

TRUST AND ESTATE UPDATE

For: Spokane Estate Planning Council

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LAIRD NORTON

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Trust and Estate Update

Overview

- State Updates
 - S.B. 5849
 - S.B. 5037
 - S.H.B. 1051
- Federal Updates
 - 2010 Tax Acts
 - Investment Fees Paid by Trusts and Estates
 - Passive Activities Owned by Trusts and Estates

State Updates

S.B. 5849

- Amends RCW 11.86.031
 - Valid disclaimers can be executed through Sept. 17, 2011
 - Interests received from decedents who died after Dec. 31, 2009 and before Dec. 18, 2011
 - Washington residents
 - Washington property
 - Conforms state disclaimer period to longer period provided in 2010 Tax Relief Act for qualified disclaimers.
- Amends RCW 11.108.090
 - Removes presumption that 2009 estate tax rules were intended by decedents who died in 2010
 - For provisions in wills that were based on federal law
 - New presumption, either \$3.5 or \$5.0 exemption

State Updates

S.B. 5057

- Amends Washington Principal and Income Act. RCW 11.104A
 - Specifically, Section 290 – Income Taxes
 - Clarifies allocation of tax when trust pays tax on entity's income
 - Clarifies impact of the tax benefit of distributions to beneficiaries
 - Changes certain words and re-numbers paragraphs
 - Effective date: July 22, 2011
- What's the issue?
 - What to do when taxable income \neq receipts from entities
 - Ex. (A) IBM dividend received = \$100
 - Trust pays \$100 to income beneficiary ► Trust has no taxable income ► Beneficiary pays tax OR
 - Trust does not pay beneficiary ► Trust has \$100 of taxable income ► Trust pays tax, allocates to income 11.104A.290(1)

State Updates

S.B. 5057, Continued

- Ex. (B) LLC receives \$1,000 of interest, pays 10% owner, a trust, \$40, gives Sch. K-1 with \$100 of income
 - If Trust pays \$40 to beneficiary ► Trust has \$60 of taxable income ► Who pays tax on \$60? Where is it charged?
 - Two alternative interpretations
 - (1) NCCUSL: Trust retains cash for tax, distributes the rest.
 - Distributes \$7.65 ► Trust has \$92.35 taxable income ► Pays tax of \$32.35 with retained \$32.35 ► Charges \$32.35 to income 290(3)(a)
 - Beneficiary pays tax of \$2.65 on \$7.65, nets \$5
 - 290(4) is interpreted (and amended) as requiring calculation of actual tax savings from distribution before making the distribution

State Updates

S.B. 5057, Continued

- (2) Alternative: Trust distributes the \$40, then determines tax
 - Trust distributes \$40 ▶ Trust has \$60 taxable income
▶ Pays \$21 of tax ▶ Charges tax to principal
290(3)(d)
 - Beneficiary pays tax of \$14 on \$40, nets \$ 26
 - 290 (4) is interpreted (and amended) as requiring an adjustment of income or principal receipts by the amount of the distribution that is deducted not the tax benefit
 - After reducing the \$40 receipt by the \$40 distribution, there is no income receipt to charge tax expense to, default under 290(3)(d) is to charge tax to principal

