REPORT OF THE ECONOMIC DEVELOPMENT, CAPITAL IMPROVEMENT & OTHER TAXES SUBCOMMITTEE

(Loftis, Cobb-Hunter, J.R. Smith, Edge & Ott - Staff Contact: Daniel Boan)

SENATE BILL 429

S. 429 -- Senators Hayes and Ford: A BILL TO AMEND SECTION 62-7-918, CODE OF LAWS OF SOUTH CAROLINA, 1976, RELATING TO THE UNIFORM PRINCIPAL AND INCOME ACT, SO AS TO PROVIDE FOR THE PROCESS TO DETERMINE THE ALLOCATION OF PAYMENT MADE FROM A SEPARATE FUND TO CERTAIN TRUSTS AND TO PROVIDE COMMENT; AND TO AMEND SECTION 62-7-929, SO AS TO PROVIDE THE SOURCE OF FUNDS THAT MUST PAY FOR A TAX ON A TRUST'S SHARE OF THE TAXABLE INCOME OF THE ENTITY AND TO PROVIDE COMMENT.

Summary of Bill: The bill sets forth how a trustee should allocate payments from a separate fund to certain types of trusts to qualify for a marital deduction. It gives a trustee flexibility on how to pay taxes on undistributed taxable income earned by a trust due to its interest in a pass-through entity and clarifies allocation between income and principal.

Introduced: 1/25/2011 ***Received by Ways and Means:*** 5/1/2012

Estimated Fiscal Impact: None

Subcommittee Recommendation: Favorable

Full Committee Recommendation: Pending

Other Notes/Comments: S.429 proposes amendments to SC's Uniform Principal and Income Act, a uniform act that has been in place since 2005 as part of SC's Uniform Trust Act. The purpose of the Act is to provide procedures by which trustees administering trusts, and personal representatives administering estates, allocate receipts and payments to principal and income.

Due IRS revenue rulings, §62-7-918 needs to be amended to conform S.C. law to the latest IRS rulings on marital deduction trusts.

FISCAL IMPACT STATEMENT ON BILL NO. *S.429*

(Doc. No. 11159dg11.docx)

TO:	The Honorable Larry A. Martin, Chairperson, Senate Judiciary Committee		
FROM:	State Budget Division, Budget and Control Board		
ANALYSTS:	K. Earle Powell		
DATE:	April 12, 2012	SBD:	2012229

AUTHOR:	Senator Hayes	PRIMARY CODE CITE:	62-7-918
SUBJECT:	Uniform Principal and Income Act		

ESTIMATED FISCAL IMPACT ON GENERAL FUND EXPENDITURES:
$0 (No additional expenditures or savings are expected)

ESTIMATED FISCAL IMPACT ON FEDERAL & OTHER FUND EXPENDITURES:
$0 (No additional expenditures or savings are expected)

BILL SUMMARY:
Senate Bill 429 amends Section 62 (The Probate Code) of the Code of Laws of South Carolina, 1976, relating to the Uniform Principal and Income Act, so as to provide a process to determine the allocation of payment made from a separate fund to certain trusts.

EXPLANATION OF IMPACT:
There is no fiscal impact on the General Fund of the State or on Federal and/or Other funds.

LOCAL GOVERNMENT IMPACT:
Pursuant to 2-7-76 of the Code of Laws of South Carolina, 1976, the State Budget Division surveyed counties to determine the impact of this Bill. To date, no responses have been received and will be forwarded to the Committee upon receipt.

SPECIAL NOTES:
None.

Approved by:

Brenda Hart
Assistant Director, State Budget Division

South Carolina General Assembly
119th Session, 2011-2012

S. 429

STATUS INFORMATION

General Bill
Sponsors: Senators Hayes and Ford
Document Path: l:\council\bills\nbd\11159dg11.docx
Companion/Similar bill(s): 3446

Introduced in the Senate on January 25, 2011
Introduced in the House on May 1, 2012
Last Amended on April 26, 2012
Currently residing in the House Committee on **Ways and Means**

