



The Wealth Counselor

A monthly newsletter for wealth planning professionals

Volume 2, Issue 10

Simplifying the Taxation of Trusts

The last issue of The Wealth Counselor examined trusts and the asset protection benefits provided to trust makers and their beneficiaries through the utilization of ongoing trusts. This issue of The Wealth Counselor addresses related and important questions about the taxation of trusts, which are important to all wealth planning professionals.

Trusts are Separate Taxpayers

All trusts are separate taxpayers. Unless disregarded under the exception for grantor trusts discussed below, each trust has its own tax year and tax accounting method. Trusts also receive income and pay expenses. Net income is taxed either to the trust or to the beneficiaries, depending upon the trust terms, local law and, in the cases of complex trusts (defined below), whether the trust distributed the income.

Planning Tip: If a trust permits accumulation of income and the trust does not distribute it, the trust pays tax on the income.

Planning Tip: If a trust distributes or is deemed to have distributed the income to the beneficiaries, the trust can deduct the amount of the distribution and the beneficiaries must include it as income.

A trust's distributable net income (DNI) determines the amount of the distribution the trust can deduct, and the amount the beneficiary must report as income. Thus, DNI acts as a ceiling on the amount of the deduction a trust can take for distributions to beneficiaries. DNI also acts as a ceiling on the amount of the distribution that the beneficiary must account for on his or her income tax return.

Planning Tip: As a general rule, distributions from a trust are first taken from DNI, then from principal.

An explanation of the DNI calculation is beyond the scope of this newsletter. However, it is important to note that this is an area where the client's wealth planning team must work together to ensure that the income taxation flows as the client desires. For example, as a general rule, capital gains will be subject to taxation at the trust level except in the year the trust terminates. However, if the client so desires and if it is permissible under state law, the lawyer can draft the trust agreement so that it defines trust income to include capital gains, thereby passing the capital gains tax liability to the beneficiary.

Planning Tip: It is critical that the client's wealth planning team work together to ensure that trust income will be subject to taxation as the client desires.

Simple vs. Complex Trusts

The Internal Revenue Code defines a **simple trust** as a trust that:

1. By its terms must distribute all of its income (meaning fiduciary accounting income) currently;
2. Makes no principal distributions; and
3. Makes no distributions to charity.

The regulations to the Internal Revenue Code define a **complex trust** as a trust that is not a simple trust; in other words, a trust that:

1. Is allowed by its terms to accumulate income;
2. Makes discretionary distributions of income or mandatory or discretionary distributions of principal; or
3. Makes distributions to charity.

Grantor Trusts

The Internal Revenue Code defines a **grantor trust** as a trust in which the trust maker has one or more of the powers specifically described in Sections 673 to 677. A trust can also be a grantor trust as to a beneficiary where the beneficiary has one or more of these same powers if the beneficiary also has or had the power over the trust principal described in Section 678. To the extent a trust is a grantor trust, it functions as a conduit; in other words, all of the income, deductions, credits, etc., flow through to the trust maker or beneficiary and are subject to tax on their own personal tax return, regardless of whether the trustee makes distributions from the trust. The general rules governing the income taxation of trusts and their beneficiaries do not apply to grantor trusts due to application of these rules.

Planning Tip: Revocable trusts are grantor trusts as to their trust maker(s) and thus a revocable trust's income and deductions flow through to its trust maker(s).

Planning Tip: Grantor trusts are powerful planning tools because of the fact that the trust is the same as the grantor for income tax purposes. Thus, a sale by a grantor to a grantor trust does not trigger income tax.

It is now clear that with a grantor trust, the grantor's payment of the trust income tax does not constitute a gift to the trust beneficiaries. Thus, for those clients who are willing to pay this tax, grantor trusts are also excellent vehicles to leverage gifts to beneficiaries.

Planning Tip: By paying the income tax of a grantor trust, the grantor is in essence making an additional contribution to the trust, but one that is not subject to gift tax.

Grantor Trusts and Life Insurance

Grantor trusts also can be very useful in the context of transfers of life insurance. When transferring life insurance (for example, from the insured to avoid estate tax inclusion or to a "new" irrevocable life insurance trust), consider selling the policy for full and adequate consideration to a trust that is a grantor trust as to the insured. As long as the sale is for the policy's full fair market value, such a transfer will avoid the three-year estate tax inclusion rule, and it will not invoke the transfer-for value rules.

Planning Tip: A sale of life insurance to a grantor trust for full and adequate consideration avoids both the three-year estate inclusion rule for transfers of ownership and the transfer-for value rule.

Compressed Income Tax Brackets for Trusts

A frequent objection to the accumulation of trust income is the fact that trusts pay federal income tax according to a compressed rate schedule. In other words, trusts pay the maximum federal income tax rate of 35% at only approximately \$10,500 of income per year in 2007, compared to approximately \$350,000 for single taxpayers, heads of household, or those married filing jointly.

On its face, it appears that it may be costly from an income tax perspective to accumulate trust income. However, the critical questions are, what type of income is it and, if interest or rent income, will accumulation result in additional tax? In other words, what are the relative tax rates of the beneficiaries?

Planning Tip: The compressed tax rates for trusts only apply to accumulated **interest and rent income**. Trusts pay the same rates as individuals for capital gains and dividend income. Thus, careful investment of trust assets can reduce or eliminate the impact of compressed tax rates.

Planning Tip: If the trust beneficiaries are already in the maximum federal income tax bracket, accumulation of interest income will not cause additional tax. In fact, with these beneficiaries, accumulation of trust income may actually reduce their overall income tax by not phasing out deductions and credits.

Planning Tip: If the trust beneficiaries are not in the maximum federal income tax bracket, what are their relative tax brackets? The tax impact of income accumulation is the difference in the tax rates, likely an additional 7% or less, not the full 35%.

Furthermore, trust makers can give a trustee the ability not only to distribute directly to a beneficiary (which is not good for asset protection), but also the discretion to make distributions on behalf of a beneficiary such as to pay rent, medical expenses, tuition, credit card bills, etc.

Planning Tip: Distributions on behalf of a beneficiary are distributions to the beneficiary for tax purposes and will be subject to tax at the beneficiary's rates. Such distributions are also good for asset protection because the trustee does not make them directly to the beneficiary. Thus, to the extent the trustee is able to "distribute" to pay for these needs directly, trust income will be taxed at the beneficiary's income tax rate.

Conclusion

A working knowledge of the taxation of trust income is important for the client's entire wealth planning team. By working together, the team can often minimize the overall tax impact and help ensure that our plan meets the client's unique planning objectives.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.