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Memorandum

To: JEB

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Re: Effect of Tax Distributions from Flow-Through Entities to Trusts: Proposed Changes to the Uniform Principal & Income Act

This memorandum reflects our discussion March 15, 2008 and changes a cross-reference in Section 505(d).

As you know, trusts include in their income their distributive share of income from flow-though entities, such as partnerships, whether they receive distributions equal to none, part, or all of the income. Generally, to the extent that trusts distribute (or are deemed to distribute) their distributive net income to their beneficiaries, trusts are not taxed on such income. When distributions from a flow-through entity to a trust are less than the trust's distributive share of income, the trust will be taxed on the undistributed income. Thus, the trust will need to retain some of the cash the entity distributed to pay tax on this undistributed income.

Uniform Principal & Income Act ("UPIA") section 505 addresses this issue. However, its ambiguity has led to litigation. The Subcommittee on Uniform State Laws of the State Law Committee of the American College of Trust and Estate Counsel ("ACTEC") agreed that Section 505 should be clarified. The American Bar Association's Real Property, Trust & Estate Law Section ("RPTE") and the American Institute of Certified Public Accountants (the "AICPA") formally agreed with this recommendation, as did (on an informal basis) the National Conference of Lawyers and Corporate Fiduciaries (the "NCLCF").

The Joint Editorial Board for Uniform Trust and Estate Acts ("JEB") met December 7, 2007. The JEB asked that ACTEC propose changes to UPIA section 505 as a technical correction. This procedure would provide expedited processing with the Uniform Laws Commission procedure for amending uniform laws.

Attached is a memo prepared by Carol Cantrell discussing these issues and providing a couple of approaches. Carol spearheaded the AICPA's efforts in responding to a request for comments. She is also a vice chair in RPTE's committee that has jurisdiction over this issue, as well as having served as an expert in litigation on UPIA section 505.[1]

The NCLCF and all practicing lawyers with whom I have talked agreed that the first priority should be to use the distributions from the entity first to pay the trust's taxes and then to make income distributions. Accordingly, I propose the following restatement to UPIA section 505(c) and (d):

[1] She is also the practitioner who supported the taxpayer throughout the *Rudkin* case.

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

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

(2) from principal to the extent that receipts from the entity are allocated only to principal;

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

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

(d) After applying subsections (a)-(c) of this section, the trustee must adjust income or principal receipts to the extent that its taxes are reduced because it receives a deduction for payments made to a beneficiary.

In addition, the following Comments should replace the current ones after § 505:

Comment

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

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

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

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

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

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

Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. The $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

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

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

D = Distribution to income beneficiary
C = Cash paid by the entity to the trust
R = tax rate on income
K = entity's K-1 taxable income

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

Taxable Income per K-1		1,000,000
Payment to beneficiary		230,769[2]
Trust Taxable Income		$ 769,231
35 percent tax	269,231	

Partnership Distribution	$ 500,000
Fiduciary's Tax Liability	(269,231)
Payable to the Beneficiary	$ 230,769

In addition, B will report $230,769 on his or her own personal income tax return, paying taxes of $80,769. Because Trust T withheld $269,231 to pay its taxes and B paid $80,769 taxes of its own, B bore the entire $350,000 tax burden on the $1 million of entity taxable income,

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

including the $500,000 that the entity retained that presumably increased the value of the trust's investment entity.

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