SPOKANE ESTATE PLANNING COUNCIL

September 13, 2011

TRUST AND ESTATE UPDATE:
Changes to the Washington Principal and Income Act, Highlights of Changes to the Washington Trust Act, and Fiduciary Income Tax Update

Kristi Mathisen, J.D., CPA/PFS
Managing Director of Tax and Financial Planning
Laird Norton Tyee
801 – 2nd Avenue, Suite 1600
Seattle, WA 98104
www.LNTyee.com
K.Mathisen@LNTyee.com

Contents:

Washington State Updates

S.B. 5849 was passed by the Legislature on April 12, and signed by the governor on April 18, 2011. This bill amends the Washington disclaimer statute, RCW 11.86.031, to allow disclaimers of interests received from those who died after December 31, 2009 and before December 18, 2010 to be executed as late as September 17, 2011. This change allows Washington residents and those disclaiming Washington property to take advantage of the longer disclaimer period provided for federal tax purposes by the 2010 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act. Included in this legislation is an amendment to RCW 11.108.090 to add a reference to H.R. 4853, P.L. 111-312 (the 2010 Tax Relief Act) to the paragraph describing dispute resolution related to the application of the federal generation skipping transfer tax.

S.B. 5057 was passed by the Legislature on April 8, and signed by the Governor on April 13, 2011. This bill amended the Washington Principal and Income Act (RCW 11.104A) to change the provision in Section 290 relating to income taxes paid by trustees on receipts from pass-through business entities. The change was made to resolve an ambiguity in the statute. Under the statute before amendment, it was not clear where the liability for trust taxes on income from entities should be allocated and how the tax allocation is affected by tax benefits of distributions.

Section 290, before amendment:

(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 to income; and

(2) From principal to the extent that:

(i) Receipts from the entity are allocated to principal; and

(ii) The trust's share of the entity's taxable income exceeds the total receipts described in (1) and (2)(i) of this subsection.

(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.

Section 290, with amendments:

(((a))) (1) A tax required to be paid by a trustee based on receipts allocated to income must be ((paid from)) charged to income.

(((b))) (2) A tax required to be paid by a trustee based on receipts allocated to principal must be ((paid from)) charged to principal, even if the tax is called an income tax by the taxing authority.

(((c))) (3) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be ((paid proportionately)) charged:

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

(2) From)) (b) To principal to the extent that((:
(i) Receipts from the entity are allocated to principal; and (ii) The trust's share of the entity's taxable income exceeds the total receipts described in (1) and (2)(i) of this subsection.
(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)) receipts from the entity are allocated only to principal;

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

(d) Otherwise to principal.

(4) Before applying subsections (1) through (3) of this section, the trustee must adjust income or principal receipts by the distributions to a beneficiary for which the trust receives an income tax deduction.

Section 290, as amended:

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

(2) *A tax required to be paid by a trustee based on receipts allocated to principal must be charged to principal, even if the tax is called an income tax by the taxing authority.*

(3) *A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be charged:*

(a) *To income to the extent that receipts from the entity are allocated only to income;*

(b) *To principal to the extent that receipts from the entity are allocated only to principal;*

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

(d) Otherwise to principal.

(4) Before applying subsections (1) through (3) of this section, the trustee must adjust income or principal receipts by the distributions to a beneficiary for which the trust receives an income tax deduction.

How did this issue become an issue? RCW 11.104A.100[1] provides that a receipt from an entity (with the exception of certain receipts from REITS or mutual funds) is classified as income,

---

[1] RCW 11.104A.100

Character of receipts.

(a) In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest. "Entity" does not mean a trust or estate to which RCW 11.104A.110 applies, a business or activity to which RCW 11.104A.120 applies, or an asset-backed security to which RCW 11.104A.240 applies.

(b) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.

(c) A trustee shall allocate the following receipts from an entity to principal:

(1) Property other than money;

(2) Money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;

(3) Money received in total or partial liquidation of the entity; and

(4) Money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

(d) Money is received in partial liquidation:

(1) To the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or

(2) If the total amount of money and property distributed in a distribution or series of related distributions is greater than twenty percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial distribution.

(e) Money is not received in partial liquidation, nor may it be taken into account under subsection (d)(2) of this section, to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

(f) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

[2002 c 345 § 401.]

unless the receipt is proceeds from sale of the trust's interest in the entity or received in total or partial distribution of the entity.

Example 1: A trust owns IBM stock. IBM pays a quarterly dividend of $100 to the trust which under RCW 11.104A.100 is classified as income. Depending on the terms of the trust, the $100 may be required to be paid to the income beneficiary, it may be paid to the beneficiary in the trustee's discretion, or retained by the trust. For federal income tax purposes, the $100 is included in the trust's gross income and it would be included in the trust's distributable net income for income tax purposes. If distributed or required to be distributed to the beneficiary, the $100 would be included in the trust's income distribution deduction, passed through to the beneficiary on a Schedule K-1, and reported by the beneficiary as income. The beneficiary would pay the tax on the dividend income. If the dividend were not required to be distributed and was not actually distributed, then the trust would report it as income and pay the required income tax. The tax payment made by the trust would be charged to income under RCW 11.104A.290 (a) which is now 290(1).

Example 2: A trust owns a 10% interest in Family LLC. Family LLC receives $1,000 of interest income. The LLC distributes $400 to its owners, and the trust receives its 10%, $40. Under the statute, the $40 is classified as income. The trust receives an annual Schedule K -1 from the LLC for tax reporting that shows $100 of interest income. The trustee is required to pay all of the trust's income to the income beneficiary. How much of the $40 should the trustee pay to the income beneficiary? Who will pay the tax on the $100 of income?

If the trust pays the $40 to the income beneficiary, it will have net taxable income of $60 (we'll ignore the exemption allowed for tax purposes) and owe tax of $21 (assuming, for simplicity, a flat 35% tax rate). The beneficiary would owe tax of $14 on the $40 of distributed income. Seems simple? How should the trustee allocate the $21 of tax that the trust has to pay? The receipt was allocated to income, but the taxable income of the trust is net of the receipt, so is there a tax based on the receipt allocated to income? In what amount? RCW 11.104A.290 (c) didn't clearly address a situation where the receipt is allocated to income, there is no receipt allocated to principal, and entity income exceeds the receipt. And what if the trust doesn't have sufficient funds to pay the $21 tax?

Paragraph (d) of section 290 before amendment was ambiguous because it didn't provide with clarity when and in what amount the adjustment for the tax benefit of the trust's income distribution to the beneficiary was to occur. Would the income receipt against which the taxes could be charged be adjusted by the amount of the tax savings or by the amount of the deduction that produces a tax savings? Corrective language offered by National Conference of Commissioners on Uniform State Laws (NCCUSL) favored the former and would require fairly complicated mathematical calculations[2] to adjust the income receipt by successive calculations of the tax benefit of the adjusted receipt until break even is achieved, in this example, with a distribution of about $7.65. The trust would distribute $7.65, its net taxable income would be $92.35, and it would retain $32.35, the amount of its tax on $92.35.

