Income Tax Considerations for Trusts and Estates: Avoiding the New Income Taxes

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I. The Importance of Trust and Estate Taxes Today

a. The trust is recognized as a separate taxable entity for federal income tax purposes and is governed by rules similar to that of individuals. It is an arrangement whereby a trustee is appointed to manage property for the benefit of beneficiaries.

b. The estate or trust must file a return on Form 1041 if it has gross income of $600 or more.

   i. The return is due on or before the fifteenth day of the fourth month following the close of the tax year.
   ii. A trust normally has a calendar tax year and an estate may have a fiscal year.

c. An estate or trust is generally regarded as a conduit with respect to its income and is allowed a deduction for the portion of income that is currently distributable or distributed to the beneficiaries. The income allocated to a beneficiary is taxed in the beneficiary's hands and retains the same character that it had in the estate or trust. (This will be important in discussing the new tax law).

d. Estates arise at the time of death and are also considered separate taxable entities for income tax purposes.

e. Both estates and trusts are managed by <u>fiduciaries</u>. These individuals serve in a fiduciary role in accordance with the terms of the will and trust agreement.

   i. Trustee for a Trust
   ii. Executor for an Estate

II. Computing Taxable Income for Estates and Trusts

a. Gross income is computed similar to individual taxation,

   i. **Less** Deductions and Expenses

ii. **Less** Income Distribution Deduction
iii. **Less** Exemption

b. Income is determined under the governing instrument and local law.

c. Treasury Regulations recognize the importance of local state provisions.

III. The New Tax Law's Impact on Trusts and Estates Income Taxes

a. The American Taxpayer Relief Act of 2012 ("ATRA") raised tax rates on individuals, estates and trusts. The maximum bracket increased from 35% to 39.6%. The capital gains bracket increased from 15% to 20%. For individuals, the maximum brackets are effective once taxable income exceeds $400,000 for an individual, and $450,000 for taxpayers married filing jointly. The threshold for head of household is $425,000 and for married couples filing separately $225,000.3

b. The income tax rates for trusts and estates are extremely condensed. Once the estate or trust has taxable income in excess of $11,950 the maximum brackets of 39.6% for ordinary income and 20% for long-term capital gains applies.

c. In addition, the 2010 health care law ushered in a complex new Medicare contribution tax of 3.8% on **Net Investment Income** ("NII") in excess of certain thresholds.

   i. The tax will begin for tax years beginning after December 31, 2012.

      1. For most trusts, the tax will generally be effective for the year beginning January 1, 2013.

      2. Estates may have a fiscal year and if an estate may adopt a November 30th year end the 3.8 % surtax would not be imposed until the tax year beginning December 1, 2013.

IV. Net Investment Income

a. Net investment income consists of gross income from interest, dividends, annuities, royalties, and rents other than those arising from an ordinary trade or business.

b. NII will also include income from a passive activity or a trade or business involving trading and financial instruments and commodities.

c. Capital gain will also be included in NII subject to certain special rules.

d. Deductions which are allocable to NII are allowed to reduce the amount subject to tax.

V. Threshold Amounts Applicable to the 3.8% Medicare Surtax

a. For taxpayers who are married filing joint returns the threshold is $250,000.

b. Single individuals have a threshold of $200,000

c. Married individuals filing separately have a threshold of $125,000.

d. It is important to note that these thresholds are based on modified adjusted gross income which includes the NII, and not on taxable income.

e. In dramatic contrast **the threshold for estates and trusts is only $11,950**.

   i. This is a result of the condensed income tax brackets for estates and trusts and will result in many entities being subject to the highest taxes and the surtax amounts. In contrast, the individual beneficiaries may be in lower brackets or not subject to the surtax.

VI. Planning Options to Consider

a. Avoid condensed trust and estate brackets, utilize the beneficiary's lower tax brackets and avoid the 3.8% surtax.

   i. By utilizing the beneficiary's income tax brackets there may be an opportunity to not only avoid the 3.8% surtax, but to take advantage of the beneficiary's lower tax brackets.

b. The key to achieving these results is to effectively utilize the special deduction available to estates and trusts for distributions to the beneficiary. Due to the fact that the estate and trust operate as a conduit, by distributing the income, including NII, to the lower bracket beneficiary substantial tax savings may result.

c. As described earlier it may also be possible to elect a fiscal year for the estate or trust and thereby delay the imposition of the surtax.

d. Special consideration should be given whenever the estate or trust owns an interest in a passive activity. Passive activity income will be included in the 3.8% surtax as it constitutes NII. It might be possible to avoid the passive activity label by having the fiduciary materially participate in the activity. The Internal Revenue Service has stated that they recognize the activities of the fiduciary having sufficient discretion and control over the affairs of the trust.

e. Lastly it may be possible to either (i) distribute appreciated property directly to the beneficiary so that the beneficiary recognizes the capital gain upon sale or (ii) to include capital gains in distributable net income or DNI.

