution from the entity with which to pay that liability. Further, if the trust has no assets other than the interest in the pass-through entity, the trust will have no

liquid assets at all available for payment of the tax. Alternatively, the trust could retain some of the distribution from the entity to satisfy its own tax liability, but the determination of how much of the distribution to retain is difficult because the trust's tax liability is affected by the amount distributed to the beneficiary.

Old § 505 was intended to guide the trustee on how to allocate the tax liability between the income and principal of the trust in this situation, but the language was unclear and capable of interpretations that produced different results. As a result of the ambiguity, disputes have arisen over how much of the tax, if any, the trustee should allocate to trust income, thereby reducing the income available for distribution to the mandatory income beneficiary. Mandatory income beneficiaries are upset if the allocation results in no distribution to them. However, trustees risk not having sufficient funds to satisfy the trust's tax liability with respect to its share of the pass-through entity's income if they pay the entire distribution to the mandatory income beneficiary.

UPIA § 505 as amended by the 2008 Amendments (hereinafter referred to as "Amended § 505") makes it clear that the trustee of a mandatory income trust may use distributions from a pass-through entity to the extent necessary to pay the trust's income taxes with respect to its allocable share of the entity's income and then distribute any remaining income to the mandatory income beneficiary.

Amended § 505 takes into account the fact that a trust's tax liability and the amounts distributed to a beneficiary are related and requires the trustee to increase the amount of the distribution from the entity payable to the mandatory income beneficiary to the extent taxes are reduced by the distribution of those receipts from the entity to the beneficiary. When distributions from the pass-through entity are less than the trust's allocable share of the entity's taxable income but at least enough to pay the tax on the trust's share of such income, this results in an interrelated calculation. The official comments to Amended § 505 include an algebraic formula that the trustee of the trust can use in this situation to allocate taxes between the income and principal of the trust. The formula produces the optimal beneficiary distribution that will assure that the trust retains just enough of the pass-through entity's distribution to pay its own taxes with respect to the entity's taxable income taking into account the distribution deduction for the payment to the beneficiary.

The 2008 Amendments have been adopted in the majority of UPIA states to date. The Committee believes that they make needed improvements and clarifications to Old § 409 and Old § 505 which are currently the law in Ohio and should be adopted in Ohio as soon as possible. The Committee is working on proposed amendments to the applicable sections of the Ohio Revised Code to incorporate the 2008 Amendments for approval by the Section Council.

APPENDIX**2008 Amendments to Uniform Principal and Income Act****SECTION 409. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS.**

(a) In this section, ~~“payment”~~:

(1) “Payment” means a payment that a trustee may receive over a fixed number of years 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, ~~including~~. For purposes of subsections (d), (e), (f), and (g), the term also 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 payment is characterized as interest, ~~or~~ a dividend, or a payment made in lieu of interest or a dividend, a trustee shall allocate ~~it~~ the payment to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(c) If no part of a payment is characterized as interest, a dividend, or an equivalent payment, 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 marital deduction for a trust, a 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 Section 2056(b)(7) of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 2056(b)(7)] [, as amended], has been made; or~~

~~(2) a trust that qualifies for the marital deduction under Section 2056(b)(5) of the Internal Revenue Code of 1986 [, as amended] [, 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 Section 2056(b)(7)(C) of the Internal Revenue Code of 1986 [, as amended] [, 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 Section 7520 of the Internal Revenue Code of 1986 [, as amended] [, 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~~ a payment to which Section 410 applies.

Comment

Scope. Section 409 applies to amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payer. While the right to receive such payments is a liquidating asset of the kind described in Section 410 (i.e., “an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration”), these payment rights are covered separately in Section 409 because of their special characteristics.

Section 409 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and “private annuities” arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (in-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (c)).

The 1962 Act. Under Section 12 of the 1962 Act, receipts from “rights to receive payments on a contract for deferred compensation” are allocated to income each year in an amount “not in excess of 5% per year” of the property’s inventory value. While “not in excess of 5%” suggests that the annual allocation may range from zero to 5% of the inventory value, in practice the rule is usually treated as prescribing a 5% allocation. The inventory value is usually the present value of all the future payments, and since the inventory value is determined as of the date on which the payment right becomes subject to the trust, the inventory value, and thus the amount of the annual income allocation, depends significantly on the applicable interest rate on the decedent’s date of death. That rate may be much higher or lower than the average long-term interest rate. The amount determined under the 5% formula tends to become fixed and remain unchanged even though the amount received by the trust increases or decreases.

Allocations Under Section 409(b). Section 409(b) applies to plans whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest. For example, some deferred compensation plans that hold debt obligations or stock of the plan’s sponsor in an account for future delivery to the person rendering the services provide for the annual payment to that person of dividends received on the stock or interest received on the debt obligations. Other plans provide that the account of the person rendering the services shall be credited with “phantom” shares of stock and require an annual payment that is equivalent to the dividends that would be received on that number of shares if they were actually issued; or a plan may entitle the person rendering the services to receive a fixed dollar amount in the future and provide for the annual payment of interest on the deferred amount during the period prior to its payment. Under Section 409(b), payments of dividends, interest or payments in lieu of dividends or interest under plans of this type are allocated to income; all other payments received under these plans are allocated to principal.