Under the alternative interpretation of paragraph (d), the income receipt of $40 would be reduced by the distribution deduction of $40. There would then be no income receipt against which to charge the tax, and the net income tax of $21 would be charged to principal as the default.

Comparing the outcomes, in the NCCUSL interpretation, the income beneficiary would be charged $32.35 so that the trust would have cash to pay tax on that $32.35 as well as the tax on the $60 of phantom taxable income from the LLC. The income beneficiary also pays tax on the $7.65 – after tax, a net benefit of $5. The NCCUSL calculation produces a tidy outcome but one that is not intuitive and which would be highly unlikely to be computed correctly - even if the trustee understood the computation. In addition, the NCCUSL interpretation seemed to favor the remainder beneficiaries to the detriment of income beneficiaries who might never receive an income distribution from an entity that only distributes amounts to pay tax. The eventual beneficiaries of the undistributed entity income would be the remainder beneficiaries.

The task force advising the Bar Association (which recommended the revised language to the Legislature) about the recommended change in language chose the alternative that results in ease of calculation. In this case, the $40 receipt will be income and paid to the beneficiary. The $40 income distribution deduction will, pursuant to new RCW 11.104A.290(4), reduce income receipts for tax allocation purposes to zero. The $21 tax on $60 of phantom taxable income is charged to principal under RCW 11.104A.290 (3)(d). In situations where the trustee needs some or all of the $40 receipt to pay tax on the phantom income, Washington has a statute that provides the trustee a discretionary power to transfer between income and principal for taxes and specifically addresses this situation.[3] In addition, many trust instruments also provide the trustee with the power to make adjustments not authorized by the Principal and Income Act.

---

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

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

This formula is from the NCCUSL Article "UPIA Amendment Clarifies the Use of Tax Distributions from Partnerships to Mandatory Income Trusts," Steve B. Gorin.

[3] RCW 11.104A.300:

Adjustments between principal and income because of taxes.

In summary, under the statute as revised, a trustee is generally not required to take the trust's taxes attributable to pass-through entity income into account in determining the portion of an income receipt from that entity that can be distributed. When a trustee allocates all of a receipt to income and distributes it to the beneficiary, there are no taxes to allocate to that income receipt. If the income is not distributed, the tax on the amount of the receipt is allocated to income. When a pass-through entity's taxable income is greater than the cash it receives from the entity, the trust pays tax on the phantom income and charges it to principal. There will be situations where a trust may not have sufficient cash to pay tax on phantom income because we all know of pass-through entities that don't pay all of their income to their owners. Entity income that is not paid out is in fact a retained investment in the entity and should ultimately enhance the entity's value. Realization of that value through a liquidation of the entity or sale or redemption of the trust's interest in the entity will be principal and will benefit the remaindermen.

It is important to remember when we are consulting with or advising clients about which assets to use to fund trusts, that in addition to the assessing the assets' potential for appreciation, we should consider other equally important factors: the cash flows, principal and income accounting treatment, and income tax consequences of owning specific assets.

S.H.B. 1051 was passed by the Legislature on April 19, 2011. It was signed by the Governor on May 12, 2011. The bill adopts changes to trust and estate law recommended by a task force of the Washington State Bar Association. The changes include: (1) modifying the methods for determining trust situs and venue for proceedings; (2) requiring certain notice by trustees to

---

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) Elections and decisions, other than those described in subsection (b) of this section, that the fiduciary makes from time to time regarding tax matters;

(2) An income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) The ownership by an estate or trust 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.

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

[2002 c 345 § 506.]

beneficiaries; (3) providing a new beginning date for the statute of limitations for bringing a claim for breach of trust, (4) allowing the courts to reform mistakes in trust documents; (5) making noncharitable trusts without ascertainable beneficiaries enforceable; and (6) codifying pre-existing common law. The effective date of this legislation is January 1, 2012. However, certain provisions only apply to irrevocable trusts created on or after that date or revocable trusts that become irrevocable on or after that date. This means that there may be some planning opportunities for the rest of 2011.

A list of the sections of the Bill and a brief description of their content follows. A complete discussion of the changes is beyond the scope of this paper. Please refer to the comprehensive discussions presented in the materials prepared by Karen Box ("The 2011 Washington Trust Act: Innovation and Clarification for Washington Trust Law'), Michael Carrico ("A Trust Lawyer's Tool Kit for Creating, Administering and Distributing Trusts in Washington") and Ann Wilson ("Sea Changes: Situs, Notice, Statute of Limitations and Venue"), for the Washington State Bar Association Real Property Probate and Trust Mid-Year Meeting (June 10-12, 2011); Kelly Bowra's summary article from the Real Property Probate and Trust Spring 2011 Newsletter, "The Top 10 Things Practitioners Should Know About Upcoming Changes to Washington Probate and Trust Law;" and the materials that will be presented at the 56th Annual Estate Planning Seminar to be held on October 31 and November 1 in Seattle.

S.H.B. 1051:

Sec. 1 Adds definitions of the words "Trustor" and "Settlor" to RCW 11.02.005.

Sec. 2. Amends RCW 11.28.237 to provide that if a trust is a legatee or devisee of an estate or a beneficiary or transferee of a nonprobate asset, the notice of the appointment of a personal representative and pendency of probate proceedings can be given to the trustee of the trust. There is no need for the personal representative to notify each beneficiary of the trust.

Sec. 3. Corrects a reference in RCW 11.68.090.

Sec. 4. In RCW 11.94.050, adds the following to the list of powers of an attorney in fact <u>that must be specifically authorized</u>: "to exercise the principal's rights to distribute property in trust or cause a trustee to distribute property in trust to the extent consistent with the terms of the trust agreement."

Sec. 5. Removes two definitions ("venue" and " situs") from those in RCW 11.96A.030 and added a new situation to the definition of "matter", which are the subjects that can be addressed under RCW11.96A (Trust and Estate Dispute Resolution) as follows: “the reformation of a will or trust to correct a mistake under section 11 of this act.”

Sec. 6 Amends RCW 11.96A.050 for a new definition of venue for proceedings involving trusts. Briefly, for testamentary trusts established under wills probated in Washington, venue is the superior court of the county where the probate was being administered or was completed, or the superior court of the county where any beneficiary of the trust entitled to notice under RCW 11.97.010 resides, the county where any trustee resides or has a pace of business, or the county where any real property that is an asset of the trust is located. For all other trusts, venue is the superior court of the county where any beneficiary of the trust entitled to notice under RCW 11.97.010 resides, the county where any trustee resides or has a pace of business, or the county where any real property that is an asset of the trust is located. Parties to proceedings may request that venue be changed. If the request is made within four months of the first notice of a proceeding, except for good cause shown, the venue must be moved to the county with the strongest connection to the trust as determined by the court.