State Updates

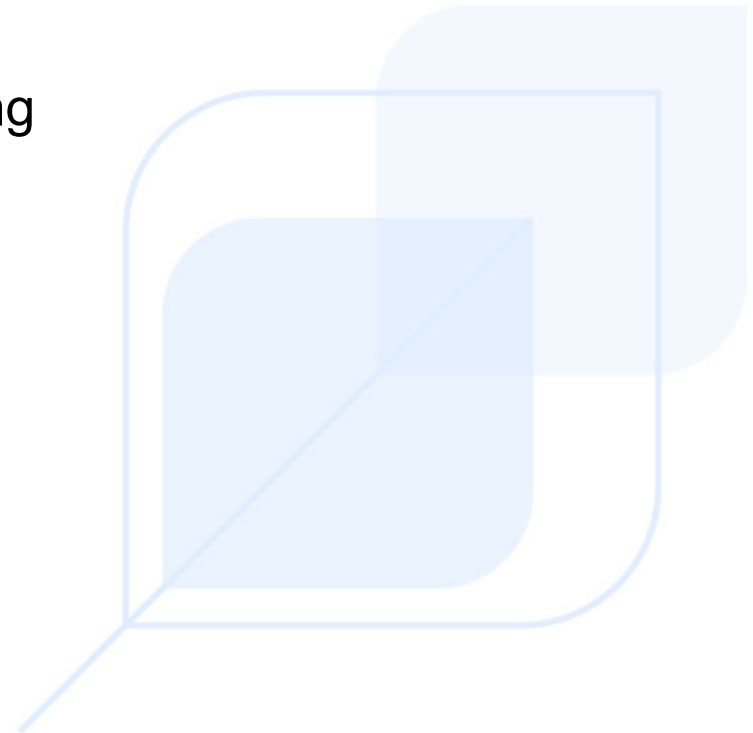
S.B. 5057, Continued

- The alternative was recommended by the Bar Association
 - Ease of calculation
 - NCCUSL would be difficult to calculate and likely calculated erroneously
 - NCCUSL favored remainder beneficiaries
 - Undistributed entity income accrues to remaindermen
 - Income beneficiaries could possibly never benefit
 - NCCUSL didn't solve the problem for trusts with taxable entity income and no entity distributions
 - RCW 11.104A.300(a)(3) provides discretion to make adjustments between income and principal for taxes when entity income doesn't equal entity distributions
 - Many trust documents provide trustees with discretion to make adjustments not provided in P & I Act.

State Updates

S.B. 5057, Continued

- Recommendation for advisors
 - Which assets to use to fund a trust should involve the consideration of a variety of factors
 - Potential for appreciation
 - Expected cash flows
 - Principal and Income accounting
 - Tax consequences



State Updates

S.H.B. 1051

- This bill makes many changes to existing Washington statutes and codifies many common law rules for trusts and estates
- The effective date is January 1, 2012 for trusts created before, on, or after that date
 - Several provisions apply only to irrevocable trusts created on or after January 1 and revocable trusts that become irrevocable on or after that date
- It is important that trustees know of the changes in the laws that govern their activities
 - There are a great number of individuals acting as trustee who are not in a position to know of these changes
 - Consider how we as advisors can get the message to them
- Additional resources are noted in the written materials
- Tonight: a very brief overview of key changes in the law

State Updates

S.H.B. 1051, Continued

- Key changes
 - Notice of appointment of a personal representative and pendency of probate should be given to the trustee of a trust named as a devisee of an estate or transferee of a non-probate asset
 - A new power of an attorney in fact that must be specifically addressed in the Power of Attorney document: the power to exercise the principals right to distribute property in trust or cause a trustee to distribute property in trust
 - New definitions of venue and situs for trusts and estates
 - Trustees may register trusts as Washington trusts when situs hasn't been provided in the document and certain connections to Washington exist
 - A trustee may furnish a certification of trust instead of a copy of the trust document to any person other than a beneficiary

State Updates

S.H.B. 1051, Continued

- Key changes, continued
 - Codifies common law concept of virtual representation in matters where the interests of the fiduciary estate and the beneficiaries are not in conflict:
 - Guardian may represent and bind the estate he/she controls
 - Agent with authority may represent and bind the principal
 - Trustee may represent and bind beneficiaries
 - Personal Representative may represent and bind persons interested in an estate
 - Holder of power of appointment (that can't be exercised for own benefit) may represent and bind those whose interests are subject to the power
 - Codifies *cy pres* doctrine so that a court may modify a gift to fulfill the trustor's or testator's charitable intent

State Updates

S.H.B. 1051, Continued

- Key changes, continued
 - Terms of trusts and wills can be reformed even if unambiguous if they were affected by a mistake
 - High standard of proof: clear, cogent and convincing evidence that both the intent or the trustor/testator and terms were affected by the mistake
 - Reformation by court proceeding or non-judicial agreement
 - Capacity to create, amend, revoke or add property to a revocable trust or direct actions of trustee is the same as that required to make a will
 - The time for a person to contest the validity of a trust that was revocable at the trustor's death ends on the earliest of 24 months after date of death or four months after the trustee sent the person notice with information about existence of the trust

