Federal Income Tax Planning for Trusts

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Following the American Taxpayer Relief Act of 2012 (ATRA), federal income tax planning for trusts is more important than ever. A new 39.6% bracket was added for ordinary income and a new 20% bracket was added for long-term capital gains. Moreover, if the new 3.8% net investment income tax (NIIT) is factored in, the top tax rates are now as high as 43.4% for ordinary income and 23.8% for long-term capital gains. Fortunately, there are a number of tax planning strategies available. These include:

(1) Shifting trust income to lower tax bracket beneficiaries;

(2) Minimizing net investment income tax (NIIT) exposure;

(3) Using charitable remainder trusts (CRTs):

(4) Including an IRC § 675(4)(C) substitution power in trusts;

(5) Reviewing trusts to determine if they still serve their intended purpose; and

(6) Taking advantage of the 65-day election.

Shifting Income with Trust Distributions

Trust tax brackets are much more compressed than the tax brackets for individuals. For 2015, the 39.6% bracket for individuals filing jointly begins at $464,850, but for trusts it begins at only $12,300. As a result, shifting trust income to beneficiaries can produce huge tax savings.

Perhaps the easiest way to shift income to beneficiaries is to increase discretionary distributions.

> *Example 1.* The XYZ Trust is a discretionary trust with $90,000 of ordinary income in 2015. The trustee has been distributing $40,000 of income to the sole beneficiary (B) each year. B is a single taxpayer whose other income in 2015 is $40,000. If the trustee continues to distribute $40,000, the trust will pay tax of $21,700 on the last $50,000 of income (.434 x $50,000). By contrast, if the trustee increases B's distribution to $90,000, the tax on the last $50,000 of income will be only $12,500 (.25 x $50,000), a savings of $9,200.

Before using this strategy, the trustee must make sure that it is allowed under the governing instrument and that it provides an overall benefit for the family and not just an income tax savings. For example, the grantor may not want the beneficiary to have so much income. It may be possible to solve this problem by making the additional distributions to LLCs or FLPs, though, because these entities can pass income to beneficiaries without making actual distributions. Note also that the strategy won't work if the beneficiary is already in the highest tax bracket or has creditor problems.

It may also be possible to increase distributions to beneficiaries by treating capital gains as trust income. Capital gains are ordinarily excluded from DNI (Reg. § 1.643(a)-1(a)). Thus, they are generally taxed to the trust rather than to the beneficiaries. However, capital gains can be included in DNI to the extent authorized by local law or pursuant to a reasonable and impartial exercise of discretion by a trustee in three situations:

(1) The capital gains are allocated to income in accordance with the trust's governing instrument or local law;

(2) The capital gains are allocated to corpus but consistently treated by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) The capital gains are allocated to corpus but actually distributed to the beneficiary (Reg. § 1.643(a)-3(b)(1)-(3))

The downside of the first alternative is that it lacks flexibility. The trustee must treat capital gains as income each year and can't treat them as income only when it is favorable to do so. On the other hand, if trust tax rates are expected to always be higher than the beneficiary's tax rate and the grantor isn't opposed to distributing more income, this option might be considered.

The downside of the second alternative is the consistency requirement. Once a trust starts treating capital gains as income, it must continue to do so even if allocating capital gain to corpus might be more favorable in a later year.

The last alternative might provide the greatest flexibility. The trustee's discretion must be reasonable and impartial, but it may not have to be consistent.

Minimizing NIIT Exposure

The NIIT imposes a flat 3.8% tax on the net investment income of many high bracket taxpayers, including most trusts. For trusts, the amount subject to the tax is the lesser of (1) undistributed net investment income (NII) or (2) the excess of AGI over a threshold amount[1]. The threshold amount for trusts and estates is indexed for inflation and is $12,300 for in 2015.

If a complex trust or an estate earns NII and retains it, the NII belongs to the trust or estate. On the other hand, if the NII is distributed, the trust gets a deduction and the NII income becomes the NII of the beneficiaries who receive it. Thus, trusts and estates can plan distributions to minimize the total NIIT paid by the trust or estate and the beneficiaries.

As noted above, the threshold amount at which trust income becomes subject to the NIIT is only $12,300. This is far lower than the threshold level for other taxpayers-- $250,000 for married taxpayers filing jointly and $200,000 for individuals. Thus, assuming that a distribution wouldn't push a beneficiary's income above the NIIT threshold amount, NIIT could be reduced by distributing more income to beneficiaries.

> *Example 2*. ABC Trust has $52,300 of NII. The trust's beneficiary (B) has $100,000 of income not counting any trust distributions. If the trust retains the income, it will pay $1,520 of NIIT (.038 x ($40,000). This tax could be avoided if the income is distributed to B.