Sec. 7 Amends RCW 11.96A.070 for the revised statute of limitations for bringing an action for breach of trust to not more than three years after the date the beneficiary or representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and informed the beneficiary of the time allowed for commencing a proceeding. The revised statute also provides a presumption that a report that contains all of the following would be that “adequate disclosure:”

1. *A statement of receipts and disbursements of principal and income that have occurred during the accounting period;*
2. *A statement of the assets and liabilities of the trust and their values at the beginning and end of the period;*
3. *The trustee’s compensation for the period;*
4. *The agents hired by the trustee, their relationship to the trustee, if any, and their compensation, for the period;*
5. *Disclosure of any pledge, mortgage, option, or lease of trust property or other agreement affecting trust property binding for a period of five years or more that was granted or entered into during the accounting period;*
6. *Disclosures of all transactions during the period that are equivalent to one of the types of transactions described in Sec. 32 of the act (Sec. 32 described below provides the trustee’s duty of loyalty and describes transactions in which a trustee is presumed to have a conflict of interest) or otherwise could have been affected by a conflict between the trustee’s fiduciary duty and personal interests;*

7. *A statement that the recipient of the account information may petition the superior court pursuant to chapter11.106 RCW to obtain review of the statement and of the acts of the trustee disclosed in the statement; and*
8. *A statement that claims against the trustee for breach of trust may not be made after the expiration of three years from the date the beneficiary receives the statement.*

If the beneficiary hasn't received the "adequate disclosure" as described above, then the three year period for a judicial proceeding against a trustee for breach of trust begins on the earlier of (1) the removal, resignation, or death of the trustee; (2) the termination of the beneficiary's interest in the trust; or (3) the termination of the trust.

Sec. 8. Adds language to RCW 11.96A.110 allowing electronic notice to those required to be given notice of proceedings if the party has previously consented to receiving notice by electronic transmission in a record delivered to the party giving notice.

Sec. 9. Adds language to RCW 11.96.120 to adopt the common law concept of virtual representation. The statute specifically addresses particular matters that affect a trust, probate estate, guardianship estate, or property subject to a power of attorney in which the interests of such fiduciary estate and the beneficiaries are not in conflict and provides that (1) a guardian may represent and bind the estate he/she or it controls; (2) an agent having authority to act with respect to the particular question or dispute may represent and bind the principal; (3) a trustee may represent and bind the beneficiaries of the trust; and (4) a personal representative of a decedent's estate may represent and bind persons interested in the estate. In addition, Section 120 is amended to add that the holder of a general or limited power of appointment that excludes as appointees only the power holder, his or her estate, his or her creditors and the creditors of his or her estate may accept notice and virtually represent and bind persons whose interests are subject to the power.

Sec. 10. Adds a new section to RCW 11.96A to codify the *cy pres* doctrine. The court may modify a charitable gift in a trust or will so that a gift is applied or distributed in a manner consistent with the testator's or trustor's intent. This provision can be applied when a charitable purpose has become unlawful, impracticable or impossible to achieve, or wasteful. An example is a gift to a charity that has dissolved, which under prior law could trigger a reversion to the other beneficiaries or heirs. This can only be achieved by court order and not through a nonjudicial proceeding.

Sec. 11. Adds another new section to RCW 11.96A to allow reformation of the terms of a will or trust even if unambiguous if the terms of the document were affected by a mistake of fact or law, whether an expression or inducement. The terms may be conformed to the intention of the testator or trustor, if it is proved by clear, cogent and convincing evidence that both the intent of the testator or trustor and the terms of the document were affected by the mistake.

Sec. 12 Amends RCW 11.97.010 regarding which duties of a trustee may not be relieved by the trustor. This section also adds the duty to notify beneficiaries and included in those duties that cannot be relieved. **The changes in this section are effective for any irrevocable trust created on or after January 1, 2012 and any revocable trust that becomes irrevocable on or after that date**. This section has been somewhat controversial.

There are two basic types of notice required. The first requirement is notice of the existence of the trust.11.96A.120(2) provides that this notice must be given within 60 days of the acceptance of the position of trustee of an irrevocable trust or the date the trustee of a formerly revocable trust acquires knowledge that the trust has become irrevocable. The trustee must give notice of the existence of the trust, the trustee's name, address and telephone number, and the right to request such information as is reasonably necessary to enable the notified person to enforce his or her rights. The notice must be given to all persons interested in the trust, as defined in RCW 11.96A.030 and who would be entitled to notice under RCW 11.96A.110 and 11.96A.120 if they were a party to judicial proceedings regarding the trust. Who gets notice? See discussion of Virtual Representation under Sec. 9 above. Note: the statute provides that the common law duty to notify trust beneficiaries of the existence of the trust is unaffected by the changes to this statute for irrevocable trusts created before January 1, 2012.

The other kind of required notice is notice about the administration of the trust. As provided in 11.96A.120(3) the same interested persons as described above must be kept reasonably informed about the administration of the trust and given information about the material facts necessary for them to protect their interests. That notice duty is presumed satisfied by a report that contains all the information discussed under Sec 7 above.

Sec. 13. Adds a new section to RCW 11.98 providing that the rules of construction that apply to the interpretation of wills will also apply to the interpretation of trusts.

Sec. 14. Slightly changes the language providing which trusts are not subject to RCW 11.98.

Sec. 15. Codifies common law and adopts UTC language regarding the creation of trusts.

Sec. 16. Codifies common law and adopts UTC language regarding the requirements for the creation of a trust.

Sec. 17. Codifies common law and adopts UTC language regarding trusts created in other states.

Sec. 18. Codifies common law and adopts UTC language regarding trust purposes.

Sec. 19. Codifies common law and adopts UTC language regarding oral trusts.

Sec. 20. Another new section of 11.98 provides that a trust may be created for a noncharitable purpose without a definite or definitely ascertainable beneficiary or for a noncharitable but otherwise valid purpose but may not be enforced for longer than the period which would not violate the rule against perpetuities.

Sec. 21. Adds language to RCW 11.98.039 to provide that a change of trustee to a foreign trustee does not change the situs of the trust.

Sec. 22. Adds a new chapter to RCW 11.98 regarding situs and governing law. The basic requirement is that if the provisions of a trust instrument designate Washington as the situs of the trust or designate Washington law to govern the trust or any of its terms, then the situs of the trust is Washington if one of the following conditions is met:

1. A trustee has a place of business in or is resident of Washington;
2. More than an insignificant part of the trust administration occurs in Washington;
3. The trustor resides in Washington at the time situs is being established or resided in Washington at the time that the trust became irrevocable;
4. On or more of the beneficiaries resides in Washington; or
5. An interest in real property located in Washington is an asset of the trust.

Unless the trust designates another state as the situs and does not expressly authorize transfer of situs, the trustee may register the trust as a Washington trust if any of the conditions above are present by filing a statement with the clerk of the court in any country where venue lies for the trust.

