Income Tax Planning for Trusts and Estates:
Techniques You Can Use and Pitfalls to Avoid

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I. Income Tax Rates for Non-Grantor Trusts and Estates

If Taxable Income Is:	The Tax Is:
Not over $2,450	15% of taxable income
Over $2,450 but not over $5,700	$367.50 plus 25% of excess over $2,450
Over $5,700 but not over $8,750	$1,180 plus 28% of excess of $5,700
Over $8,750 but not over $11,950	$2,034 plus 33% of excess over $8,750
Over $11,950	$3,090 plus 39.6% of the excess over $11,950

II. Overview of Taxation of Grantor Trusts

A. A grantor trust is an inter vivos trust which, pursuant to Code §§ 671 – 679, is taxed as if owned in whole or in part by the trust's "grantor(s)". Accordingly, the income tax brackets applicable to the grantor's personal income taxes apply instead of the above –referenced tax brackets.

B. Who is a "grantor"?

1. For purposes of the grantor trust rules, a "grantor" includes "any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust." Treas. Reg. § 1.671-2(e)(1). A gratuitous transfer is any transfer of property (including cash) for other than fair market value. Treas. Reg. § 1.671-2(e)(2). Note, however, that a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under §§ 671 – 677 or 679. Treas. Reg. § 1.671-2(e)(1). Section 678 describes situations where a person other than the grantor may be treated as the owner of the trust if such person possesses any of the powers enumerated in § 678. *However § 678 is trumped by the other grantor trust provisions. If the trust is treated as a grantor trust under §§ 671-677, then § 678 does not apply.*

2. A trust can have multiple grantors.

C. Single Grantor Trust: If a person is deemed to own the entire trust (corpus and income), then such person is treated as the owner of all the trust assets as if the trust did not exist and must take into account "all items of income, deduction, and credit" arising from the trust assets in computing his or her individual income tax liability. Treas. Reg. § 1.671-3 (a)(1).

D. Partial/Multiple Grantor Trusts:

1. If a person is deemed to own only a portion of a grantor trust and that portion consists of specific trust property, then such person is only attributed items of income, deduction, and credit directly related to that specific trust property. Treas. Reg. § 1.671-3 (a)(2). Tax items directly related to trust property not included in the portion deemed owned by such person will be subject to the traditional income tax provisions of Subchapter J of the Code. Id. Any tax items that relate both to the portion deemed owned by the grantor and to the balance of the trust must be "apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent." Id.

2. If a person is deemed to own only a portion of a grantor trust and that portion consists of "an undivided fractional interest in the trust, or of an interest represented by a dollar amount," then such person will be allocated "a pro rata share of each item of income, deduction, and credit" arising from the trust." Treas. Reg. § 1.671-3 (a)(3).

E. Common provisions used to cause a trust to be treated as a grantor trust for income tax purposes

1. Rules are contained in Code §§ 671 – 678. The game is to utilize provisions that will cause grantor trust status but not cause inclusion of the trust assets for estate tax purposes.

a. A grantor can be taxable either on the income or corpus of a trust, or both.

b. Code § 672(e) provides that a grantor is treated as holding any power or interest held by an individual who was the spouse of the grantor at the creation of such power or interest, or who thereafter became the spouse of the grantor. Therefore, it is important to analyze the interest or powers held by a spouse when analyzing grantor trust status.

2. Code § 673. Reversionary Interests - If the grantor retains a reversionary interest in any portion of either the corpus or income from a trust, from the inception of such trust, and the value of the reversionary interest (at the time of the transfer to the trust) retained exceeds five percent of the value of such portion, then the grantor shall be treated as the owner of such portion. Note, also, that the retention of a reversionary interest of more than 5% could result in inclusion of the trust property in the grantor's estate if the grantor dies while the reversionary interest is still in effect. Section 2037.

3. Code § 674. Beneficial Enjoyment. Grantor treated as owner under Code § 674(a) of any portion of which the beneficial enjoyment of corpus or income is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

a. Code §§ 674(b)-(d) provide a number of exceptions to what constitutes a "power of disposition". Some of the powers a grantor can hold without causing it to be treated as a grantor trust under Code §674 include:

(1) A power to apply income for the support of a dependent (§674(b)(1)).

(2) A power to allocate among charitable beneficiaries. (§674(b)(4)).

(3) A power to distribute corpus to or for a beneficiary, provided the power is limited by a reasonably definite standard. (§674(b)(5)).

