NEW JERSEY LAW REVISION COMMISSION

Final Report

Relating to

Amendments to Uniform Principal and Income Act

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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.

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 set forth in the comments to the sections below. The changes were summarized by the ULC as follows: (1) the changes to the first section below should "serve to resolve issues brought about by IRS Revenue Ruling 2006-26 and assist separate funds within a trust in qualifying for the IRS estate tax marital deduction safe harbor" and (2) the changes to the second section below should "allow mandatory income trusts that own an entity to retain the proper amount of funds from distributions to meet their existing tax obligations". *See, Uniform Law Commission, Principal and Income Amendments, Summary*, http://www.uniformlaws.org/ActSummary.aspx?title=Principal%20and%20Income%20Amendments%20(2008).

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 34 states and Washington, D.C. 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 2009 ULC proposed changes is shown below.

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” includ~~ing~~es 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 four 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.

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

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

b. (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.

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

~~e.~~ i. 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 in the initial portion of the subsection, but includes references to the marital deduction thereafter. As a result, the language – as drafted – may be adequate and no comments were received to suggest otherwise.

In addition, subsection g. calls for the selection of a number between 3% and 5% and, since Staff was unable to elicit comment on this issue, the amount of 4% was selected. It appears that 36 jurisdictions have adopted the revisions to the Act. Among the jurisdictions that have done so, 4% was the most common choice (27 states and D.C.). Of the remaining jurisdictions, six chose 3%, one chose 3.5%, one chose 3-4%, and one chose 5%.

Subsection h. was a separate transitional section in the ULC draft, and would have been 3B:19B-32 in the New Jersey statute. Staff chose to include the transitional provisions in the Section they modified, rather than in a separate section at the end of the Act, and inserted them here as a result.

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 <u>only</u> to income; and

(2) from principal to the extent that~~:~~

~~(A)~~ receipts from the entity are allocated <u>only</u> 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).~~

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

<u>(4) from principal to the extent that the tax exceeds the total receipts from the entity.</u>

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.~~ <u>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.</u>

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 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.

Taxable Income per K-1	1,000,000
Payment to beneficiary	230,769[1]

[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).

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.

~~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:~~

~~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

<u>These provisions have been moved in an effort to avoid confusion and are now found in subsection h. of Section 3B:19B-17.</u>