Trust & Estates

Taxes and Planning

TM Financial Services

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Trustee's Power to Adjust

§104 (UPIA-1997)

When the National Conference of Commissioners on Uniform State Laws issued their revision to the Uniform Principal & Income Act in 1997, one of their primary goals was to establish a means to implement the transition to an investment regime based upon the Uniform Prudent Investor Act and its objective of investing for the best total return. Two sections relevant to this discussion are: §2(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole ….and §3 A trustee shall diversify the investments of the trusts unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

(Continued on page 2)

Will the States Step Up?

Modified carryover basis confusion

For 2010 the default rule is that an estate tax applies with a $5,000,000 exemption and a 35% rate. Executors may elect out of the new estate tax rules under §1022 with assets receiving a carryover basis with limited FMV adjustments ($1.3 million and $3 million spousal).

This seems straight forward enough (!?!) but as many states (including NJ, NY & CT) will impose an estate tax regardless of which federal method is used, one should get a full step up in basis for state purposes, necessitating two sets of cost basis records. Right?

Well the answer is definitely no for NY & CT as they determine income tax costs under federal rules. Therefore in those states you will pay an estate tax and still face a capital gains tax when the assets are sold. New Jersey is perhaps similar to NY & CT. but complicated further by the case of Koch vs. Director, Div. of Taxation, where a higher income tax basis for NJ purposes than for federal purposes was allowed because no previous tax benefits had been received from partnership loss allocations.

This is another reason that it is often necessary to run the numbers before making the quick determination that an estate over $5,000,000 should elect modified carryover basis.

Power to Adjust (continued from page 1)

Although on the surface these requirements seem obvious and easy to comply with, complications arise when considering one of the basic tenets of the Uniform Principal & Income Act - §103 (b) …. a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable **to all of the beneficiaries** except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries.

The problem is that what is best for balancing the desires of the income beneficiaries and the principal beneficiaries may not be what is best to produce the greatest overall return for the trust. Consider a period of high inflation where a portfolio heavily or exclusively comprised of bonds would produce the highest total return to the trust. While the income beneficiaries might be thrilled with this course of action the remainder beneficiaries may not be as happy. Or on the other hand if conditions dictated that the portfolio lean heavily toward capital appreciation with little or no current income we could expect the opposite reaction among the beneficiaries.

To remedy this dilemma, the 1997 UPIA added the trustee's power to adjust in §104. This section authorizes a trustee to adjust between income and principal to the extent that the trust's income is either too small or too large based upon the trustee's investment decisions. To make an adjustment the trustee must satisfy a number of conditions:

- The trustee must invest & manage trust assets as a prudent investor as specified by language in the trust document.
- The trust language must specify the income beneficiary's distribution rights in terms of the right to receive income in the sense of traditional fiduciary accounting income.
- If the trustee in administering the trust according to the terms of the trust instrument and the UPIA concludes that he cannot administer the trust impartially an adjustment is permitted.
- The trust document must not deny the trustee the right to adjust.

Despite having satisfied the above requirements, §104(C) specifies instances where an adjustment is disallowed in order to preserve the trust's intended tax consequences.

The following is an example of the trustee's power to adjust as provided in §104:

The trustee receives assets transferred per the provisions of a pour-over will. The executor had the assets invested 50% in stocks and 50% in bonds. Using the rules of the Prudent Investor's Act, the trustee determines that an investment strategy of 80% stocks and 20% bonds will result in optimal risk and return objectives suited to the trust. This will result in a smaller amount of dividend and interest income. After considering the provisions of §104, the trustee may transfer cash from principal to income to the extent necessary to increase the amount distributed to the income beneficiary.

Terms of trust: All income is distributed equally to Bob and Joe. The following items of income & expense were incurred

	Total	**Income**	**Principal**
Dividends	50,000	50,000	
Tax exempt int.	25,000	25,000	
Rental Income	15,000	15,000	
Capital Gains	20,000		20,000
Trustee fee	4,500	3,500	1,000
Rental expense	6,000	6,000	

DNI – Distributable Net Income
FAI – Fiduciary Accounting Income
DNTI – Distributable Net Taxable Income
TEI – Tax Exempt Interest
IDD – Income Distribution Deduction
ATI – Adjusted Total Income

Calculation of Income Distribution Deduction:

			DNI	Schedule B			**FAI**	Schedule B
Income	Dividends		50,000				50,000	
	Tax exempt interest						25,000	
	Capital Gains		20,000					
	Rental Income		15,000				15,000	
	Total Income		85,000				90,000	
Expenses	Trustee fees	4,500				4,500		
	To principal					(1,000)		
	TEI adjust. (1)	(1,250)	3,250			______	3,500	
	Rental Expenses		6,000				6,000	
	Total Expenses		9,250				9,500	
	ATI		75,750	< Line 1	**FAI**		80,500	< Line 8
	Add back Tax exempt		23,750	< Line 2	Required Dist.		80,500	< Line 9
	Less Capital Gain		(20,000)	< Line 6	Other amounts paid		______	< Line 10
					Total distributions		80,500	< Line 11
	DNI		79,500	< Line 7				
	Less tax exempt int.		(23,750)	< Line 12			(23,750)	< Line 12
	DNTI (Tentative IDD)		55,750	< Line 14	**FAI less Net TEI** (Tentative IDD)		56,570	< Line 13

(1) 4,500 x (25,000/90,000)

IDD **55,750** (Lesser of DNTI or FAI less Net TEI)

	Rental Inc.	**Rent Exp.**	**Trustee fee**	**Dividends**	**Total**	**Trust:**	
Bob	7,500	(3,000)	(1,625)	25,000	27,875	ATI	75,750
Joe	7,500	(3,000)	(1,625)	25,000	27,875	IDD	(55,750)
					55,750	Exemption	(300)
							19,700 *

*Capital gain of 20,000 not distributed to beneficiaries less simple trust exemption of 300.

Trusts & Estates
Taxes and Planning

IRS	General Information	800-829-1040
	EINs	800-829-4933
	Form 706 & 709	866-699-4083
NJ	General Information	609-826-4400
	Estate & Inheritance	609-292-5033
NY	General Information	518-457-5181
	Estate Tax	518-457-5387
CT	General Information	860-297-5962
PA	General Information	717-787-8201

Important Phone Numbers

Doubling the tax savings

In situations where the taxpayer is terminally ill, it may be wise to waive certain expenses as to the estate tax deduction, pay them prior to death so they will be deductible on the decedent's final return. Although this forgoes the §2053 estate deduction, the funds used to pay the expenses are no longer part of the gross estate and the taxable estate is correspondingly reduced. This way the same estate tax savings is achieved but with the added advantage of an income tax deduction. Such expenses would include accrued medical costs and property taxes.

Estate & Inheritance filing dates

NJ	IT-R	Due - 8 months from DOD
	IT-Estate	9 months from DOD
NY	ET-706	9 months from DOD
CT	CT-706/709	6 months from DOD
PA	REV-1737	9 months from DOD

NJ-1041, IT-205, CT-1041 & PA-41 all due April 15

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