(4) A power to temporarily withhold income distributions to any current income beneficiary (§674(b)(6)).

(5) A power to allocate receipts and disbursements between corpus and income (§674(b)(8)).

(6) A power exercisable by trustees, none of whom are the grantor and no more than half of whom are related or subordinate to the grantor, to distribute, apportion, or accumulate income among beneficiaries; or to pay out corpus to or for a beneficiary or class of beneficiaries (§674(c)).

(7) A power exercisable by trustees, none of whom are the grantor or spouse living with the grantor, to allocate income if limited by a reasonably definite external standard (§674(d)).

4. Code § 675. Administrative Power. If the grantor and/or a nonadverse party posses certain "administrative powers" that allow him or her to engage in specified transactions with the trust, then the grantor shall be taxed as the owner of that portion of the trust over which he or she (or a nonadverse party) retained such power. Two common grantor trust powers under Section 675 include:

a. Power to Borrow Without Adequate Interest or Adequate Security. The grantor will be treated as the owner of any portion of a trust over which the grantor and/or any nonadverse party retains the power to borrow trust corpus or income (directly or indirectly) without adequate interest or security (§675(b)). Note, however, that this treatment does not apply where a trustee (other than the grantor or the grantor's spouse) is authorized under a general lending power to loan trust corpus or income to any person without regard to interest or security. *Id*. Note that the ability of the grantor to borrow without adequate interest could potentially cause estate tax inclusion.

b. Borrowing of Trust Funds. The grantor will be treated as the owner of any portion of a trust over which the grantor has directly or indirectly borrowed trust corpus or income and has not completely repaid the loan (including interest) before the beginning of the taxable year (§675(c)). Note, however, that this treatment will not apply to a loan that provides for adequate interest and security and the trustee who makes the loan is not the grantor, the grantor's spouse or a related or subordinate trustee subservient to the grantor. *Id*.

c. Power of Substitution. The grantor will be treated as the owner of any portion of a trust over which any person has the power to reacquire the trust corpus by substituting other property of an equivalent value.

(1) A non-fiduciary power exercisable by the grantor to substitute assets will not, by itself, trigger inclusion of trust assets under Code §§ 2036 or 2038 for estate tax purposes, provided the trustee has a fiduciary obligation to ensure property substituted is of equivalent value. Rev. Rul. 2008-22.

(2) A non-fiduciary power of substitution by the grantor exercisable over a life insurance policy will not be treated as an incident of ownership causing inclusion under Code § 2042(2). Rev. Rul. 2011-28.

5. Code § 676. Power to Revoke. The grantor will be treated as the owner of any portion of a trust (whether or not the grantor is treated as the owner under any other provision of the grantor trust rules) where at any time the grantor and/or a nonadverse party may exercise the power to revest such trust portion in the grantor (§676). Note this power will cause estate tax inclusion of trust assets.

6. Code § 677. Income for Benefit of Grantor. If the grantor and/or a nonadverse party has the power with respect to any portion of a trust to (i) distribute trust income to the grantor or the grantor's spouse, (ii) hold or accumulate income for future distributions to the grantor or the grantor's spouse, or (iii) apply income to the payment of insurance premiums on the life of the grantor or the grantor's spouse, then the grantor shall be treated as the owner of that portion of the trust over which he or she (or a nonadverse party) retained such power (§677(a)). Note that (i) and (ii) may cause estate tax inclusion of trust assets if the income is distributable to the grantor.

7. Code § 678. Person *Other Than Grantor* Treated as Substantial Owner. If a person other than the grantor has the power, exercisable solely by him or herself, to vest all, or a portion of, trust corpus or income in him or herself, then such person will be the deemed owner of the portion of the trust over which they have such power. Pursuant to §678(a)(2), if a person described in §678(a)(1) has previously partially released or modified such a power but thereafter retains such control as would subject the grantor of a trust to treatment as the owner thereof (within the principles of §§ 671 – 677), then such person will be deemed the owner of that portion of the trust.

a. Example: Crummey powers; withdrawal rights exercisable at certain ages

F. Reporting Requirements for Grantor Trusts

1. Grantor trust still has reporting requirements even if it is a wholly-owned grantor trust and all items are included on a grantor's personal income tax return. See Treas. Reg. 1.671-4 or instructions to Form 1041.