Summary: Uniform Principal and Income Act

HISTORY OF LEGISLATIVE ACTIONS

Date	Body	Action Description with journal page number
1/25/2011	Senate	Introduced and read first time (Senate Journal-page 13)
1/25/2011	Senate	Referred to Committee on **Judiciary** (Senate Journal-page 13)
1/28/2011		Scrivener's error corrected
3/7/2011	Senate	Referred to Subcommittee: Rankin (ch), Campsen, Coleman, Davis, Nicholson
4/25/2012	Senate	Committee report: Favorable with amendment **Judiciary** (Senate Journal-page 13)
4/26/2012	Senate	Committee Amendment Adopted (Senate Journal-page 52)
4/26/2012	Senate	Read second time (Senate Journal-page 52)
4/26/2012	Senate	Roll call Ayes-34 Nays-0 (Senate Journal-page 52)
4/26/2012	Senate	Unanimous consent for third reading on next legislative day (Senate Journal-page 52)
4/27/2012	Senate	Read third time and sent to House (Senate Journal-page 1)
4/27/2012		Scrivener's error corrected
5/1/2012	House	Introduced and read first time (House Journal-page 6)
5/1/2012	House	Referred to Committee on **Ways and Means** (House Journal-page 6)

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VERSIONS OF THIS BILL

1/25/2011
1/28/2011
4/25/2012
4/26/2012
/./.

~~Indicates Matter Stricken~~
Indicates New Matter

COMMITTEE AMENDMENT ADOPTED
April 26, 2012

S. 429

Introduced by Senators Hayes and Ford

S. Printed 4/26/12--S. [SEC 4/27/12 2:13 PM]
Read the first time January 25, 2011.

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[429-1]

A BILL

TO AMEND SECTION 62-7-918, CODE OF LAWS OF SOUTH CAROLINA, 1976, RELATING TO THE UNIFORM PRINCIPAL AND INCOME ACT, SO AS TO PROVIDE FOR THE PROCESS TO DETERMINE THE ALLOCATION OF PAYMENT MADE FROM A SEPARATE FUND TO CERTAIN TRUSTS AND TO PROVIDE COMMENT; AND TO AMEND SECTION 62-7-929, SO AS TO PROVIDE THE SOURCE OF FUNDS THAT MUST PAY FOR A TAX ON A TRUST'S SHARE OF THE TAXABLE INCOME OF THE ENTITY AND TO PROVIDE COMMENT.

Amend Title To Conform

Be it enacted by the General Assembly of the State of South Carolina:

SECTION 1. A. Section 62-7-918 of the 1976 Code is amended to read:

"Section 62-7-918. (A) In this section~~, "payment"~~:

(1) 'Payment' means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer~~, including~~. For purposes of subsections (D), (E), (F), and (G), the term also includes any payment from any separate fund, regardless of the reason for the payment.

(2) 'Separate fund' includes a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

(B) To the extent that a payment is characterized as interest, ~~or~~ a dividend, or a payment made instead of interest or a dividend, a trustee shall allocate ~~it~~ the payment to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(C) If part of a payment is not characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income ten percent of the part that is required to be made during the accounting period and the balance to principal. If a part of a payment is not required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.

(D) ~~If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.~~ Except as otherwise provided in subsection (E), subsections (F) and (G) apply, and subsections (B) and (C) do not apply, in determining the allocation of a payment made from a separate fund to:

(1) a trust to which an election to qualify for a marital deduction under Section 2056(b)(7) of the Internal Revenue Code of 1986, as amended, has been made; or

(2) a trust that qualifies for the marital deduction under Section 2056(b)(5) of the Internal Revenue Code of 1986, as amended.

(E) Subsections (D), (F), and (G) do not apply if and to the extent that the series of payments would, without the application of subsection (D), qualify for the marital deduction under Section 2056(b)(7)(C) of the Internal Revenue Code of 1986, as amended.

(F) A trustee shall determine the internal income of each separate fund for the accounting period as if the separate fund were a trust subject to this act. Upon request of the surviving spouse, the trustee shall demand that the person administering the separate fund distribute the internal income to the trust. The trustee shall allocate a payment from the separate fund to income to the extent of the internal income of the separate fund and distribute that amount to the surviving spouse. The trustee shall allocate the balance of the payment to principal. Upon request of the surviving spouse, the trustee shall allocate principal to income to the extent the internal income of the separate fund exceeds payments made from the separate fund to the trust during the accounting period.