Sec. 23. Amends RCW 11.98.045 to modify how a trust’s sutus can be changed.

Sec. 24. Amends RCW 11.98.051 to modify how and to whom the trustee must provide notice of a change of the situs of a trust.

Sec. 25. Amends RCW 11.98.055 to provide the procedure for having the court authorize a change of situs.

Sec. 26. Amends RCW 11.98.070 to expand the powers of a trustee. One subsection provides how a trustee can make a distribution on behalf of a beneficiary who is under a legal disability or who the trustee reasonably believes is incapacitated. The trustee can (1) pay the beneficiary directly or apply the payment for the beneficiary's benefit, (2) pay it to certain defined third parties, or (3) or manage the payment as a separate fund on the beneficiary's behalf subject to a continuing right in the beneficiary to withdraw. The amendment provides that if a third party is paid in accordance with the statute, the trustee has no further obligations regarding the amounts so paid.

Other new sections authorize a trustee to pay or contest, and settle or release claims belonging to a trust; make tax elections; prosecute or defend actions or claims to protect trust property and the trustee in the performance of the trustee's duties; select a mode of payment under employee benefit plans, annuities or life insurance payable to the trustee; and, on termination of a trust, exercise the powers appropriate to wind-up the trust administration and distribute the trust property.

Sec. 27. Adds a new section to RCW 11.98 providing a process a trustee can follow to distribute the trust property upon the termination of the trust. It provides a 30 day window to object if the trustee provides the beneficiaries a proposed plan of distribution, including plans that provide for non pro rata distributions.

Sec. 28. Adds a new section to RCW 11.98 that provides nonliability to persons other than beneficiaries who in good faith and without knowledge that a trustee is acting inappropriately assist, deal with, or deliver assets to the trustee. These individuals acting in good faith and without knowledge are not required to inquire into the extent of a trustee's power or ensure that assets delivered to the trustee are applied properly.

Sec. 29. Adds a new section to RCW 11.98 that exculpatory language inserted into document in an abuse of a fiduciary or confidential relationship between the trustor and the trustee is unenforceable.

Sec. 30. Adds a new section to RCW 11.98 to provide that a trustee is not liable to a beneficiary for breach of trust if the beneficiary consented to the conduct constituting the breach, or released the trustee of liability, unless the consent or release was induced by improper conduct of the trustee.

Sec. 31. Adds a new section to RCW 11.98 to authorize the trustee to furnish a certification of trust instead of furnishing a copy of the trust instrument to any person other than a beneficiary. The section includes the information that must be included in the certification, allows the recipient of the certification to request copies of the excerpts from the trust instrument that designate the trustee and confer the power to act in the pending transaction, and provide that a person acting in reliance on a certification without knowledge that the information in it is incorrect, is not liable for so acting. Knowledge of the terms of the trust cannot be inferred from the fact that the person relying on the certification has a copy of the trust instrument. If a person is found to have demanded the trust instrument in bad faith may be liable for damages including reasonable attorney fees.

Sec. 32. Adds a new section to RCW 11.98 codifying the common law duty of loyalty. This section also describes the situations where a trustee is presumed to have a conflict of interest and the basis on which a transaction may be voidable by a beneficiary affected by the transaction.

Sec. 33. Adds a new section to RCW 11.98 codifying the damages for breach of trust. Those damages will be the greater of the amount required to restore the value of the trust property and trust distributions to what they would have been had the breach not occurred or the profit that the trustee made by reason of the breach.

Sec. 34. Amends RCW 11.100.090 [self dealing] to refer to excepted acts authorized by the new statutory Duty of Loyalty (see Sec. 32 discussion above).

Sec. 35. Adds a new section providing that the capacity required to create, amend, revoke, or add property to a revocable trust; or to direct the actions of the trustee of a revocable trust, is the same as that required to make a will.

Sec. 36. Adds a new section providing that a trustor cannot revoke or amend a trust unless its terms expressly state that it is revocable. The section also provides direction for revocation and amendment when there are more than one trustor and when the trust consists of property other than community property. This section also includes provisions regarding the character of property transferred to and from revocable trusts and rules describing how to revoke or amend a revocable trust.

Sec. 37. Adds a new section providing that while a trust is revocable, the trustee's exclusive duty is to the trustor and the beneficiaries' rights are subject to the control of the trustor.

Sec. 38. Adds a new section providing that the time for a person to commence a judicial proceeding to contest the validity of a trust that was revocable at the trustor's death ends on the earliest of 24 months after the trustor's death or four months after the trustee sent the person notice with the information described in RCW 11.97.010 (See Sec. 12 above) and notice of the time allowed to commence the proceeding. The trustee may commence to distribute the property of a trust that was revocable at the trustor's death unless the trustee knows of a pending judicial proceeding contesting the validity of the trust, or the trustee has been notified of a possible judicial proceeding to contest the trust and the proceeding is commenced within 60 days after the contestant sent notification.

Sec. 39. States that a new chapter will be added to Title 11 RCW to include sections 35 through 38 above.

Sec.40. Applicability. S.H.B. 1051 applies to all trusts created before, on, or after January 1, 2012. It applies to all judicial proceedings concerning trusts commenced on or after January 1, 2012. Any rule of construction or presumption provided in S.H.B. 1051 applies to trust instruments executed before January 1, 2012 unless there is a clear indication of a contrary intent in the terms of the trust. Am action taken before January 1, 2012 is not affected by S.H.B. 1051. Rights acquired, extinguished, or barred upon the expiration of a prescribed period that has commenced to run under any other statute before January 1, 2012, that statue continues to apply to the right even if it has been repealed or amended.

Sec. 41. The act takes effect on January 1, 2012.

Fiduciary Income Tax Update

2010 Tax Legislation:

- Hiring Incentives to Restore Employment Act (March 18, 2010)
- Patient Protection and Affordable Care Act (March 23, 2010)
- Health Care and Education Reconciliation Act (March 31, 2010)
- Small Business Jobs Act (September 27, 2010)
- Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (December 17, 2010)

Today's remarks will touch briefly on the Tax Relief Act and focus on certain provisions of the Health Care Acts. However, you should be aware of provisions in the other two tax acts that may affect the trusts, estates, and beneficiaries that you deal with everyday.

Hiring Incentives Act:

Key features of this legislation are provisions that allow those who hire the unemployed to claim certain payroll tax exemptions and income tax credits. However, this tax act also included significant provisions covering offshore investments and modifying withholding rules under IRC §§1441 and 1442 (effective for tax years beginning after March 18, 2010) and the information reporting of PFICs (effective for tax years beginning after March 18, 2010).