State Updates

S.H.B. 1051, Continued

- Key changes, continued
 - A trustee may commence distribution of a trust 30 days after sending the plan of distribution to the beneficiaries as long as no one objects within that 30 day period
 - New Duty to Notify Beneficiaries
 - Most controversial part of the new trust act
 - The duty to notify cannot be waived by the trustor/testator
 - Two types of notice are included in the duty to notify
 - Notice of existence of trust
 - Effective only for irrevocable trusts created on or after Jan. 1, 2012 and revocable trusts that become irrevocable on or after that date
 - Send within 60 days of becoming trustee or acquiring notice that a revocable trust has become irrevocable

State Updates

S.H.B. 1051, Continued

- Key changes, continued
 - Notice of existence of trust, continued
 - Required information to persons interested in a trust:
 - Existence of the trust
 - Trustee's name, address, telephone number
 - The person's right to request such information as is reasonably necessary to enable the person to enforce his or her rights
 - "Such information" would be a copy of the trust
 - If requested, must provide within 60 days
 - Persons interested in the estate or trust include trustor , all persons beneficially interested, persons holding powers over the assets, attorney general (for charities), personal representative, and trustee

State Updates

S.H.B. 1051, Continued

- Key changes, continued
 - Duty to notify, continued
 - Notice about administration of the trust
 - Same individuals as received notice of existence
 - Provide information about the material facts necessary for them to protect their interests
 - Adequate disclosure safe harbor
 - Damages for breach of trust are the greater of the amount required to restore the value of the trust property and trust distributions to what they would have been without the breach or the trustee's profit from the breach
 - New statute of limitations for bringing an action for breach of trust
 - Three years after beneficiary is sent a report that adequately disclosed the existence of a potential breach and time to commence a proceeding

State Updates

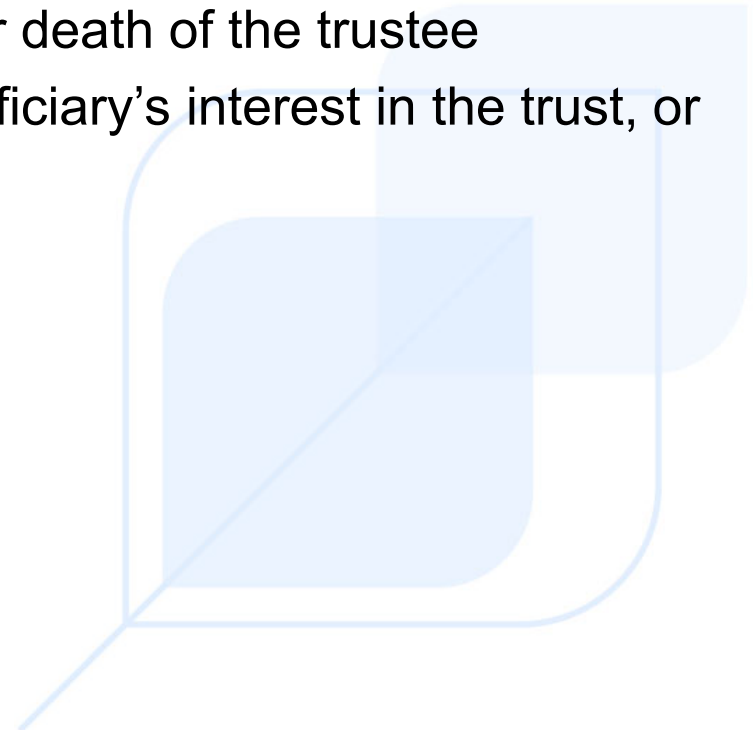
S.H.B. 1051, Continued

- Key changes, continued
 - Statute of limitations, continued
 - A report with the following is presumed to be adequate:
 - P & I receipts and disbursements for the reporting period
 - Beginning and ending assets and liabilities
 - Trustee's compensation
 - Agents hired, their relationship to trustee, & compensation
 - Disclosure of agreements affecting trust property lasting five years or more entered into during the period
 - Disclosure of all transactions that could have been affected by a conflict of interest between trust and trustee
 - Notice that recipient can request court review of the report
 - Notice of three year period to bring action for breach