2. The grantor trust has reporting options. In short, the trustee can file a Form 1041 (which would be essentially blank) and attach a statement showing all income, deduction and credit attributable to the grantor trust. This separate statement forms the basis for reporting on the grantor's personal income tax return. Alternatively, the trustee may report the grantor's information to all payors and (i) furnish the statement of tax items to the grantor, or (ii) file with the IRS Forms 1099 reporting trust income and showing the trust as the payor and the grantor as the payee, and provide required information to the grantor for the grantor's personal income tax return.

G. Employer Identification Numbers (EINs) – To issue or not to issue?

1. See Treas. Reg. § 301-6109-1(a) for specific rules.

2. General Rule: A wholly-owned grantor trust is not required to obtain a separate EIN if the grantor's SSN is furnished to all payors. Rather, the grantor's SSN can be used. However, it may still be a good idea to issue a separate EIN even if not required.

a. Separate EIN segregates trust tax items from personal tax items, which can simplify trust administration.

b. Grantor's SSN remains private.

c. Financial institutions seem to prefer that grantor trusts have separate EINs.

3. Grantor trust must obtain an EIN following the death of the grantor if the trust will continue.

III. Overview of Taxation of Non-Grantor Trusts

A. General rules (Conduit principle) – "He who gets the income, pays the tax"

1. Taxable income is computed in the same manner as an individual, subject to certain exceptions.

a. The term "income" refers to fiduciary accounting income as defined under state law and the terms of the trust. Items which are not treated as income are "principal". Trust terms that depart fundamentally from traditional principles of income and principal generally will not be recognized. In Florida, Chapter 738 governs the allocation of receipts and expenses between income and principal.

b. The term “distributable net income” (DNI) means taxable income subject to certain modifications. DNI is the measuring rod for determining the amount of a distribution of income that is taxable to a beneficiary and the amount of a distribution that a trust may deduct. DNI can never exceed fiduciary accounting income.

2. Distributions carry out net income first to the extent of DNI, then principal. Trust gets a deduction for the amount of DNI distributed to beneficiaries.

3. Distributions are included in the beneficiary’s taxable income to the extent the distribution is comprised of DNI.

4. The character of the gain/income in the hands of the beneficiary is the same as it was in the hands of the trust.

5. Trust will generally only pay income tax on undistributed net income or on income or gains allocated to principal, such as capital gains (except if capital gains are distributed as income as described in Section VII B below).

B. Distributions in kind (§ 643(e))

1. Distributions in kind generally are not a taxable disposition unless the distribution is made in satisfaction of an obligation, such as the right of a beneficiary to receive a pecuniary amount or right to receive other specific property.

2. When a distribution in kind does not cause a taxable disposition, the trustee may elect under Code § 643 for the trust to realize the gain or loss. If a loss is triggered, however, the trust cannot deduct the loss because of Code § 267, which disallows losses for transactions between related parties. The suspended loss will offset gain to the beneficiary upon a subsequent sale or exchange of the property.

a. This election is typically used for distributions of appreciated property only if the trust has losses that can be used to offset the gain. If the election is made, the beneficiary will receive a stepped-up basis If the election is not made, the beneficiary will take the property with a built-in gain and, thus, the tax will be deferred.

C. Separate share rule (§ 663(c)) – separate shares of a single trust (such as a trust with multiple beneficiaries) are generally treated as separate trusts for income tax purposes, which means income, DNI, deductions, etc. are calculated separately for each share

1. Separate share rule is mandatory, not elective.

2. Also applies to estates.

3. Separate share rule does not apply to trusts in which the trustee has discretion to sprinkle or accumulate income or principal among beneficiaries.

IV. Overview of Taxation of Estates

A. Similar to taxation of non-grantor trusts, subject to certain exceptions.

V. Planning with Grantor and Non-Grantor Trusts

A. Toggling between grantor trust status and non-grantor trust status

1. ***Planning Point***: The importance of toggling has increased with the enactment of the higher exemptions and tax rates under ATRA and implementation of the 3.8% tax on net investment income. Review your existing trusts to determine if it makes tax sense to shift the burden of the income tax generated by trust assets.

a. Example: Grantor is in the 43.4% income tax bracket while the beneficiaries are in the 25% bracket. If the trust assets are projected to generate income of $100,000 per year going forward, the aggregate income tax liability could be reduced from $43,400 per year to $25,000 per year if the trust is changed to a non-grantor trust, assuming the trust actually distributes income.