Small Business Jobs Act:

You might think there was nothing in this legislation affecting trusts or estates since most trusts and estates are not also small businesses. But this act included the temporary expansion of the Small Business Stock Partial Gain Exclusion of IRC §1202. The exclusion was temporarily expanded to 100% of qualifying gain and was slated to expire for stock purchased after December 31, 2010. The Tax Relief Act extended the provision for stock purchased through December 31, 2011. §1202 applies to all taxpayers other than corporations. There are numerous requirements that must be satisfied to obtain the benefits of this provision (5 year holding period for the stock, and certain business activity requirements and gross asset limitations for the "small business"). Only stock purchased after September 27, 2010 is eligible for the 100% gain exclusion.

Health Care Acts:

The Patient Protection and Affordable Care Act and Health Care and Education Reconciliation Act together are referred to as the Health Care Acts. These two pieces of legislation are intended improve and expand health care coverage for everyone. Specifically, the laws mandate that most individuals obtain basic health care coverage for themselves and their families and, to insure universal coverage, some individuals who can't pay all or a portion of the cost of coverage will get payment assistance from the government. To improve access to coverage, employers are encouraged to provide access for their employees, but not necessarily to pay the cost of insurance. Providing payment assistance to the needy and incentives to employers costs money so the legislation includes some revenue raising provisions that will affect most taxpayers and that includes both trusts and their beneficiaries. The two major taxes affecting individuals or trusts and estates are discussed in these materials.

<u>New Taxes:</u>

- The <u>Medicare Payroll Tax</u> (IRC §1401) is not effective until 2013. This new tax increases the Medicare tax on certain earned income by 0.9%. At current rates, that would make the total Medicare tax rate for affected individuals 2.35%, compared to today's 1.45%. The tax only applies to compensation income, including self-employment income, <u>in excess</u> of certain thresholds: $200,000 for single and head of household taxpayers; $250,000 for those who are married and file joint returns; and $125,000 for married individuals who file separately. Unlike the existing Medicare tax, there is no employer share of the Medicare Payroll tax; it is imposed only on those who earn income. Unlike most payroll taxes, this tax is based on the combined <u>earned</u> income of married couples. Some employers will be required to withhold the tax from employees' pay. In most cases though, the tax will be paid with individual taxpayers' annual returns.

- The <u>Unearned Income Medicare Contribution Tax</u> (IRC §1411) tax is also not effective until 2013. Unlike the Medicare Payroll tax it applies to estates and trusts as well as individuals. The complete text of IRC §1411 is provided in Appendix A on page 25.
  - The tax rate is 3.8%
  - The threshold amounts for individuals are the same as those for the payroll tax discussed above. For estates and trusts, the threshold is the dollar amount that is the beginning of the highest fiduciary income tax bracket (IRC §1(e)). Based on the 2011 tax rate schedule (Appendix C, Page 31), that amount would be $11,350.
  - The tax applies to the lesser of net investment income (undistributed net investment income in the case of a trust or estate), or adjusted gross income (adjusted income in the case of an estate or trust) in excess of the applicable threshold.
    - Adjusted income for trusts and estates is as defined in IRC §67(e), and takes into account the income distribution deduction, as well as deductions related to the administration of a trust or estate, but not deductions which are miscellaneous itemized deductions.

- Net investment income is everything you would expect: interest, dividends, rental income, income from annuities, business income (if the business is an investment rather than an active trade or business) and capital gains.
    - Tax exempt income is not included in net investment income.
    - Net investment income does not include distributions from employer sponsored plans or IRAs
    - Business income is passive activity income and income from businesses that are described in IRC §475(e)(2)
- Net investment income is net of expenses allowed by the tax code allocable to such gross income or net gain.
    - It is not clear which expenses will be "properly allocable" to investment income in the computation of "net investment income" for §1411(c)(1)
        - "miscellaneous itemized deduction,s" §67(a)?
        - rental expenses related to rental income, §469?
        - "investment expenses" as determined for the investment interest expense limitation, §163(d)(4)(C)

- You can imagine how this provision will apply to trusts and estates since they normally retain their capital gains and generally most of their income is investment income.

- EXAMPLE:
  The Johnson Family Trust has the income, expense, and distribution items shown in Appendix B (page 28) for 2013. For simplicity, assume that the 2013 tax rates and brackets are the same as those in 2011. The calculations are the author's best guess of how the Unearned Income Medicare Contribution Tax will be computed.

  As you can see, because the trust has both undistributed net investment income and undistributed adjusted income in excess of the threshold, it is subject to the 3.8% tax. However, the tax isn't imposed on all of its net investment income of $116,176, only on the undistributed adjusted income in excess of the threshold, the lesser amount of the alternative tax bases.

  You can also see that the amount of the tax is small, here an additional $1,804. That doesn't mean that the tax is insignificant. With this tax, the distinction between the income tax base and the Social Security and Medicare tax (or "contribution" as they are often referred to) bases has become more blurred. We can wonder about the relationship, other than the need for more tax revenue, between investment income of individuals, trusts and estates and Medicare.

The rate of this tax, 3.8% is the same as the maximum tax for Medicare that is applied to an individual's earned income (including the employer's share, 1.45%. and the employee's maximum share, 2.35% after 2012). We can assume that if Medicare taxes are increased in the future, this tax will also increase.

Taxpayer Relief Act – Income Tax Provisions

The provisions of this tax act have been discussed by tax professionals in great detail since last December 17. There is no intention to dwell on them here except as they may affect the income taxes of trusts and estates. Of the seventy-two enumerated sections of H.R. 4853 (that's the bill number of the Taxpayer Relief, Unemployment Reauthorization, and Job Creation Act of 2010), forty-four apply mostly to businesses and two are administrative, leaving only twenty-six sections related to individuals and/or fiduciaries. Only a few of them will be discussed here.

Income Tax Rates:

For all of 2010 and pretty frequently between about 2008 and 2010, presentations and publications about taxes and investments were filled with warnings about tax rates that would expire on December 31, 2010, pursuant to §901 of the Economic Growth and Tax Relief Reconciliation Act, EGTRRA) – unless Congress did "something." What Congress eventually did was retain the lower ordinary and capital gain tax rates that the 2001 and 2003 tax relief acts had instituted. These rates apply to individuals as well as estates and trusts.

Ordinary income tax rates did not revert from six (for individuals) brackets with rates ranging from 10% to 35% down to only 5 brackets with rates from 15% to 39.6%. Long-term capital gains rates did not increase from the 0%, 15%, 25%, and 28% series of rates to 10%/8%, 20%/18%, 25%, and 28% series that had been replaced in 2003. Qualified dividends, which had been taxed like long-term capital gains with a maximum rate of 15%, retained that favorable tax rate classification rather than reverting to classification as ordinary income, maximum rate 39.6%.

The retention is only through 2012, so these lower tax rates are actually still temporary and the proverbial can has simply been kicked down the road. BUT tax rates did not increase on January 1, 2011. What a relief! Appendix C on pages 29 through 31 presents an approximation of the ordinary income tax tables we might have seen on January 1, but for this act, compared to the tables we now have.

Extenders:

- Some slightly obscure provisions related to trusts were extended through 2012: (1) the pass-through treatment of qualified dividends from common trust funds and (2) the favorable income tax treatment for Alaska Native Settlement Trusts and their beneficiaries.