(G) If a trustee cannot determine the internal income of a separate fund but can determine the value of the separate fund, the internal income of the separate fund is deemed to equal four percent of the fund's value, according to the most recent statement of value preceding the beginning of the accounting period. If the trustee can determine neither the internal income of the separate fund nor the fund's value, the internal income of the fund is deemed to equal the product of the interest rate and the present value of the expected future payments, as determined under Section 7520 of the Internal Revenue Code of 1986, as amended, for the month preceding the accounting period for which the computation is made.

(H)~~(E)~~ This section does not apply to payments subject to Section 62-7-919."

REPORTER'S COMMENTS

Scope. Section 62-7-918 applies to amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payer. While the right to receive such payments is a liquidating asset of the kind described in Section 62-7-919 i.e., "an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration," these payment rights are covered separately in Section 62-7-918 because of their special characteristics.

Section 62-7-918 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and "private annuities" arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (in-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (C).

Prior Acts. Under Section 12 of the 1962 Act and Section 62-7-414 of the 1963 SC Act, receipts from "rights to receive payments on a contract for deferred compensation" are allocated to income each year in an amount "not in excess of 5% per year" of the property's inventory value. While "not in excess of 5%" suggests that the annual allocation may range from zero to five percent of the inventory value, in practice the rule is usually treated as prescribing a five percent allocation. The inventory value is usually the present value of all the future payments, and since the inventory value is determined as of the date on which the payment right becomes subject to the trust, the inventory value, and thus the amount of the annual income allocation, depends significantly on the applicable interest rate on the decedent's date of death. That rate may be much higher or lower than the average long-term interest rate. The amount determined under the five percent formula tends to become fixed and remain unchanged even though the amount received by the trust increases or decreases.

Allocations Under Section 62-7-918(B). Section 62-7-918(B) applies to plans whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest. For example, some deferred compensation plans that hold debt obligations or stock of the plan's sponsor in an account for future delivery to the person rendering the services provide for the annual payment to that person of dividends received on the stock or interest received on the debt obligations. Other plans provide that the account of the person rendering the services shall be credited with "phantom" shares of stock and require an annual payment that is equivalent to the dividends that would be received on that number of shares if they were actually issued; or a plan may entitle the person rendering the services to receive a fixed dollar amount in the future and provide for the annual payment of interest on the deferred amount during the period prior to its payment. Under Section 62-7-918(B) payments of dividends, interest or payments in lieu of dividends or interest under plans of this type are allocated to income; all other payments received under these plans are allocated to principal.

Section 62-7-918(B) does not apply to an IRA or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in Section 62-7-918(C).

Allocations Under Section 62-7-918(C). The focus of Section 62-7-918, for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is provided for in Section 62-7-918(D)). An IRA is subject to federal income tax rules that require payments to begin by a particular date and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 62-7-918(C) which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), ten percent of the amount received is allocated to income and the balance is allocated to principal. All other payments are allocated to principal because they represent a change in the form of a principal asset; Section 62-7-918 follows the rule in Section 62-7-913(2) which provides that money or property received from a change in the form of a principal asset be allocated to principal.

Section 62-7-918(C) produces an allocation to income that is similar to the allocation under the 1962 Act formula and the 1963 SC Act formula if the annual payments are the same throughout the payment period, and it is simpler to administer. The amount allocated to income under Section 62-7-918 is not dependent upon the interest rate that is used for valuation purposes when the decedent dies, and if the payments received by the trust increase or decrease from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will also increase or decrease.

Marital deduction requirements. When an IRA or other retirement arrangement (a "plan") is payable to a marital deduction trust, the IRS treats the plan as a separate property interest that itself must qualify for the marital deduction. IRS Revenue Ruling 2006-26 said that, as written, the prior uniform act version of Section 62-7-918 does not cause a trust to qualify for the IRS' safe harbors. Revenue Ruling 2006-26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans. Without necessarily agreeing with the IRS' position in that ruling, the revision to this section is designed to satisfy the IRS' safe harbor and to address concerns that might be raised for similar assets. No IRS pronouncements have addressed the scope of Code § 2056(b)(7)(C).

