Washington State
House of Representatives
Office of Program Research

BILL ANALYSIS

Judiciary Committee

SSB 5171

Title: An act relating to modifying the Washington principal and income act of 2002.

Brief Description: Modifying the Washington principal and income act of 2002.

Sponsors: Senate Committee on Judiciary (originally sponsored by Senators Kline and Rockefeller; by request of Uniform Legislation Commission).

Brief Summary of Substitute Bill

- Amends the Washington Principal and Income Act of 2002 by changing provisions related to estate tax marital deductions and income taxes on receipts from business entities.

Hearing Date: 3/11/09

Staff: Courtney Barnes (786-7194)

Background:

The National Conference of Commissioners on Uniform State Laws (NCCUSL) is an organization that authors and promotes enactment of uniform state laws in areas of law where national uniformity is desirable and practical. The Washington Uniform Legislation Commission (Commission) was established to promote uniformity of legislation with other states. The Commission works with similar commissions from other states, including NCCUSL, to draft and recommend uniform laws for approval and adoption by the various states.

Washington Principal and Income Act of 2002

The current Principal and Income Act is based on a version of the Uniform Principal and Income Act and has rules about allocating the receipts and disbursements of a trust. A trust may create different classes of beneficiaries. For instance, a trust may have an income beneficiary who is entitled to the income of the trust for his or her lifetime, and a remainder beneficiary who is

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entitled to the principal of the trust upon the death of the income beneficiary. A trustee of such a trust has a fiduciary duty to both kinds of beneficiaries. If a trust has two or more beneficiaries, the trustee is to act impartially among them and is to take into account the differing interests of the beneficiaries. The Principal and Income Act gives a trustee the power to reallocate or adjust receipts of the trust between or among beneficiaries.

Marital Deductions for Deferred Compensation, Annuities, and Similar Payments

Federal law allows a martial deduction from the federal estate tax for property left for the benefit of a surviving spouse. When a martial trust is the named beneficiary of a decedent's individual retirement account (IRA) or other qualified retirement plan, the surviving spouse may be considered to have a qualifying income interest for life in the IRA and in the marital trust for purposes of an election to treat both the IRA and the trust as qualifying terminable interest property (QTIP). According to a recent ruling of the Internal Revenue Service (IRS), if the marital deduction is sought, the QTIP election must be made for both the IRA and the trust. IRS Rev. Rul. 2006-26.

Income Taxes on Receipts from Business Entities

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 trustee must pay taxes on the trust's share and deduct the amount paid between income and principal.

Summary of Bill:

<u>Washington Principal and Income Act of 2002</u>

The definition of "payment" is amended to include any payment from any separate fund, regardless of the reason for the payment. "Separate fund" is defined.

Marital Deductions for Deferred Compensation, Annuities, and Similar Payments

The provision authorizing a trustee to allocate more of a payment to income to qualify for an estate tax marital deduction is removed. In determining the allocation of a payment made from a separate fund, a trustee must determine the internal income of each separate fund as if the fund was a trust subject to the Principal and Income Act. This provision applies only when a trustee is 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 is made under the IRS code governing life estates for surviving spouses; or (2) a trust that qualifies for the martial deduction under the IRS code governing life estates where the power of appointment resides in the surviving spouse.

The surviving spouse may request the trustee to demand that the person administering the separate fund distribute the internal income to the trust. A formula is provided for how payment from the separate fund is allocated to income or principal. If a trustee cannot determine the internal income of the separate fund, a formula is provided depending on whether the trustee can determine the value of the separate fund.

Survivor annuities are excluded from these provisions to the extent that the series of payments would qualify for the marital deduction under the IRS code governing survivor annuities.

A timeline is given for when the provisions related to deferred compensation, annuities, and similar payments apply, depending on when the trust is funded.

Income Taxes on Receipts from Business Entities

A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid proportionately from income and principal to the extent that receipts from the entity are allocated to both income and principal. Taxes must be paid from principal to the extent that the tax exceeds the total receipts from the entity.

A trustee must adjust the 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.

Appropriation: None.

Fiscal Note: Not requested.

Effective Date: The bill takes effect 90 days after adjournment of the session in which the bill is passed.