2. The income tax status of a trust can change (either intentionally or inadvertently) upon the occurrence of certain events, such as a change in trustees.

3. The ability to change the grantor trust status of a trust is highly dependent upon the specific terms of the trust. A trust could have more than one provision that makes it qualify as a grantor trust. Thus, if you are attempting to convert a grantor trust to a non-grantor trust, it is important that <u>all</u> grantor trust powers are terminated.

a. How to toggle out of grantor trust status

(1) Irrevocably release the power of substitution or other power(s) causing grantor trust status.

(2) Change trustees to fall within the safe harbors of Code § 674(a) (i.e., appoint an adverse party as Trustee or Co-Trustee).

(3) Decant the trust into a non-grantor trust.

b. How to toggle into grantor trust status

(1) Change the trustee(s) to trigger the application of Code § 674(a). This can be done by replacing an independent trustee with the grantor, the grantor's wife or a nonadverse party who is related to the grantor. However, you must also make sure none of the exceptions under §§ 674(b) – (d) will apply. Otherwise, changing the trustee, by itself, may not be sufficient.

(a) Example: Trust provides for discretionary distributions of income and principal to beneficiary for HEMS. If the grantor's brother, who is not a beneficiary of the trust, is appointed as trustee, then 674(a) will apply. However, 674(b)(5) and 674(d) apply to override 674(a), which means it will not be a grantor trust.

(2) Appoint a foreign trustee. § 679.

(3) Have the grantor borrow income or principal and not completely repay the loan, including interest, before the beginning of the tax year. § 675(3). However, the borrowing is measured at the beginning of the tax year, which might make it difficult to plan for issues that arise later in the year.

4. ***Planning Point:*** Build in flexibility when drafting a trust to simplify the conversion from a grantor trust to a non-grantor trust, or from a non-grantor trust to a grantor trust. One possible way to accomplish this is to appoint a trust protector with the authority to (i) grant a power of substitution to the grantor or another individual (675(4)) or (ii) appoint an individual to make loans to the grantor without adequate security or without charging adequate interest (675(3)).

5. Tax considerations when changing grantor trust status

a. The conversion of a grantor trust to a non-grantor trust is a taxable event which could trigger gain or loss. Rev. Rul. 77-402; Treas. Reg. 1.1001-2(c), Ex. 5; *Madorin v. Commissioner,* 84 TC 667 (1985). Basically, the grantor is treated as transferring assets to the trust at the moment it becomes a non-grantor trust. Therefore, if there is a note outstanding (such as a promissory note arising from an installment sale to a grantor trust), then the assets will be treated as transferred in exchange for the note and gain or loss could arise. (Note: practitioners disagree as to whether a conversion caused by the death of a grantor will be a taxable event).

b. However, toggling from a non-grantor trust to a grantor trust should not trigger gain. Chief Counsel Advise Memo 200923024.

B. Obtaining a basis step-up for trust assets

1. ***Planning Point:*** With the increased tax exemptions and portability, it may no longer be necessary to exclude certain trust assets from a decedent's gross estate. Therefore, consider techniques for appreciated trust assets to get a tax free step-up in basis upon a decedent's death.

2. Generally, assets gifted to a trust acquire a carryover basis, except that if fair market value is less than basis at the time of the gift, then the trust takes a basis equal to fair market value for purposes of determining loss. I.R.C. 1015.

3. Assets sold to a trust acquire a cost basis, except that if the sale is by the grantor to a grantor trust, then the transaction is disregarded for income tax purposes and the grantor trust gets a carryover basis. Rev. Rul. 85-13.

4. Assets owned in an irrevocable trust that is not included in the estate of the grantor or beneficiary do not receive a basis adjustment under Code 1014 upon the death of the grantor or beneficiary. If there is significant built-in gain in trust assets as a result of appreciation or prior depreciation (such as rental property), the loss of the basis step-up can be costly.

a. Example: Assume a rental real property with a value of $1 million, an original purchase price of $500,000 and a depreciated basis of $100,000. If the asset is owned by an irrevocable trust and does not receive a stepped-up basis upon grantor's death, then selling the asset for $1 million could cause income tax of approximately $173,600 + $119,000 = $292,600 (assuming 43.4% income tax rate on depreciation recapture and 23.8% capital gain rate).

5. Techniques to obtain a basis step-up for irrevocable trust assets

One obvious difficulty with the following strategies is that the actions must occur prior to a beneficiary or grantor's death, but the date of death is often unpredictable. Standby documents might facilitate fast implementation of these transactions.

a. Techniques that do not increase the decedent's estate and will not trigger gain.