Subsection (F) requires the trustee to demand certain distributions if the surviving spouse so requests. The safe harbor of Revenue Ruling 2006-26 requires that the surviving spouse be separately entitled to demand the fund's income (without regard to the income from the trust's other assets) and the income from the other assets (without regard to the fund's income). In any event, the surviving spouse is not required to demand that the trustee distribute all of the fund's income from the fund or from other trust assets. Treas. Reg. § 20.2056(b)-5(f)(8).

Subsection (F) also recognizes that the trustee might not control the payments that the trustee receives and provides a remedy to the surviving spouse if the distributions under subsection (d)(1) are insufficient.

Subsection (G) addresses situations where, due to lack of information provided by the fund's administrator, the trustee is unable to determine the fund's actual income. The bracketed language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)-1. In determining the value for purposes of applying the unitrust percentage, the trustee would seek to obtain the value of the assets as of the most recent statement of value immediately preceding the beginning of the year. For example, suppose a trust's accounting period is January 1 through December 31. If a retirement plan administrator furnishes information annually each September 30 and declines to provide information as of December 31, then the trustee may rely on the September 30 value to determine the distribution for the following year. For funds whose values are not readily available, subsection (G) relies on Code Section 7520 valuation methods because many funds described in Section 62-7-918 are annuities, and one consistent set of valuation principles should apply whether or not the fund is, in fact, an annuity.

Application of Section 62-7-904. Section 62-7-904(A) of this act gives a trustee who is acting under the prudent investor rule the power to adjust from principal to income if, considering the portfolio as a whole and not just receipts from deferred compensation, the trustee determines that an adjustment is necessary. See Example (5) in the Comment following Section 62-7-904.

B. Section 62-7-918 of the 1976 Code, as amended in subsection (A) of this section applies to a trust described in Section 62-7-918(D) on and after the following dates:

(1) if the trust is not funded as of the effective date of this act, the date of the decedent's death;

(2) if the trust is initially funded in the calendar year beginning January 1, 2011, the date of the decedent's death;

(3) if the trust is not described in subsections (1) or (2) of this section, January 1, 2011.

SECTION 2. Section 62-7-929 of the 1976 Code is amended to read:

"Section 62-7-929.(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 the taxable income of the entity must be paid ~~proportionately from~~:

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

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

~~(a)~~ receipts from the entity are allocated only to principal; ~~and~~

~~(b) the trust's share of the taxable income of the entity exceeds the total receipts described in items (1) and (2)(a)~~

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

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

(D) ~~For purposes of this section, receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.~~ After applying subsections (A) through (C), the trustee shall adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary."

REPORTER'S COMMENTS

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 (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 (D) requires the trust to increase receipts payable to a beneficiary as determined under subsection (C) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

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

Example (1) - Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket. Trust T's tax on $1 million of taxable income is $350,000. Under subsection (C) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

Example (2) - Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket. Trust T's tax on $1 million of taxable income is $350,000. Under subsection (C), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. The $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

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

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

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

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

Taxable Income per K-1	$1,000,000
Payment to beneficiary	$230,769 [1]
Trust Taxable Income	$769,231
35 percent tax	$269,231
Partnership Distribution	$500,000
Fiduciary's Tax Liability	($269,231)

Payable to the Beneficiary $230,769

In addition, B will report $230,769 on his or her own personal income tax return, paying taxes of $80,769. Because Trust T withheld $269,231 to pay its taxes and B paid $80,769 taxes of its own, B bore the entire $350,000 tax burden on the $1 million of entity taxable income, including the $500,000 that the entity retained that presumably increased the value of the trust's investment entity.

If a trustee determines that it is appropriate to do so, it should consider exercising the discretion granted in Section 62-7-930 to adjust between income and principal. Alternatively, the trustee may exercise the power to adjust under Section 62-7-904 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.

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

SECTION 3. This act takes effect upon approval by the Governor.

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