HOUSE
RESEARCH
ORGANIZATION bill analysis 4/12/1999

HB 1373
Williams

SUBJECT: Declaring increase in value to be income in certain trusts

COMMITTEE: Pensions and Investments — favorable, without amendment

VOTE: 5 ayes — Greenberg, Bonnen, Rangel, Salinas, Williams

0 nays

4 absent — Tillery, Clark, George, Telford

WITNESSES: For — Tyson Payne, Kenneth Tooley, William Waxman, Texas Association of Life Underwriters

Against —None

BACKGROUND: Under charitable remainder trusts, persons may set aside funds to go to charities when they die. They receive periodic payments from the trusts, and the charities receive the remaining amount.

Under federal law, a minimum of 5 percent of the value of a charitable remainder trust must be distributed to the individual each year over the life of the trust, unless the trust instrument provides otherwise. It is common practice to roll this income over into the principal of the trust instead of paying it out. This boosts the total value of the trust, ultimately providing a greater benefit for the charity.

A charitable remainder trust has the option of purchasing a variety of financial instruments, including deferred annuities. A deferred annuity is a contract between a buyer and an insurance company that may be out paid either in a lump sum or in a series of payments. As long as the funds remain in the annuity, income taxes on the increase in their value are deferred.

There is no current state law on whether an increase in the value of a deferred annuity in a trust should be treated as principal or income. The Internal Revenue Service defers to the states to make that determination.

DIGEST: HB 1373 would amend the Property Code by adding sec. 113.1021, which would declare to be trust income any increases in value of a deferred annuity before annuitization and in the value of an active life insurance contract before the death of the insured, unless the trust provided otherwise.

No money from the increase in the value of these instruments would be distributed to the beneficiaries of the trust until the trustee actually received cash for the value the annuities. If the obligation was surrendered or partly converted to cash proceeds, the cash would be attributed first to the increase in value of the annuity or contract.

The increase would be available for distribution to the person who was designated as the income beneficiary at the time of distribution, not the individual who was income beneficiary when the income built up. This provision would supersede sec. 113.103 of the Property Code, which deals with income distribution rights of an income beneficiary.

HB 1373 would establish that principal and income for a deferred annuity after annuitization would be governed by the Property Code, sec. 113.109, which deals with property other than natural resources that are subject to depletion.

The bill would take effect September 1, 1999, and would apply to principal and income subject to allocation on or after this date. Principal and income allocated before September 1, 1999, would be subject to the former law and subsequently would continue in effect.

SUPPORTERS SAY: HB 1373 would codify current practice for charitable remainder trusts. The bill specifically would allow income beneficiaries of charitable remainder trusts, referred to as "spigot trusts," to apply the income that is distributed to them annually to the principal of the trust. They no longer would be required to distribute a minimum of 5 percent of the trust to the income beneficiaries each year.

The income on annuities would not be taxed as ordinary income because income realized on annuities purchased by a trust is not subject to individual income tax provisions. HB 1373 would make state law consistent with Internal Revenue Service provisions that allow states to specify what monies will be considered principal and what would be considered income for trust purposes. This potentially could make purchase of certain types of annuities more attractive.

The bill would not create any adverse tax consequences. A trust beneficiary would retain the flexibility to choose whether to "roll" the income into the trust principal or to have it disbursed. This also would allow benefit trustees to act with greater flexibility in carrying out the intent of the creator of the trust.

OPPONENTS SAY:

While HB 1373 is aimed at charitable remainder trusts, its broad provisions potentially could affect other trusts with deferred annuities and life insurance contracts. This would increase paperwork for these trusts, since attorneys drafting the trusts would be required to specify that they did not want such tax treatment. If the intent of the bill is that it apply only to charitable remainder trusts, that intent should be stated clearly.

Not everyone with annuities in a trust necessarily would want increases in value to be treated automatically as income for tax purposes. Normally, increases in the value of an annuity and life insurance contract are not treated this way.

For some people, HB 1373 potentially could lead to unfavorable treatment to certain deferred annuities and life insurance contracts when in a trust. The "inside-build up" of the annuity asset normally is not taxed until there is a cash surrender when the trust terminates, which typically occurs when the beneficiary is in a lower tax bracket. HB 1373 potentially could undercut this favorable tax consequence.

NOTES:

A similar bill, HB 2936 by Williams, was reported favorably by the Pensions and Investments Committee during the 1997 legislative session, but died in the Calendars committee.