(1) Sell the asset to decedent prior to death (assuming the trust is a grantor trust as to the decedent).

(a) If the donor does not have sufficient other assets, repurchase will be difficult. One alternative would be for the grantor to borrow funds from an outside lender, and use the cash proceeds to purchase the appreciated assets. The loan could be repaid following the grantor's death.

(b) There is uncertainty regarding the income tax consequences if a note is used to repurchase property from the grantor trust. The trust's basis in the note may equal the grantor's basis in the reacquired asset so that the payment of the trust's note would ultimately generate gain.

(2) Grantor can exercise power to substitute high basis assets or cash of equivalent value for low basis assets.

(3) Sell asset(s) to another trust (assuming both trusts are grantor trusts) which is includible in the decedent's gross estate. Sales between two grantor trusts which have the same grantor should not trigger gain.

(a) Example: G is the grantor of Trust 1, which is a Dynasty Trust for A and his descendants, and Trust 2, which is not a Dynasty Trust, but gives A a testamentary general power of appointment. Since Trust 1 and Trust 2 are both grantor trusts as to G, a sale of assets between the trusts would not be taxable. The asset would not get a step up in basis if held in Trust 1 at A's death, but it would if held in Trust 2 at A's death.

(b) Likewise, if the grantor's spouse is the anticipated decedent, a sale between a grantor trust and (i) the grantor's spouse or (ii) a trust of which the grantor's spouse is treated as the grantor, will not trigger gain. Code § 1041. However, § 1014(e) may apply to eliminate the basis step-up if the property is devised by the deceased spouse back to the grantor.

(4) Decant or modify the trust, either judicially or nonjudicially, to add flexibility to obtain a basis step up. For example, a broad power of distribution or power of substitution could be added. A power could also be given to a disinterested person to confer a general power of appointment on a beneficiary.

b. Techniques that will increase the grantor's estate by causing inclusion of the trust or specific asset, but will not cause gain.

(1) Because of the permanent large indexed estate tax exemption, the client who will not have to pay any federal estate tax may want to take steps purposefully to cause previously transferred assets to be included in the gross estate in order to receive the basis step-up. This could be desired where the income tax cost of the loss of basis step-up outweighs the estate tax savings because the appreciation is not sufficient.

(2) Distribute the asset to the decedent.

(3) Sell the asset to another trust (assuming both trusts are grantor trusts) which contains provisions that will then permit the asset to be distributed to the decedent.

(4) Grant a testamentary general power of appointment in the decedent (if authority is granted under the trust).

(5) Have the beneficiary exercise a limited power of appointment at death in a manner that violates the *Delaware Tax Trap.*

(a) Delaware law at one time (perhaps still) provided that if someone exercises a power of appointment to grant a presently exercisable power of appointment to another person, even a *limited* power of appointment, that grant of the new power is treated as a vesting of property for purposes of the rule against perpetuities. The original power could be exercised to appoint the assets in further trust, with a new perpetuities period running from the date of exercise, which means that the trust could be extended indefinitely without having the assets subjected to estate tax. Sections 2041(a)(3) and 2514(d) were enacted to prevent avoiding the estate tax indefinitely by successive exercises of limited powers of appointment and creating new powers in other persons of new presently exercisable limited powers of appointment. Section 2041(a)(3) provides that property subject to a non-general power of appointment (which would generally not cause inclusion under § 2041) will cause estate inclusion under that section if the power holder exercises the power of appointment "by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power."

(b) The decision of whether to trigger estate inclusion in the beneficiary's gross estate is totally up to the beneficiary. If the beneficiary wants to trigger estate inclusion, the beneficiary would exercise the original power to create a presently exercisable general power of appointment in someone else. That would cause estate inclusion in the original power holder's gross estate under § 2041(a)(3) and result in a step-up in basis for the appointed assets. § 1014(b)(4).

(c) A negative aspect of causing estate inclusion in that manner is that the assets would also have to be included in the successor power holder's gross estate as well (because the second power holder would hold a general power of appointment).

(6) Move from an asset protection jurisdiction to jurisdiction in which the grantor's creditors can reach the assets may cause estate inclusion.

