



Stepping Stones

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Will the 3.8% Net Investment Income Tax Affect You? Will It Affect Your Trust?

Lawrence D. Hunt

Along with the sweeping changes which the American Tax Relief Act brought at the beginning of the year, 2013 saw the implementation of a tax of 3.8% of the net investment income earned over certain thresholds by individuals, estates and trusts. It is important for taxpayers to know whether they are subject to the tax, how much, and in certain cases, how to avoid it.

The tax applies to "net investment income" which generally means income from passive activities. Such income includes, among other items, investment interest, dividends, capital gains, rents and royalties, nonqualified annuities, and income from passive business activities. It does not include wages, income from a nonpassive business, social security benefits, tax-exempt interest, self-employment income, or distributions from qualified retirement plans, 401(k) plans and IRAs. Gains included in net investment income include gain from the sale of stocks, bonds and mutual funds; capital gain distributions from mutual funds; and gains from real estate and certain business interests. Of particular interest is that the tax applies to the gain on the sale of a personal residence to the extent the personal residence exemption from capital gains does not apply. (The personal residence exemption is \$250,000 for individuals and \$500,000 for married couples).

Planning opportunities are available to individuals who are business owners, where it is questionable whether or not the individual takes an active or passive

role in the business. Questions on this point include the extent to which the individual participates in the business and how the income has traditionally been treated on the individual's income tax return.

The tax applies only to investment income, however, an individual's total income counts toward the threshold. The income threshold is \$200,000 for single taxpayers and heads of household; \$250,000 for married individuals filing jointly; and \$125,000 for married individuals filing separately.

The tax not only applies to individuals but also to trusts and estates. However, the income threshold to trigger this tax is far lower for trusts than for individuals, just as the highest marginal rate applies to trusts at a far lower threshold than it does to individuals. The 3.8% net investment income tax is expected to apply to estates and trusts which have total income of more than approximately \$12,000 in 2013. This low threshold amount gives rise to some important planning opportunities. In those cases where a trust gives the trustee discretion to distribute income to an individual beneficiary, the income can be shifted from the low-threshold trust to the higher-threshold individual. It is helpful that this planning can be undertaken during the first 65 days of 2014, the distributions of which during that time can be treated as having been made in 2013.

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CLOSER TO THE ISSUES

Things to Consider Before Taking on the Role of Trustee

Melissa E. Darigan, David S. Raymon



Holding assets in trust is often more desirable than an outright transfer. Among the factors considered in making this decision are the ease of management of assets, creditor protections and the various tax advantages that may be gained through the use of trusts. Deciding who will serve as trustee is just as important. The trustee is the legal title holder of the trust assets and is responsible for carrying out the terms of the trust in accordance with the settlor's wishes. Because of the importance of this role, there is often an inclination to choose a close family member or friend to serve as trustee. However, serving as trustee is a significant time- and energy-consuming undertaking, and the trustee may be subject to personal liability for errors. Before taking on the role of trustee, it is important to be fully aware of what trusteeship entails. This article will provide a brief overview of a few of the trustee's basic duties.

A trustee's most fundamental duty is to carry out the terms of the trust. While this requirement may seem straightforward, for some trusts this can be a difficult task. For instance, a trust may require distributions for the health, education, maintenance and support (a commonly used ascertainable standard) for a group of several beneficiaries. Based on this direction, the trustee must determine when to make or withhold distributions. Thus, the trustee must keep well informed of the needs of all of the beneficiaries in the group; otherwise the trustee can be subject to personal liability for making distributions when

inappropriate, for not making distributions when appropriate or for favoring one beneficiary over another.

A trustee is responsible for the investment of the trust assets. With respect to securities such as stocks and bonds, this requires diligently monitoring the trust portfolio and making any necessary adjustments. With respect to other assets such as real estate, the trustee is responsible for maintenance and upkeep, and may be required to make the asset income-producing. An additional layer of complication arises due to the fact that trusts typically include both present and remainder beneficiaries. The interests of each of these beneficiaries often diverge, and the trustee must balance the investment strategy between them.

A trustee is charged with keeping clear and accurate records because the trustee is always accountable for the assets in the trust. This requires accounting for trust assets and periodically reporting to beneficiaries in a clear and understandable format. If the trustee does not possess the requisite expertise, the trustee should engage third parties such as investment managers, attorneys or accountants to assist. Even then, a trustee remains responsible for the assets under the trustee's care and the accuracy of all reports.

A trustee is responsible for various reporting requirements associated with the trust, such as the filing of all necessary tax returns with the IRS as well as any state taxing authorities. In addition, depending on the type of trust, there may be reporting requirements with other state authorities such as the secretary of state or the attorney general.

Filling the role of trustee for a family member or close friend can be emotionally rewarding. However, compliance with the various duties of trusteeship requires time and dedication, and carries personal liability for missteps. Though individual trustees are well advised to hire professionals such as investment managers, attorneys and accountants to assist them, the ultimate responsibility for the proper administration of the trust remains with the trustee. Before accepting the role of trustee (or naming a family member or close friend to serve in that capacity), talk to your personal planning counsel to gain a full understanding of what is involved.