- Alternative Minimum Tax: The expanded exemptions have been retained and adjusted for cost of living for both 2010 and 2011. These bigger exemptions had expired on December 31, 2009. Without these changes some 20 to 21 million additional taxpayers would have to the Alternative Minimum Tax in 2010. Instead, only the 4.5 million or so who paid the tax in 2009 will likely face it again in 2010 and 2011. The exemptions we now have for 2010 and 2011 compared to those we would have had are shown below. The hoopla surround the AMT is less of an issue for the taxation of trusts and estates because their exemption hasn't been expanded since 1993 when it increased to $22,500 from $20,000. It remains an issue for beneficiaries.

  Alternative Minimum Tax Exemptions:

	Before Tax Act	After Tax Act	
	2010 & 2011	2010	2011
Married Filing Jointly	$45,000	$72,450	$74,450
Unmarried	$33,750	$47,450	$48,450
Married Filing Separately	$22,500	$36,255	$37,225
Estates and Trusts	$22,500	$22,500	$22,500

Investment Fees paid by Trusts and Estates

On January 16, 2008, the Supreme Court issued a decision in *Michael J. Knight, Trustee of William Rudkin Testamentary Trust v. Commissioner*, 522 U.S.181, 128 S Ct 782 (2008) . The holding was that amounts paid to an investment advisor by a nongrantor trust or estate generally are subject to the two percent floor for miscellaneous itemized deductions under IRC §67(a) because they are expenses *commonly or customarily* incurred by individuals. The Court held that expenses fully allowable under §67(e)(1) were those that were uncommon, unusual, or unlikely to be incurred by individuals. This decision resolved a long-standing controversy about trust and estate expenses that had resulted in a split among the Courts of Appeal and the Tax Court. Generally, the fees in question have been investment advisory fees paid by trusts and estates. The Sixth Circuit (*O'Neill v. Commissioner*, 994 F2d 302 (1993)) held that these fees were fully deductible §67(e)(1) expenses. The Federal (*Mellon Bank NA v. United States*, 265 F3d

132(2003), Second (*Knight v, Commissioner*, 467 F3d 146 (2006), and Fourth Circuits (*Scott v. United States*, 328 F3d 132(2003)) all held that they were subject to limitation under §67(a) as did the Tax Court *(Knight v Commissioner,* 124 TC 304(2005)).

While *Knight* was working its way through the courts, Treasury issued proposed regulations under IRC §67(e)(1). Prop Reg. 1.67-4. These regulations provide that expenses of trusts and estates that are "unique" to these entities are NOT subject to the two percent floor of IRC §67(a). Unique was defined to mean expenses that <u>could not</u> be incurred by an individual in connection with property not held by an estate or trust. The proposed regulations focus on the type of service provided not the characterization of the service. Thus a combined or "bundled" fee paid to a trustee for both investment advisory services and trustee services would have to be allocated between the two services; a portion of the fee would be subject to the two percent floor of §67(a); the other portion, not limited pursuant to §67(e)(1). Prop. Reg. §1.67-4(c).

When the Supreme Court agreed to hear *Knight*, the issuance of final regulations was put on hold. After the Court's January 2008 decision, it was expected that Treasury would issue regulations consistent with the Court's basis for the decision, which used a slightly less stringent standard than did the proposed regulations for determining expenses that were fully allowable under §67(e)(1). A key concern was the issue of the so-called "bundled" fees that included payments for the services of the trustee as a trustee and for expenses that would not commonly be incurred by individuals but also for services by the trustee as investment advisor and for investment expenses that are commonly incurred by individuals.

Regulations weren't available for the 2007 tax return filing season and Notice 2008-32, 2008-11 I.R.B. 593, provided that taxpayers were not required to determine the portion of a bundled fiduciary fee that would subject to the two percent floor. Notice 2008-116, 2008-52 I.R.B. 1372(12/11/2008) extended that guidance for years before January 1, 2009, and Notice 2010-32, 2010-16 I.R.B. 594 (4/1/2010) further extended it for years before 2010. On April 14, 2011, Notice 2011-37, 2011-20 I.R.B.(<u>*no page number yet)*</u>, further extended that original guidance for years before January 1, 2011 and for all years before final regulations are published in the Federal Register. Notice 2011-37 states that the final regulations will provide guidance regarding bundled fees and will be consistent with Knight. There was no indication though on the timing of those regulations.

This lack of guidance and continued deferral of the requirement to "un-bundle" fees results in a tax advantage for trusts that pay bundled fees and a disadvantage for those in which fees and costs are not bundled. There are two direct tax benefits derived from not splitting apart the bundled fee. First, none of the expenses that would be subject to the two percent floor are limited so trusts with bundled fees have lower Distributable Net Income (DNI) and lower taxable income than those that pay separately for all of their costs. Secondly, none of those bundled expenses are reported as miscellaneous itemized deductions. You'll recall that miscellaneous itemized deductions are not allowable for purposes of the Alternative Minimum Tax. Hence, trusts that don’t bundle fees and do report expenses subject to the two percent floor have the potential of paying higher tax due to the Alternative Minimum Tax, or passing through to the beneficiaries an Alternative Minimum Tax adjustment that could result in the beneficiaries paying higher taxes if they are subject to the Alternative Minimum Tax. The trade-off is less fee transparency for greater tax savings and the result is that similarly situated taxpayers are still treated differently even though avoiding that outcome that was the reason the Supreme Court agreed to hear *Knight*.

With the new 3.8% Medicare tax for trusts and estates taking affect on January 1, 2013, there will be yet another situation in which similarly situated trusts may be treated differently for tax purposes. The Unearned Income Medicare Contribution tax applies to the lesser of undistributed adjusted income greater than the threshhold or undistributed net investment income. Net investment income is investment income as defined in §1411(c)(1) minus properly allocable investment expenses. We don’t know which expenses will be deductible in determining net investment income. Those bundled fees that are fully deductible for regular income tax may not be deductible in computing net investment income for the Unearned Income Medicare tax since they aren’t treated as investment fees. However, under current law, bundled fees are deductible for purposes of computing adjusted income under IRC §67(e). It appears that for most trusts, the amount most likely to be subject to the 3.8% tax will be the adjusted income in excess of the threshold rather than net undistributed investment income.

Passive Activities Owned by Trusts

The Tax Reform Act of 1986 made such sweeping changes to U.S. law that after its enactment the code was referred to as the 1986 code to distinguish it from the previous, 1954, version. Significant changes were made to the law governing the income taxation of individuals, businesses, and trusts and estates. Most of those changes have been accepted and incorporated into the body of tax law.