(7) The estate may take the position that there was an implied agreement of retained enjoyment. For example, the parent may continue living in the house in a QPRT or other trust to which a residence was transferred without paying rent to trigger Code § 2036(a)(1). However, the IRS conceivably may not take the position in that type of circumstance that the failure to pay rent, based on the changed circumstances, reflects an implied agreement to retain the interest at the outset (which is a requirement under Code § 2036(a)(1)). As another example, if a parent has given undivided interests in a vacation home to children, the parent may start using the vacation home exclusively without paying rent in a similar attempt to trigger an implied agreement of retained enjoyment under Code § 2036(a)(1).

VI. S Corporation Issues with Estates and Trusts

A. ***Planning Point:*** One of the most frequent problems we see is the inadvertent termination of a S election because S stock is acquired by a non-permitted shareholder or the time period for remaining a permitted shareholder has expired. This is especially prevalent when stock is owned by a trust or transferred in connection with an estate administration. Be sure to pay attention to the rules for qualifying as a permitted shareholder if S stock is owned by an estate or trust.

B. Estates are permitted shareholders

1. Caution: Under Treas. Reg. § 1.641(b)-3(a), if an estate administration is unduly prolonged, the estate will be considered terminated after the expiration of a reasonable period of time for the performance by the personal representative of all duties of administration. Therefore, S stock cannot remain in an estate indefinitely. If a Code § 645 election was made, then the estate will not be deemed to terminate prior to the termination of the 645 election period.

C. *Certain* trusts are permitted shareholders

1. Qualified Subchapter S Trust (QSST)

a. All of the trust income under § 643(b) must be distributed currently, or be required to be distributed currently, to the current income beneficiary of the QSST.

b. The current income beneficiary must be an individual who is a U.S. citizen or resident.

c. The current income beneficiary must be the only income beneficiary of the trust during such beneficiary's lifetime.

d. Any corpus of the QSST distributed during the current income beneficiary's lifetime must be distributed only to the current income beneficiary.

e. The current income beneficiary's income interest must terminate on the earlier of the beneficiary's death or the termination of the trust.

f. If the trust terminates during the current income beneficiary's life, all of the trust assets must be distributed to the current income beneficiary.

g. The current income beneficiary must make an election on a timely basis to treat the trust as a QSST as set forth in Reg. §1.1361-1(j)(6)(iii)(C) within 2 months and 16 days of acquiring the stock.

h. QSST election results in the income beneficiary being treated as the owner of the stock for income tax purposes. In addition, a disposition of the S stock by the trust is treated as a disposition by the beneficiary for purposes of applying Code §§ 465 and 469 to the beneficiary.

i. Upon the death of the income beneficiary, the QSST election will remain in place if the existing QSST continues for the benefit of a new income beneficiary, unless the new income beneficiary affirmatively refuses to consent to the QSST election within 15 days and 2 months after becoming the income beneficiary. However, if the existing QSST distributes out to new trusts upon the death of the current income beneficiary, then a new QSST or ESBT election must be made for the new trusts.

j. Relief for late QSST elections is available.

2. Electing Small Business Trust (ESBT)

a. Generally, any trust which does not have as a beneficiary any person other than an individual, estate or 170(c) organization. Moreover, the interest in the trust cannot have been acquired by purchase.

b. All potential current beneficiaries of the trust must be permitted shareholders.

c. Election must be filed <u>by the trustee</u> within 2 months and 16 days after the acquisition of the stock.

d. The ESBT election allows a trust which provides for multiple beneficiaries and discretionary distributions to be a permitted shareholder of an S corp.

e. An ESBT is taxed in 3 portions: the grantor trust portion; the S portion; and the non-S portion. The grantor trust income tax rules apply first. Thus, an ESBT which is a wholly-owned grantor trust will be taxed entirely to the grantor. An ESBT which is not a grantor trust will be subject to tax at the highest marginal rate for the S portion and the non-S portion of the ESBT will be taxed under the non-grantor trust rules of Subchapter J.

f. Relief for late ESBT elections is available.

3. Grantor trusts (revocable and irrevocable)

a. Are permitted shareholders during the life of the grantor, even without making a QSST or ESBT election. However, if grantor trust status terminates during the grantor's lifetime, then a QSST or ESBT election must be made within 2 months and 16 days of termination.

b. ***Planning Point***: Consider making an ESBT election for a grantor trust even though the grantor trust is a permitted shareholder. The ESBT election will not change how the grantor trust is taxed because the grantor trust portion is taxed first under the ESBT rules. However, if the grantor trust is ever converted to a non-grantor trust or the grantor trust status is inadvertently terminated, then the ESBT election is already in effect and won't jeopardize the S status of the company.