State Updates

S.H.B. 1051, Continued

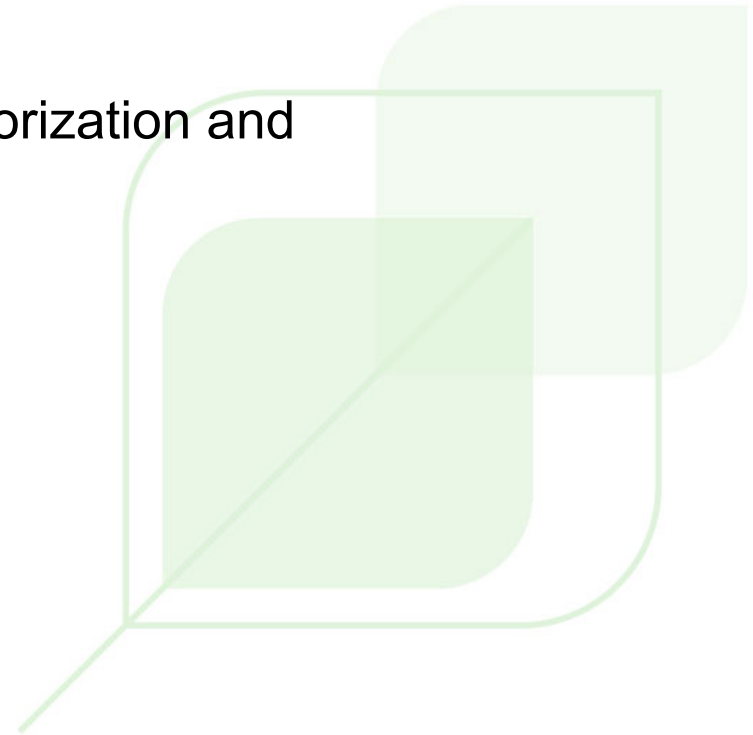
- Key changes, continued
 - Statute of limitations, continued
 - If adequate disclosure is not provided, the statute of limitations for commencing a proceeding begins on later of
 - the removal, resignation, or death of the trustee
 - the termination of the beneficiary's interest in the trust, or
 - the termination of the trust



Federal Updates

2010 Tax Acts

- 2010 Tax Legislation
 - Hiring Incentives to Restore Employment Act
 - Patient Protection and Affordable Care Act
 - Health Care and Education Reconciliation Act
 - Small Business Jobs Act
 - Tax Relief, Unemployment Reauthorization and Jobs Creation Act



Federal Updates

2010 Tax Acts, Continued

- Hiring Incentives Act, aka HIRE Act
 - Payroll tax exemptions
 - Tax credit for hiring the unemployed
 - New offshore reporting and withholding rules
- Small Business Jobs Act
 - Small business stock gain exclusion, §1202
 - Available to individuals, estates, and trusts
 - 100% exclusion for certain stock purchased during 2010
 - 2010 Tax Relief act extended for purchases through 2011
 - 5-Year holding period, business activity and gross asset limitation
 - Exclusion is 100% for AMT as well

Federal Updates

2010 Tax Acts, Continued

- Health Care Acts
 - Two separate bills were enacted in March, 2010
 - Mandate: All individuals are required to obtain and maintain health insurance coverage for themselves and their families by 2014.
 - Improved access
 - Employers are encouraged to offer insurance
 - Carrots for small employers; sticks for large
 - Insurers are encouraged to offer policies to everyone
 - Purchase assistance for low-income individuals
 - Credits and reduced co-pays
 - If not eligible for an exemption or exception, individuals will be penalized for not obtaining health coverage