Estate Planning Tips For Artists, Composers and Authors

Kathleen A. Ryan, John E. Ottaviani

Intellectual property, such as artwork, musical compositions and literary works, can present unique challenges to administer after the creator's death. Steps may be taken during the creator's lifetime which can increase the value of the property, facilitate the management of the property and effect the transfer of the

property to the intended beneficiaries, while minimizing taxes, delays and costs.

Organize and Inventory

For artists, composers and authors, it is important to make sure all works are properly catalogued and

organized, including drafts or lesser works. Good organization and documentation is key. To the extent possible, each work should be identified and labeled, with art and manuscripts signed, titled or identified. It is helpful to have a procedure for documentation as the works are created. Works will need to be authenticated after death, and it is much easier for the author or artist to do so than leaving it to the fiduciary in charge of the estate. With respect to any transfers, license agreements, or royalty agreements, the creator should keep a list of all such arrangements and copies of all relevant documents.

Registering the copyrights also helps promote a complete listing of the works. In the United States, a copyright comes into existence as soon as a work is “fixed in any tangible medium of expression.” In order for a copyright to be enforceable in a court, when the creator is a U.S. citizen or resident, the copyright must be registered with the U.S. Copyright Office. There is no deadline for submitting the application for registration, and it may even be filed after death. Applicable law does provide for the recovery of attorney’s fees and other advantages in litigation if the copyright application is filed before there is an infringement. Details regarding dates of creation and publication, and details concerning the creator, are required to complete the copyright application. Thus, registering the copyrights also helps catalog and organize the creative works.

Valuation

Inventories should include values whenever possible. The values will be useful in securing adequate insurance protection. Appraisals may be obtained for certain types of works, and for artwork, a guaranty of value may be obtained from an auction house. Other works may be difficult to appraise, and may fluctuate in value.

Ultimate Disposition of the Works

Planning for future disposition of artwork and musical or literary works will center on either sale of a portion or all of the works, licensing some or all of the rights in the works to third parties in exchange for royalties, or donating them to individuals or to charitable organizations. When making an estate plan, you will need to consider transfer of these rights while the creator is alive or after death. Some of the considerations in making this decision include whether the creator will exploit the intellectual property rights during his or her lifetime, the gift and estate tax ramifications of transferring these rights, the likelihood that the intellectual property rights will be exploited after the creator’s death, and the willingness of the creator’s heirs to exploit and manage the intellectual property rights if received by gift or inheritance.



There are very different tax consequences for transfers of works during lifetime versus at death. A sale of works during the creator’s lifetime will result in treatment of the sale proceeds as regular income taxable to the creator. Alternatively, the sale of the artwork by a beneficiary who received the works at the creator’s death is treated as a sale of a capital asset subject to capital gains tax. If the art, musical and literary works are included in

the creator’s gross estate, the assets receive a basis step up to the value at death for federal estate tax purposes. Capital gain will result for the estate beneficiary only to the extent the value of the work increased from the creator’s death.

Many times it is advantageous to transfer copyright rights during the creator’s lifetime to a trust, limited liability company or other entity. In addition to removing the assets from the probate estate and reducing taxes on the estate, such transfers provide other advantages. These transfers can make sure that the copyright assets are transferred to the desired beneficiaries. Either trust or business entity ownership may provide centralized management of the copyrights, so potential licensees or purchasers do not have to deal with multiple owners.

Business entities may also provide a tax-efficient mechanism to transfer interests. With business entity ownership, the creator’s interest in the physical work is changed from a tangible to an intangible property interest, subjecting the estate to estate tax only in the creator’s state of domicile as opposed to where the work is

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physically located. The transfer of small fractional interests in a business would be entitled to discounts for lack of marketability and lack of control. At the death of the creator, if the creator's interest in the business entity constitutes a substantial portion of the estate, there may be favorable terms for the payment of the estate tax liability over a period of years at a low interest rate, avoiding the need to fund the tax within the nine months after death.

Announcements

Marvin Silver presented "The Essentials of Estate Planning" at the Whitney Place Assisted Living Residences on September 19, 2013.

Deborah DiNardo was a panelist of the "Purse, Power, and Planning: A Roundtable Discussion Just for Women" on October 9, 2013.

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John E. Ottaviani (jeo@psh.com), Chair of the Intellectual Property Group, concentrates his practice in business transactions, trademark and brand management, protection and disputes, copyright protection and disputes, Internet and technology contract negotiations, limiting liability of entities using the Internet, and advising athletes and other high net worth individuals as to how to limit risk in their personal investments.

Kathleen A. Ryan (kar@psh.com), Chair of the Trusts and Estates Group, applies her extensive knowledge of probate, trust and tax laws to advise clients on a wide variety of wealth preservation, asset transfer and charitable giving issues.

Contact your attorney in the Trusts & Estates Group for a consultation on how these issues may impact your situation. Our attorneys are admitted to practice in Rhode Island, Massachusetts and Florida. Through our association with Meritas, an organization of worldwide independent law firms with broad-based practices, Partridge Snow & Hahn LLP offers its clients access to quality legal services on a national and international basis.

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