Section 409(b) does not apply to an IRA or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in Section 409(c).

Allocations Under Section 409(c). The focus of Section 409, for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is provided for in Section 409(d)). An IRA is subject to federal income tax rules that require payments to begin by a particular date and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 409(c), which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the amount received is allocated to income and the balance is allocated to principal. All other payments are allocated to principal because they represent a change in the form of a principal asset; Section 409 follows the rule in Section 404(2), which provides that money or property received from a change in the form of a principal asset be allocated to principal.

Section 409(c) produces an allocation to income that is similar to the allocation under the 1962 Act formula if the annual payments are the same throughout the payment period, and it is simpler to administer. The amount allocated to income under Section 409 is not dependent upon the interest rate that is used for valuation purposes when the decedent dies, and if the payments received by the trust increase or decrease from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will also increase or decrease.

~~**Marital deduction requirements.** When an IRA is payable to a QTIP marital deduction trust, the IRS treats the IRA as separate terminable interest property and requires that a QTIP election be made for it. In order to qualify for QTIP treatment, an IRS ruling states that all of the IRA's income must be distributed annually to the QTIP marital deduction trust and then must be allocated to trust income for distribution to the spouse. Rev. Rul. 89-89, 1989-2 C.B. 231. If an allocation to income under this Act of 10% of the required distribution from the IRA does not meet the requirement that all of the IRA's income be distributed from the trust to the spouse, the provision in subsection (d) requires the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction. The requirement of Rev. Rul. 89-89 should also be satisfied if the IRA beneficiary designation permits the spouse to require the trustee to withdraw the necessary amount from the IRA and distribute it to her, even though the spouse never actually requires the trustee to do so. If such a provision is in the beneficiary designation, a distribution under subsection (d) should not be necessary.~~

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.

Application of Section 104. Section 104(a) of this Act gives a trustee who is acting under the prudent investor rule the power to adjust from principal to income if, considering the portfolio as a whole and not just receipts from deferred compensation, the trustee determines that an adjustment is necessary. See Example (5) in the Comment following Section 104.

SECTION 505. INCOME TAXES.

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

(b) A tax required to be paid by a trustee based on receipts allocated to principal must 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

(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 must 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), 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

~~**Electing Small Business Trusts.** An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust even if some or all of that income is distributed to the beneficiaries.~~

~~A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (d) takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries. Only limited guidance has been issued by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that may arise, but the powers granted to a trustee in Sections 506 and 104 to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.~~

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.

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.

<u>Taxable Income per K-1</u>	<u>1,000,000</u>
<u>Payment to beneficiary</u>	<u>230,769¹</u>
<u>Trust Taxable Income</u>	<u>\$ 769,231</u>
<u>35 percent tax</u>	<u>269,231</u>
<u>Partnership Distribution</u>	<u>\$ 500,000</u>
<u>Fiduciary's Tax Liability</u>	<u>(269,231)</u>
<u>Payable to the Beneficiary</u>	<u>\$ 230,769</u>

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.

ALTERNATIVE A

SECTION 606. TRANSITIONAL MATTERS. Section 409, as amended by this

[amendment], applies to a trust described in Section 409(d) on and after the following dates:

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

(2) 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.

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

ALTERNATIVE B

SECTION 606. TRANSITIONAL MATTERS. Section 409 applies to a trust

described in Section 409(d) on and after the following dates:

(1) If the trust is not funded as of [the effective date of this [act]], the date of the decedent’s death.

(2) If the trust is initially funded in the calendar year beginning January 1, _____ [insert year in which this [act] takes effect], the date of the decedent’s death.

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

END OF ALTERNATIVES

Legislative Note: *Use Alternative A if your state has already enacted the Uniform Principal and Income Act. Use Alternative B if your state has not enacted the Uniform Principal and Income Act.*

If your state has not adopted the Uniform Principal and Income Act, use the text of Sections 409 and 505, as amended by these amendments, instead of the text of the previous version of those Sections.

ENDNOTES:

¹As used in this article, “Marital Trust” refers to a general power of appointment trust under Internal Revenue Code § 2056(b)(5) or a trust for which a QTIP election is made under Internal Revenue Code § 2056(b)(7).

²Revenue Ruling 2006-26, 2006-1 C.B. 939.

³Old § 409 (c).

⁴Old § 409 (d).

THE POWER TO ADJUST—IS NOW THE RIGHT TIME?

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I attended the recent 48th Annual Heckerling Institute on Estate Planning in Orlando, Florida. The amount of technical detail, estate planning star power (myself not included) and

hotel food was a bit overwhelming. I came away with the feeling that this one conference is the genesis of most of the leading estate planning ideas that are later refined for our clients for reasons they trust us to understand. One thing trust settlors and beneficiaries understand clearly without our help is the amount of a trust distribution and when it will be available. For a visual, think about Rod Tidwell yelling “show me the money” in the movie Jerry Maguire.

The timing and amount of a distribution depends on what sort of beneficiary (current v. future) is asking, what the document says about principal and income distribution standards, and the current investment strategy. This leaves the trustee in the delicate position of balancing competing interests with an eye on risk management (i.e., not getting sued)