Federal Updates

2010 Tax Acts, Continued

- Health Care Acts, Continued
 - Employer incentives and purchase assistance are tax expenditures which will be paid for through estimated “cost savings” and some new taxes. We’ll talk about two new taxes.
 - Beginning in 2013, the Medicare Payroll Tax of 0.9% applies to compensation income over certain thresholds:
 - \$200,000 for single and head of household taxpayers,
 - \$250,000 for married taxpayers filing joint returns
 - \$125,000 if married filing separately.
 - Tax is imposed on only those who earn compensation (workers), not those who pay it (employers)
 - Married couples’ earnings are combined for this tax
 - Self-employment income is included

Federal Updates

2010 Tax Acts, Continued

- Health Care Acts, continued
 - The Unearned Income Medicare Contribution tax, with a rate of 3.8%, applies to individuals, estates, and trusts beginning in 2013
 - For individuals, it is imposed on the lesser of:
 - net investment income or
 - modified adjusted gross income over certain thresholds:
 - \$200,000 for single and head of household taxpayers,
 - \$250,000 for married filing joint returns, and
 - \$125,000 if married filing separately
 - For estates and trusts, the 3.8% tax is applied to the lesser of:
 - Undistributed net investment income or
 - Adjusted income (§67(e)) in excess of the dollar amount at which the highest income tax bracket for estates and trusts begins, for 2011, that would be \$11,350

Federal Updates

2010 Tax Acts, Continued

- Health Care Acts, continued
- What is “net investment income” for the Medicare tax?
 - Investment income minus properly allocable investment expenses

Included

- Interest
- Dividends
- Capital gains
- Rental income
- Annuities
- Business income if the business is an investment rather than a livelihood

Excluded

- Tax-exempt interest/dividends
- Excludible home sale gain
- Wages and self-employment income (but new payroll tax!!)
- Social security
- Distributions from retirement plans and IRAs
- Prizes, awards and tax refunds

Federal Updates

2010 Tax Acts, Continued

- Health Care Acts, continued
 - Tax is highly likely to apply to estates and trusts which typically have mostly investment income and typically retain capital gain
 - Example, materials page 12
 - Tax is not imposed on all investment income
 - Greater of undistributed investment income OR
 - Adjusted income greater than \$11,350
 - Amount of tax is not great but the fact of the tax is significant
 - Blurs distinction between income and Medicare tax bases
 - If Medicare tax increases, this one likely increases too

Federal Updates

2010 Tax Acts, Continued

- Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (hereafter 2010 Tax Relief Act)
 - Fiduciary Income Tax issues
 - Ordinary income tax rates do not return to pre-2001/2003 levels for two more years, 2011 and 2012
 - The 10% rate is retained (for Individuals only)
 - Reinstatement of the 36% and 39.6% rates is deferred
 - Capital gain tax rates stay at 0% and 15% through 2012 as well
 - Qualified dividends are included in net capital gains

Federal Updates

2010 Tax Acts, Continued

- 2010 Tax Relief Act, Continued

2011 and 2012 after 2010 Tax Act

Income Taxes

- Ind. Rates 10, 15, 25, 28, 33, 35
- Fid. Rates 15, 25, 28, 33, 35
- Qualified Dividends: LTCG rate
- LTCG rates: 0% & 15%

Expected 2011 under EGTRRA

Income Taxes

- Ind. Rates 15, 28, 31, 36, 39.6
- Fid. Rates 15, 28, 31, 36, 39.6
- Qualified Dividends: Regular rates
- LTCG rates: 10% & 20%
 - Qual. 5 yr prop: 8 % & 18%

Federal Updates

2010 Tax Acts, Continued

- 2010 Tax Relief Act, continued
 - Extension of larger Alternative Minimum Tax exemptions
 - Prevents 21 million taxpayers from paying AMT in 2010 & 2011
 - Only (!) 4.5 million pay AMT after the change
 - Personal credits are allowed to offset AMT for 2010 and 2011
 - Child tax credit offsets AMT through 2012
 - Non-refundable personal credits offset AMT through 2011:
 - Continues practice of short-term fixes rather than long-term reform
 - Permanent reform is deemed too costly in lost revenue
 - 0%/15% capital gains tax rates retained for AMT for 2010 - 2012

