**South Carolina General Assembly**

119th Session, 2011-2012

**H. 3446**

**STATUS INFORMATION**

General Bill

Sponsors: Rep. Harrison

Document Path: l:\council\bills\nbd\11146dg11.docx

Companion/Similar bill(s): 429

Introduced in the House on January 26, 2011

Currently residing in the House Committee on **Judiciary**

Summary: Uniform Principle and Income Act

**HISTORY OF LEGISLATIVE ACTIONS**

Date Body Action Description with journal page number

1/26/2011 House Introduced and read first time ([House Journal‑page 11](file:///h:\hj%20archive\2011\01-26-11.docx))

1/26/2011 House Referred to Committee on **Judiciary** ([House Journal‑page 11](file:///h:\hj%20archive\2011\01-26-11.docx))

2/4/2011 Scrivener's error corrected

**VERSIONS OF THIS BILL**

[1/26/2011](file:///p:\pprever\2011-12\3446_20110126.docx)

[2/4/2011](file:///p:\pprever\2011-12\3446_20110204.docx)

**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.

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.”

**Commissioners**’ **on Uniform Laws Comment**

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, Section 409 does not cause a trust to qualify for the IRS’ safe harbors. Revenue Ruling 2006‑26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans. Without necessarily agreeing with the IRS’ position in that ruling, the revision to this section is designed to satisfy the IRS’ safe harbor and to address concerns that might be raised for similar assets. No IRS pronouncements have addressed the scope of Code § 2056(b)(7)(C).

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

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

Subsection (G) addresses situations where, due to lack of information provided by the fund’s administrator, the trustee is unable to determine the fund’s actual income. The bracketed language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)‑1. In determining the value for purposes of applying the unitrust percentage, the trustee would seek to obtain the value of the assets as of the most recent statement of value immediately preceding the beginning of the year. For example, suppose a trust’s accounting period is January 1 through December 31. If a retirement plan administrator furnishes information annually each September 30 and declines to provide information as of December 31, then the trustee may rely on the September 30 value to determine the distribution for the following year. For funds whose values are not readily available, subsection (g) relies on Code section 7520 valuation methods because many funds described in Section 409 are annuities, and one consistent set of valuation principles should apply whether or not the fund is, in fact, an annuity.

B. Section 63-7-918 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) income, to the extent that receipts from the entity are allocated to income; and

(2) 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.”

**Commissioners**’ **on Uniform Laws 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 (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 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.

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

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