

ALERT

July 2010

DISTRIBUTE OR ACCUMULATE?-THE NEW TRUST DILEMMA

On March 23, 2010, President Obama signed into the law the Patient Protection and Affordable Care Act. Shortly thereafter, on March 30, 2010, he signed a companion bill entitled the Health Care and Education Tax Credits Reconciliation Act of 2010. These two acts constitute what is commonly referred to as the Health Care Act (the “Act”) and they represent the most expansive social legislation enacted in decades. Nearly every individual and business in the United States will be affected by the new law’s provisions. While the Act is broad and comprehensive, those of us who practice in the Tax, Trust and Estates Departments of Moritt Hock Hamroff & Horowitz, LLP are focused on the impact that it will have on many of our clients, in particular those who have established irrevocable trusts and those with special needs children.

A significant portion of the cost for health care reform will be funded from a new Medicare surtax, effective beginning in tax years ending after December 31, 2012. The new law imposes a 3.8% surtax or “unearned income Medicare contribution” on the investment income of higher income individuals, and on certain estates and trusts. Net investment income includes gross income from interest (other than tax-exempt interest), dividends, annuities, royalties, rents, net capital gain, and income earned from passive trade or business activities. The surtax does not apply to qualified retirement plan and individual retirement account distributions. However, it does apply to the lesser of (i) the undistributed net investment income of a trust or estate, or (ii) the amount by which the adjusted gross income exceeds the top inflation-adjusted bracket for estate and trust income, which is expected to be approximately \$12,000 in 2013.

We recommend that individuals who have established trusts with net investment income that is expected to exceed \$12,000 in 2013 strongly consider the impact that the 3.8% surtax will have on accumulated trust income and on distributions to beneficiaries with high incomes. Many trusts commonly created for estate planning purposes allow fiduciaries the flexibility to either distribute or accumulate a trusts’ net income. Until recently, unless the beneficiaries of a trust needed income, it has generally been advisable to accumulate such income rather than distributing it to the beneficiaries since this allowed trust assets to grow in value. The Act may now cause many of these trusts to not only pay income tax at the highest income tax bracket, but also pay an additional 3.8% surtax. As a result, it may now make sense for the creator of a trust to direct distribution of income to the beneficiary of a trust (if the beneficiary is in a position to manage the receipt of this income and not spend it unwisely). If distribution of income is not, or cannot be directed, then Fiduciaries will be placed in the difficult position

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of having to determine whether it is more tax advantageous to distribute net income or accumulate it.

Fiduciaries of trusts created for minor children or supplemental needs trusts created for individuals with disabilities will also be in the same difficult position. A Supplemental Needs Trust ("SNT") is a trust that is designed to provide benefits to, and protect the assets of, physically disabled or mentally disabled persons by allowing such persons to be qualified for and receive governmental health care benefits. New York law provides that under a properly structured SNT, neither principal nor income held in trust shall be deemed an available resource under any government benefit or assistance program. Because a SNT is specifically intended to supplement rather than supplant government benefits, fiduciaries are restricted from spending assets in a manner that could reduce government benefits. In fact, it is common for income to accumulate for the benefit of the disabled individual and not be distributed from a SNT, particularly in the case of a minor child or a disabled individual without any above and beyond health care costs. Income that is undistributed and exceeds the applicable threshold amount will soon not only be taxed at the highest income tax rate but also subject to the 3.8% surtax. Certainly, this creates a disincentive for fiduciaries to accumulate income for the benefit of a disabled individual, which, of course, runs afoul of any public policy supporting the creation and funding of such trusts.

We can assist you with the review of your estate planning structure and related documents to determine if changes are necessary.

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