Federal Updates

2010 Tax Acts, Continued

- 2010 Tax Relief Act, Continued
 - Expanded AMT exemptions: 2010/2011 amounts pre-and-post Act
 - Trusts and estates have had no change since 1993

Before Tax Act

2010

- ❖ \$45,000 – Married filing jointly
- ❖ \$33,750 – Unmarried
- ❖ \$22,500 – Married, separate
- ❖ \$22,500 – Estates and Trusts

2011

- ❖ \$45,000 – Married filing jointly
- ❖ \$33,750 – Unmarried
- ❖ \$22,500 – Married, separate
- ❖ \$22,500 – Estates and Trusts

After Tax Act

2010

- ❖ \$72,450 – Married filing jointly
- ❖ \$47,450 – Unmarried
- ❖ \$36,225 – Married, separate
- ❖ \$22,500 – Estates and trusts

2011

- ❖ \$74,450 – Married filing jointly
- ❖ \$48,450 – Unmarried
- ❖ \$37,225 – Married, separate
- ❖ \$22,500 – Estates and Trusts

Federal Updates

Investment Fees Paid by Trusts and Estates

- The Supreme Court's decision in *Knight v. Comm.* 128 S. Ct. 782, 01/16/2008, in January 2008 clarified the tax treatment of investment advisor fees and other investment expenses for trusts and estates.
 - Expenses are miscellaneous itemized deductions if they are of a kind that are “commonly or customarily” incurred by individuals.
 - The deduction for these miscellaneous expenses is limited to the amount that exceeds 2% of the trust or estate's adjusted income.
 - The allowed deduction for miscellaneous itemized deductions is also a preference item for Alternative Minimum Tax, meaning not deductible
 - Fully deductible miscellaneous expenses of trusts and estates are those “uncommon, unusual, or unlikely” to be incurred by individuals.

Federal Updates

Investment Fees Paid by Trusts and Estates, Continued

- The rules seem clear until the business reality of a trust company is taken into account. Many fiduciaries charge one fee that includes several different services such as:
 - Fiduciary fees
 - Investment management or advisory fees
 - Custodial fees
 - Accounting fees
- These services, referred to as “bundled,” fall into both categories, those subject to the 2% limitation and those not limited.
- The Court in Knight said that an investment fee could be partly limited if it was the same amount that an individual would pay with the excess amount possibly not limited if related to special investment requirements of the trust, i.e. “unbundled.”

Federal Updates

Investment Fees Paid by Trusts and Estates, Continued

- Treasury issued proposed regulations in 2007, before *Knight*. The regs. used a stricter standard, “unique-ness” than the Court did.
- After *Knight*, Treasury said in Notice 2008-32 that final regulations under §1.67-4 would be issued that were consistent with the Court’s holding in *Knight*. The final regulations would also address the bundled fee issue. BUT not in time for the 2007 return filing season, hence Treasury would not require the unbundling of fees for years before 2008.
- Notice 2008-116 extended the exemption from unbundling for years before 2009
- Notice 2010-32 extended it again for years before 2010
- Notice 2011-37 extended it until final regulations are published.
- Result has been unequal regular and alternative minimum tax outcomes for trusts and their beneficiaries depending on whether fees are bundled or unbundled

Federal Updates

Investment Fees Paid by Trusts and Estates, Continued

- September 7, 2011: Treasury withdraws the 2007 proposed regulations and issues new proposed regulations
 - The comment period for these regulations ends Dec. 7, 2011
 - The public hearing will be Dec. 19, 2011
 - The regulations will be effective for tax years beginning after the publication of final regulations in the Federal Register
 - Publication is unlikely to occur during 2011
 - These regulations will likely be effective for taxable years beginning in 20
 - Proposed regulations do reflect the Knight decision
 - Include categories of expenses that would be limited
 - Provide for “unbundling”

Federal Updates

Investment Fees Paid by Trusts and Estates, Continued

- New proposed regulations, continued
 - “Unbundling” safe harbor
 - If a single trustee fee is not billed hourly, the trustee may elect to deduct without limit the portion of the bundled fee that exceed the amount of the investment fee that an individual would have paid.
 - However, if the excess fee includes amounts paid to third parties that would have been limited were they paid by the trust directly, that amount must be limited.
 - The regulations provide that the allocation of a bundled fee between the portion that must be limited by the 2% rule and the unlimited portion may be made by any reasonable allocation method.
 - Comments are requested on the methods of reasonable allocation and substantiation required for “reasonableness.”