One issue that has remained unresolved is how a trust or estate would materially participate in a trade or business, which is a requirement for deducting net losses from that business under IRC §469. When the regulations under IRC §469 were issued in the late 1980’s, the guidance on material participation of trusts and estates was reserved. Treas. Reg. §1.469-5T(h). CPAs and tax preparers are familiar with the quantitative tests to determine whether an individual materially participates in an activity (the 500 and 100 hour tests provided in the regulations). The legislative history of the 1986 act contained language to the effect that the activities of the trustee or executor acting in that capacity would determine the participation of the trust or estate. (Senate Report No. 99-313 (PL 99-514), p.735.) The IRS relies on the legislative history and consistently finds that that the trustee or executor must be ” involved in the business operations on a basis which is regular, continuous and substantial” (the definition of “material participation” under IRC §469(h)(1)), and not merely by hiring others to do the work. In addition, according to the

IRS, when the trustee acts as a trustee with regard to the trust's passive activities (example, negotiating a sale), those activities don't "count." Even the beneficiary's involvement is disregarded. TAM 200733023 and IRS Letter Ruling 201029014.

A District Court in the 5th Circuit found differently, in *Carter, Mattie K. Trust v U.S*., (256 F Supp. 2d 536 (D.C. Tex., 2003)) where it said that the statute clearly states that the trust is the "person" subject to the limitations of §469.((§469(a)(2)(A)). The court said that there was no need to look at the legislative history of the 1986 act because the statute was clear. The court further said that since a trust itself can't act, the activities of <u>all</u> of those who labor on the trust's business should be scrutinized. In the Carter case, a ranch owned by a trust had a full-time manager and other full- and part-time employees, which included the person who was the trustee. The holding in Carter was that the trust met the material participation test through the activities of all those individuals. The IRS has continually disregarded the *Carter* decision.
Someday, maybe, regulations will be issued and fill in that gap at 1.469-5(h). Most likely though, they aren't going to be trust and estate friendly given the trail of Treasury rulings that narrowly limit the activities that can meet the "material participation" test of §469(h) to those of a fiduciary not acting as a fiduciary but rather acting as the person whose involvement in the business operations is regular, continuous, and substantial.

In the past, the concern with passive activities has focused on those that produce losses since net passive activity losses are what is limited by §469. But, net passive income will also be a concern beginning in 2013 when the Unearned Income Medicare Contribution Tax takes effect. §1411 (c)(2) specifically includes ordinary income from passive activities as investment income potentially subject to the 3.8% tax. Income from a trade or business which is not passive is not included in net investment income under IRC §1411. Appendix D, page 32, demonstrates the sensitivity that the categorization of business income as passive could have in the determination of a trust's Unearned Income Medicare Contribution tax liability.

Appendix A

§ 1411 Imposition of tax.

(a) In general.

Except as provided in subsection (e) —

(1 Application to individuals.

In the case of an individual, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax equal to 3.8 percent of the lesser of—

(A) net investment income for such taxable year, or

(B) the excess (if any) of—

(i the modified adjusted gross income for such taxable year, over

(ii the threshold amount.

(2) Application to estates and trusts.

In the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax of 3.8 percent of the lesser of—

(A) the undistributed net investment income for such taxable year, or

(B) the excess (if any) of—

(i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over

(ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

(b) Threshold amount.

For purposes of this chapter, the term “threshold amount” means—

(1 in the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), $250,000,

(2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, 1/2 of the dollar amount determined under paragraph (1) , and

(3) in any other case, $200,000.

(c Net investment income.

For purposes of this chapter—

(1) In general.

The term “net investment income” means the excess (if any) of—

(A) the sum of—

(i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2) ,

(ii) other gross income derived from a trade or business described in paragraph (2) , and

(iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in paragraph (2) , over

(B) the deductions allowed by this subtitle which are properly allocable to such gross income or net gain.

(2) Trades and businesses to which tax applies.

A trade or business is described in this paragraph if such trade or business is—

(A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or

(B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

(3) Income on investment of working capital subject to tax.

A rule similar to the rule of section 469(e)(1)(B) shall apply for purposes of this subsection .

(4) Exception for certain active interests in partnerships and S corporations.

In the case of a disposition of an interest in a partnership or S corporation—

(A) gain from such disposition shall be taken into account under clause (iii) of paragraph (1)(A) only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest, and

(B a rule similar to the rule of subparagraph (A) shall apply to a loss from such disposition.

(5) Exception for distributions from qualified plans.

The term “net investment income” shall not include any distribution from a plan or arrangement described in section 401(a) , 403(a) , 403(b) , 408 , 408A , or 457(b) .

(6) Special rule.

Net investment income shall not include any item taken into account in determining self-employment income for such taxable year on which a tax is imposed by section 1401(b) .

(d) Modified adjusted gross income.

For purposes of this chapter, the term “modified adjusted gross income” means adjusted gross income increased by the excess of—

(1) the amount excluded from gross income under section 911(a)(1) , over

(2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts described in paragraph (1) .

(e) Nonapplication of section.

This section shall not apply to—

(1) a nonresident alien, or

(2) a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B).

Appendix B

Unearned Medicare Contribution Tax

Johnson Family Trust - 2013

Income, Deductions, and Distributions

	Gross Amts	Fiduciary Income	Adjusted Income (1)	Net Invest. Income (2)	Taxable Income
Income:					
Interest	20,000	20,000	20,000	20,000	20,000
Dividends	75,000	75,000	75,000	75,000	75,000
Capital Gains, Long-Term	40,000		40,000	40,000	40,000
Expenses:					
Fiduciary Fees	5,000	2,500	5,000		5,000
Trust Accounting Fees	1,500	750	1,500		1,500
Tax Return Preparation	1,000	500	1,000		1,000
Investment Management Fees	20,000	10,000		20,000	20,000
2% Floor				(1,176)	(1,176)
Distributions to Income Beneficiary	81,250				81,250
DNI Adjustment					(12,874)
Trust Accounting Income		81,250			
Exemption			300	.	300
Adjusted Income			127,500	116,176	
Less: Income Distribution Deduction/Distributions			(68,676)	(68,676)	
Undistributed Adjusted Income			58,824		
Undistributed Net Investment Income				47,500	
Fiduciary threshold			11,350		
Undistributed Adjusted Income in Excess of threshold			47,474		
Unearned Income Medicare Contribution Tax			1,804		
Taxable Income					40,000

(1) IRC §67(e) pursuant to IRC §1411(a)(2)(B)(i)

(2) IRC §1411 (c)

Appendix C, Page 1
Ordinary Income Tax Rates

Married Filing Jointly (1)

2011 Without 2010 Tax Relief Act

Taxable Income Over	Taxable Income Not Over	Tax				
-	58,200			15.0%	of taxable income	
58,200	140,600	8,730.00	plus	28.0%	of excess over	58,200
140,600	214,250	31,832.00	plus	31.0%	of excess over	140,600
214,250	382,650	54,663.50	plus	36.0%	of excess over	214,250
382,650		115,287.50	plus	39.6%	of excess over	382,650