The trustee could also reduce NIIT by (1) investing in tax-deferred bonds, tax-deferred annuities or life insurance, (2) timing recognition of gains and losses or (3) reducing the trust's taxable income by investing in ETFs or low turnover funds. Keep in mind, however, that trustees have a fiduciary duty in investing trust assets. Thus, investments must comply with the applicable state's prudent investor act unless the governing instrument expressly eliminates this requirement.

Charitable Remainder Trusts (CRTs)

CRTs can provide large tax savings for taxpayers who sell an asset with a large capital gain that pushes income for a tax year into higher tax brackets and/or subjects the taxpayer to the NIIT. Because CRTs are tax-exempt entities, they can sell assets without recognizing gain. Instead, the gain realized on the sale is taxed to the grantor, but only as the annuity or unitrust payments are received. This allows the grantor to spread income recognition over a number of tax years and smooth out taxable income. Consider the following examples.

> *Example 3.* Ken, a single taxpayer age 48, has salary income of $150,000 and no other income in 2015. Ken sells Greenacre, vacant land with a basis of $100,000, for $900,000, recognizing a long-term capital gain of $800,000. The gain on the sale is taxed as follows:
>
> - First $50,000 @ 15% (15% regular tax, no NIIT)...$7,500
>
> - Next $213,200 @ 18.8% (15% regular tax + 3.8% NIIT)..$40,082

- Last $536,800 @ 23.8% (20% NIIT + 3.8% NIIT)……………………………………………….……….$127,758

- Total…………………………………………………….…$175,340

Example 4. Assume the same facts as in Example 3 except that instead of selling the land himself, Ken contributes it to a 20-year charitable remainder annuity trust (CRAT) at a time when the IRC § 7520 rate is 2.0%. Ken sets the value of the charity's remainder interest at the minimum 10% value allowed under the tax law and retains a lead annuity interest of $49,536/year. Assume further that the trust assets are all invested in tax-exempt bonds so that the capital gain from Greenacre is the only taxable income received by Ken.

The CRAT sells the land and realizes a gain of $800,000 but none of the gain is recognized. The annuity payments to Ken are taxable to him until the entire $800,000 of capital gain realized on the sale of Greenacre has been distributed. Thus, Ken will recognize $49,536 of capital gain for 16 years and $7,424 of gain in Year 17. Assuming that Ken's salary income stays at $150,000/year, the full $800,000 of gain will be taxed at 15%. This would make the total tax payable on the sale of Greenacre $120,000 (.15 x ($800,000) instead of $175,340, a savings of $55,340. Ken also achieves tax deferral.

While similar income smoothing and tax deferral can be achieved with an installment sale, the CRT may be a better choice for a taxpayer with charitable intent or a taxpayer who can benefit from the charitable deduction.

IRC § 675(4)(C) Substitution Power

Assets held directly by a decedent at death receive a basis step up, but assets the decedent transferred to irrevocable trusts do not. This makes it important for taxpayers with trusts to die with the lowest basis assets. This can be accomplished by including an IRC § 675(4)(C) substitution power in a trust. The substitution power enables the grantor to reacquire low basis assets for flat basis cash or other high basis assets.

Including the power causes the trust to be a grantor trust. As a result, all items of income, deductions and credits are reported by the grantor on the grantor's Form 1040. For taxpayers with a taxable estate, payment of the trust's income tax liability has the added advantage of creating a tax-free transfer to the beneficiaries.

Reviewing Trusts

Practitioners should review irrevocable trusts to determine whether they continue to serve their intended purpose. If not, they should consider decanting the trust into a new trust with more favorable provisions. Decanting provides a simple, cost effective means of (1) correcting errors or ambiguities, (2) adapting a trust to changes in the grantor's objectives or a beneficiary's circumstances, (3) taking advantage of new planning opportunities or (4) adding flexibility to a trust.

Another reason to review is to determine if the taxpayer has any trusts that are no longer necessary following recent increases in the unified credit. For example, many taxpayers created ILITs to provide liquidity to pay estate tax, but no longer expect to have a taxable estate. Such taxpayers may wish to cash in the policies, distribute the proceeds to beneficiaries and terminate the trusts.

The 65-Day Rule (IRC § 663(b)

Under this rule, a trust can elect to have amounts paid or credited to a beneficiary during the first 65 days of a tax year treated as paid or credited as of the last day of the previous tax year. This election can be used to smooth income or minimize NIIT after the income results of the previous tax year have been determined.

The IRC § 663(b) election is made by checking the required box on Schedule G of Form 1041. Note that the election wouldn't apply to a simple trust because it is required to distribute all its income by the end of each tax year.

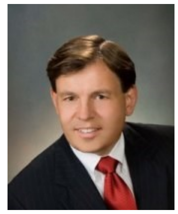
Conclusion

Recent developments have increased the importance of federal tax planning for trusts. This article highlights some of the planning options.

CITATIONS:

[1]IRC §1411(a)(2).

ABOUT THE AUTHOR:



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