Federal Updates

Passive Activities Owned by Trusts and Estates

- The Tax Reform Act of 1986 introduced a new concept to taxation
- Losses from passive activities cannot (normally) be deducted unless the taxpayer has equivalent income from passive activities
 - Unused losses “suspend” and carryover from year to year
 - Current and suspended losses are allowed in disposition year
- Passive activities are those that involve the conduct of a trade or business activity in which the taxpayer doesn’t materially participate
- Material participation means the taxpayer is involved in the operations of the activity on a basis that is
 - Regular
 - Continuous
 - Substantial
- These rules apply to individuals, trusts, estates, some corporations

Federal Updates

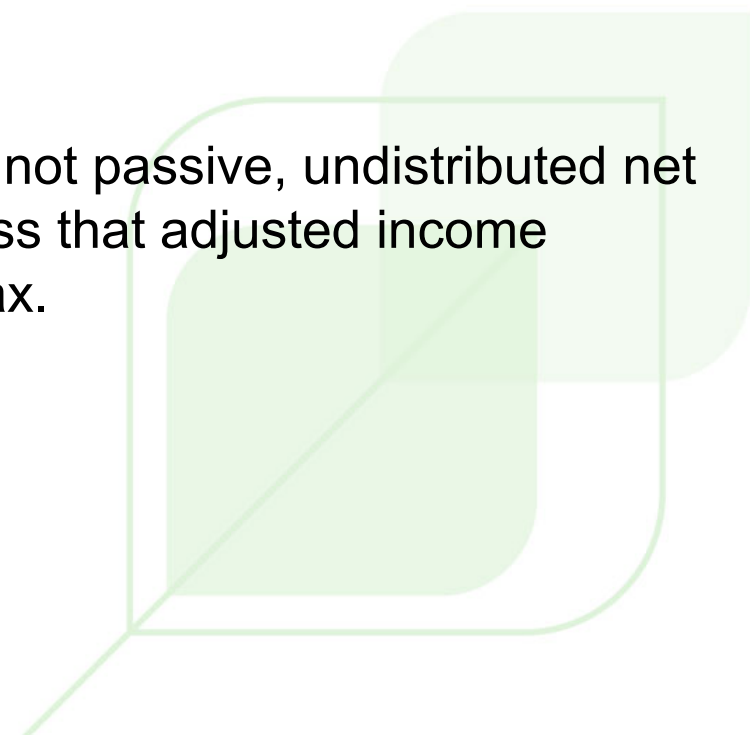
Passive Activities Owned by Trusts and Estates, Continued

- To date, there has been no *official* guidance as to how an estate or trust would satisfy the material participation requirement.
 - Regulations addressing this issue for trusts and estates have been reserved since the time that temporary regulations under §469 were first issued in the late 1980s. Reg. 1.469-5T(h)
- Treasury's position in TAM (200733023) and PLR (201029014) is that the trust or estate can only satisfy the material participation requirement through the trustee's or executor's involvement with the activity other than as a fiduciary, i.e. by doing "hands on" work.
- Courts have held differently, saying that the activities of all those who perform work for the trust should be sufficient. *Carter, Mattie K. Trust v U.S.*, 256 F. Supp. 536 (DC. TX. 2003)
- No ETA on regulations but the TAM and PLR show the direction they'll likely take.

Federal Updates

Passive Activities Owned by Trusts and Estates, Continued

- In the past, the concern with passive activities focused on those with losses.
- The Unearned Income Medicare Tax includes passive activity income in “investment income,” potentially subject to a 3.8% tax if not distributed.
 - Example, page 32 of materials
 - If passive activity income were not passive, undistributed net investment income might be less than adjusted income resulting in a lower Medicare tax.



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