VII. Distributable Net Income ("DNI")

a. Definition of DNI: Estates and trusts utilize a concept of distributable net income. This computation governs the allocation of trust taxable income between the trust and the beneficiaries. DNI will determine the character and the amount of the distribution deduction which flows through to the beneficiaries under the conduit theory. The distribution will act to reduce the tax of the trust. The beneficiary's tax is based on the amount and character of the DNI distributed.

b. Calculating DNI: In its essence, DNI will be the taxable income of the estate or trust without certain exemptions or deductions. Capital gains and losses are generally excluded from DNI. The importance of this exclusion is that the capital gain will be taxed at the estate or trust level and because of the condensed tax brackets will quickly result in a 3.8% Medicare surtax and the imposition of high tax brackets.

c. Example: Consider a trust where there is interest income of $7,500, Dividends of $14,500, Capital Gains of $5,000 and administrative expenses of $5,000. The trust makes distributions to the beneficiary of $27,000 however the distribution deduction does not include the capital gains, and even though the $27,000 was distributed to the beneficiary, the distribution deduction to the estate or trust following the normal rules is only $17,000 thereby resulting in taxable income reported at the trust level.

d. The separation of income from capital gains reflects the differing interests of the income beneficiaries and the residuary beneficiaries. Generally, capital gains are considered corpus and pass to the remainder beneficiaries. Therefore, capital gains are taxed to the trust and reduce the amount passing to the remainder beneficiaries.

VIII. Reducing Income Taxes

a. The first opportunity will be to distribute NII. In many instances, NII will consist of interest and dividends which are included in distributable net income and therefore the distribution will be able to reduce the trust taxes and reduce the surtax.

b. Distribute NII: It might also be possible to distribute capital gains. Capital gains are included in NII not normally included in DNI therefore, they are taxed to the estate or trust. It might be possible to include the capital gain distributions in DNI and thereby pass them out to the beneficiaries.

c. Distribute Capital Gains: The objective is to use the lower brackets of the beneficiaries and avoid the surtax.

IX. Including Capital Gains in DNI Where It Is Taxed To The Beneficiary

a. Capital gains are generally excluded from DNI and are allocated to principal. Therefore they are generally taxed to the trust and will result in increasing the trust income taxes and possibly subjecting the trust to the surtax. However, capital gains can be included in DNI if the fiduciary is able to use one of two prerequisites and one of three methods that will result in beneficiary taxation.

b. 2 Prerequisites**:** (1) Inclusion in DNI pursuant to the governing instrument and local law. (2) A reasonable and impartial exercise of trustee discretion in accordance with a power granted by local law or by the governing instrument so long as it is not prohibited by local law. (As you can see a great deal of attention must be focused on the governing instrument and the law of each jurisdiction. Every state may differ in this regard).

c. 3 Methods: There are also three methods once the prerequisites are met. (1) An allocation of capital gain to income. (2) Require a consistent practice by the fiduciary, including documentation on the books and records of the fiduciary indicating that distributions of principal would first be paid out of capital gains. (3) This method applies when the capital gains are actually distributed by the fiduciary in accordance with the fiduciary's determination of the amount required to be distributed.

X. Best Ways to Achieve These Important Tax Savings

a. Drafting the Governing Instrument: First and foremost are the provisions within the governing instrument.

   i. In the planning stage, attention should be given to allocation of capital gains and allowing sufficient discretion to the fiduciary.

      1. The fiduciary should be permitted to distribute trust principal and to allocate receipts and disbursements between income and principal.

   ii. In appropriate instances capital gains may even be included in income.

   iii. If the instrument is silent, state law generally provides the governing factors.

b. In-Kind Distribution: The documents should clearly allow for in-kind distributions. Under the tax rules when appreciated property is distributed to the beneficiary, the beneficiary will report the capital gain on the later sale. This will avoid the trust level taxation and reduce the Medicare surtax. It is important not to check that the executor is making the section 643(e)(3) election.

c. 65 Day Election: Estates and trusts have another special rule that distributions paid within the first 65 days of the taxable year may be treated as paid on the last day of the previous fiscal year.

   i. The election is made simply by the fiduciary checking the box on page two included within the other information on line 6 and then taking care to make the distributions within the first 65 days of the next year.

   ii. This election will allow fiduciaries sufficient time to compute the trust income and affords a very handy look-back in instances where distributions were not addressed.

iii. The deduction cannot exceed the DNI for the previous taxable year. Therefore, the considerations previously discussed regarding capital gain inclusion in DNI, will affect this computation.

XI. Conclusion

a. There are many unique aspects of trust and estate income taxation which will help lower the respective income taxes. Executors and trustees must adhere to fiduciary standards and owe duties of care and loyalty to all beneficiaries and participants in the estate and trust. Therefore, fiduciaries must be knowledgeable about the individual beneficiary circumstances as well as the overall structure of the entity. Drafting for suitable discretion will help the fiduciary better manage these considerations. Fiduciaries must carefully document the factors which they are considering and make their decisions accordingly.

b. Modern portfolio theory and investing for total return play a large role in trust administration but can result in increased taxes at the trust level. Fiduciaries and their advisors must work as a team in developing an appropriate strategy.