Estate & Trust Checklist – Reducing the NIIT

1. Consider the proper investments for estates and trusts to avoid the imposition of the NIIT.
    a. Reduce Taxable Interest Income
        i. Tax-Exempt Bonds (assuming after-tax return is increased)
        ii. Tax-Deferred annuities
    b. Reduce Capital Gains
        i. Low Turn-Over Funds
        ii. ETFs
        iii. Similar Strategies
    c. Review the Role of Life Insurance
        i. Tax Deferred Growth
        ii. Lifetime Tax-Free Recovery of Basis
        iii. Tax-Free Death Benefit
        iv. Income smoothing (can borrow against policy without increasing taxable income)
    d. Review Proven Tax Shelters
        i. Master Limited Partnerships
        ii. Real Estate
        iii. REITs
        iv. Oil and Gas

2. Allocation of Trust Income
    a. The NIIT applies only to a trust's undistributed net investment income (IRC § 1411(a)(2)).
    b. Deductions can be used to reduce net investment income (IRC §1411(c)(1)(B)).
    c. A trustee has some discretion in deciding how to charge indirect expenses to various classes of income, although some amount must be allocated to any tax-exempt income earned during the year (Reg. § 1.652(b)-3(b)). Note: A trustee must allocate direct expense to the income that generated the expense.
    d. Thus, although there is some uncertainty, it appears that a trustee could allocate trust expenses to minimize the amount subject to the NIIT to some extent.
        i. E.g., expenses could be allocated to interest first, then rents, then dividends and finally to business income.
    e. Trustee could also leave more dividend income in the trust if such income still qualified for the 0 percent or 15 percent rate in 2014.
    f. May be possible to program your software to make favorable allocations of expenses.
    g. If trust has no business income, allocation of investment income wouldn't matter.

3. Early QSST election for Estates
    a. Making the QSST election passes estate income out to the beneficiaries.
    b. This is favorable because the beneficiaries will generally have a much higher applicable threshold amount than the estate.
    c. Thus, the QSST election should be made as early as possible

4. S Corporation Notes Payable to Shareholders
    a. Interest income would be NII
    b. Offsetting expense is on Schedule E
    c. Should shareholders borrow the money personally?

5. Passive Activities
    a. In order for an activity to be nonpassive, the taxpayer must materially participate.
    b. It is unclear who's participation is counted for purposes of "material participation" for a trust or estate.
        i. Only case law concludes that participation of agents (e.g., managers and employees) could be added to participation of trustee (see *Mattie Carter Trust v. United States*, 256 F.Supp. 2d 536 (N.D. Tex. 2003).
        ii. The IRS concludes that only a fiduciary's (i.e., an executor or trustee in his or her capacity as such) participation can be counted (see TAM 200733023, LTR 201029014, & LTR 201317010).
    c. The IRS also takes the position that a trust can never be a real estate professional (see CCA 201244017).

This is a 3.8% NIIT specific checklist for Fiduciary Income Tax planning, and does not replace a comprehensive AICPA or other Fiduciary Income Tax checklist.

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