2011 After 2010 Tax Relief Act

Taxable Income Over	Taxable Income Not Over	Tax				
-	17,000			10%	of taxable income	
17,000	69,000	1,700.00	plus	15%	of excess over	17,000
69,000	139,350	9,500.00	plus	25%	of excess over	69,000
139,350	212,300	27,087.50	plus	28%	of excess over	139,350
212,300	379,150	47,513.50	plus	33%	of excess over	212,300
379,150		102,574.00	plus	35%	of excess over	379,150

Single
(1)

2011 Without 2010 Tax Relief Act

Taxable Income Over	Taxable Income Not Over	Tax				
-	34,850			15.0%	of taxable income	
34,850	84,350	5,227.50	plus	28.0%	of excess over	34,850
84,350	176,000	19,087.50	plus	31.0%	of excess over	84,350
176,000	382,650	47,499.00	plus	36.0%	of excess over	176,000
382,650		121,893.00	plus	39.6%	of excess over	382,650

2011 After 2010 Tax Relief Act

Taxable Income Over	Taxable Income Not Over	Tax				
-	8,500			10%	of taxable income	
8,500	34,500	850.00	plus	15%	of excess over	8,500
34,500	83,600	4,750.00	plus	25%	of excess over	34,500
83,600	174,400	17,025.00	plus	28%	of excess over	83,600
174,400	379,150	42,449.00	plus	33%	of excess over	174,400
379,150		110,016.50	plus	35%	of excess over	379,150

Appendix C, Page 2

Ordinary Income Tax Rates

Head of Household (1)

Taxable Income		Tax				
Over	Not Over					
-	46,650			15.0%	of taxable income	
46,650	120,500	6,997.50	plus	28.0%	of excess over	46,650
120,500	195,150	25,778.00	plus	31.0%	of excess over	120,500
195,150	382,650	48,919.50	plus	36.0%	of excess over	195,150
382,650		116,419.50	plus	39.6%	of excess over	382,650

Taxable Income		Tax				
Over	Not Over					
-	12,150			10%	of taxable income	
12,150	46,250	1,215.00	plus	15%	of excess over	12,150
46,250	119,400	6,330.00	plus	25%	of excess over	46,250
119,400	193,350	24,617.50	plus	28%	of excess over	119,400
193,350	379,150	45,323.50	plus	33%	of excess over	193,350
379,150		106,637.50	plus	35%	of excess over	379,150

Married Filing Separately (1)

Taxable Income		Tax				
Over	Not Over					
-	29,100			15.0%	of taxable income	
29,100	70,300	4,365.00	plus	28.0%	of excess over	29,100
70,300	107,125	15,901.00	plus	31.0%	of excess over	70,300
107,125	191,325	27,316.75	plus	36.0%	of excess over	107,125
191,325		57,628.75	plus	39.6%	of excess over	191,325

Taxable Income		Tax				
Over	Not Over					
-	8,500			10%	of taxable income	
17,000	34,500	850.00	plus	15%	of excess over	8,500
69,000	69,675	4,750.00	plus	25%	of excess over	34,500
139,350	106,150	13,543.75	plus	28%	of excess over	69,675
212,300	189,575	23,756.75	plus	33%	of excess over	106,150
379,150		51,287.00	plus	35%	of excess over	189,575

Appendix C, Page 3

Ordinary Income Tax Rates

Estates and Trusts (2)

Taxable Income		Tax				
Over	Not Over					
-	2,335			15.0%	of taxable income	
2,335	5,495	350.00	plus	28.0%	of excess over	2,335
5,495	8,380	1,235.00	plus	31.0%	of excess over	5,495
8,380	11,470	2,129.00	plus	36.0%	of excess over	8,380
11,470		3,241.00	plus	39.6%	of excess over	11,470

Taxable Income		Tax				
Over	Not Over					
-	2,300			15%	of taxable income	
2,300	5,450	345.00	plus	25%	of excess over	2,300
5,450	8,300	1,132.50	plus	28%	of excess over	5,450
8,300	11,350	1,930.50	plus	33%	of excess over	8,300
11,350		2,937.00	plus	35%	of excess over	11,350

(1) Thomson-Reuters RIA

(2) Computed by author using inflation percentages for Single taxpayers

Appendix D

Larson Family Trust – 2013

Income, Deductions, and Distributions

	Gross Amts	P & I	Adjusted Income	Net Invest. Income	Taxable Income
Income:					
Passive Activity Income	30,000	30,000	30,000		30,000
Dividends	75,000	75,000	75,000	75,000	75,000
Capital Gains, Long-Term	40,000		40,000	40,000	40,000
Expenses:					
Fiduciary Fees	20,000	10,000	20,000		20,000
Trust Accounting Fees	1,500	750	1,500		1,500
Tax Return Preparation	1,000	500	1,000		1,000
Investment Management Fees	5,000	2,500		5,000	5,000
2% Floor				(784)	(784)
Distributions to Income Beneficiary	91,250				91,250
DNI Adjustment					(8.266)
Trust Accounting Income		91,250			
Exemption			300		300
Adjusted Income			122,500	110,784	
Less: Distributions			(82,984)	(82,984)	
Undistributed Adjusted Income			39,516		
Undistributed Net Investment Income				27,800	
Fiduciary threshold			11,350		
Undistributed Adjusted Income in Excess of threshold			27,866		
Unearned Income Medicare Contribution Tax				1,056	
Taxable Income					40,000

Biography:

As managing director of tax and financial planning at the Laird Norton Tyee Trust Company, Kristi Mathisen develops protocols to identify appropriate tax and financial strategies that benefit clients. She is an attorney and CPA/PFS with more than 25 years of finance-related experience. She's a member of the Washington State and King County Bar Associations, and a member of the Washington Society of Certified Public Accountants and American Institute of Certified Public Accountants. Kristi is also an active member of the Seattle CPA Roundtable, Washington Women in Tax, and the Seattle Tax Group. She is a board member of the Washington Planned Giving Council and the University of Washington Foundation and is a past president of the Estate Planning Council of Seattle. In addition, she serves on the Planned Giving Advisory Boards for both the King County Library Foundation and the University of Washington. Kristi is a graduate of the University of Washington Schools of Business and Law. Prior to joining Laird Norton Tyee in 2006, she was a shareholder of Bader Martin, PS., a Puget Sound area public accounting firm.

Disclaimer and Circular 230 Disclosure:

The information contained in these materials is for education and instructional use only. No warranty, express or implied, is made as to their use. Any tax advice contained in these materials was not intended or written by the author to be used and it cannot be used by any taxpayer for the purposes of avoiding penalties that may be imposed on the taxpayer. Any tax advice contained in these materials was not written to support, within the meaning of Treasury Department Circular 230, the promotion or marketing of the transaction or matter addressed by such advice because the author has reason to believe that it may be used or referred to by another person in promoting, marketing or recommending an entity, investment plan or arrangement to one or more taxpayers. Before using any tax advice contained in these materials, a taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.