4. Grantor trusts that become non-grantor trusts upon the death of the grantor

a. Retain permitted shareholder status for 2 years after the grantor's death. After 2 years, the trust must make a QSST or ESBT election to remain a permitted shareholder.

5. Testamentary Trusts

a. A testamentary trust for permitted shareholder status is a trust to which S stock is (i) transferred pursuant to the terms of a will, (ii) transferred pursuant to the terms of a Code 645 qualified revocable trust during the election period or (iii) deemed to be distributed to at the close of the Code 645 election period. In each case, however, the permitted shareholder status only lasts for 2 years from the day the stock is transferred or deemed to be transferred to the testamentary trust.

b. ***Planning Point:*** Making a Code 645 election for a decedent's revocable trust that owned S stock at death can significantly extend the deadline by which a QSST or ESBT election must be made. The revocable trust typically would only be a permitted shareholder for 2 years from decedent's date of death under § 1361(c)(2)(A)(ii). If a Code 645 election is made, then the trust is a permitted shareholder for the remainder of the 645 election period because it is treated as part of the estate. For estates required to file an estate tax return, the 645 election period typically does not terminate until 12 months from the receipt of the estate tax closing letter. Upon the earlier of the termination of the 645 election period or the distribution of the S stock to a successor trust, the successor trust will be treated as a testamentary trust. Accordingly, the successor trust will be a permitted shareholder for 2 years from the date of receipt of the stock. See Treas. Reg. 1.1361-1(k)(1) Ex. 3(ii).

VII. Application of Net Investment Income Tax to Estates and Trusts

A. Application of 3.8% tax on Net Investment Income under Affordable Care Act

1. Section 1411 imposes a tax (in addition to federal income taxes) of 3.8% on the unearned income of individuals, estates, and trusts for taxable years beginning <u>after</u> December 31, 2012.

2. For individuals, the tax is 3.8% of the <u>lesser</u> of:

a. the individual's modified adjusted gross income in excess of a threshold amount ($200,000 for individuals and $250,000 for couples); or

b. the individual's net investment income for the year.

3. For estates and trusts, §1411(a)(2) imposes a tax equal to 3.8% times the <u>lesser</u> of:

a. the estate's or trust's adjusted gross income (as defined in §67(e)) in excess of the highest income tax bracket threshold ($11,950 for 2013); or

b. the estate's or trust's undistributed net investment income.

4. The threshold for individuals is not indexed. The threshold for estates and trusts is the dollar value for the highest income tax bracket for estates and trusts, which is indexed, but which is a very low number.

5. The 3.8% tax is never imposed on more than net investment income, regardless of the amount of gross income.

6. *Grantor Trusts.* The 3.8% tax is not imposed on grantor trusts, but items of income, deduction or credit are treated as if they had been received or paid directly by the grantor for purposes of calculating that person's individual net investment income.

7. *ESBTs.* ESBTs are still treated as two separate trusts for income tax computational purposes, but S portion and non-S portion are combined into a single trust for purposes of determining if the MAGI threshold is met.

8. Net Investment Income

a. "Net investment income" includes gross income from interest, dividends, annuities, royalties and rents other than such incmoe which is derived in the ordinary course of a trade or business.

b. Additionally, NII includes (1) any other gross income derived from a trade or business if such trade or business is a "passive activity" within the meaning of § 469, with respect to the taxpayer; and (2) any net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is not a passive activity under § 469 with respect to the taxpayer.

c. Now, a partner, includeing a limited partner, LLC member and an S corporation shareholder, will be subject to the 3.8% tax on his or her distributive share of the operating income of the partnership, LLC or S corporation, as the case may be, if the activity generating such income is passive under § 469 with respect to such partner, LLC member or S corporation shareholder.

9. Several types of income are specifically excluded from investment income, including (i) distributions from IRAs in qualified plans, (ii) non-passive trade or business income, (iii) tax-exempt income and tax-exempt annuities, and (iv) guaranteed payments from partnerships.

a. Deductions properly allocable to such income reduce NII.

b. Income derived in the ordinary course of business that is active (not passive) as to the taxpayer for such tax year is not included in NII

10. Passive vs. non-passive income for purposes of 3.8% tax

a. ***Planning Point:*** Convert passive income into non-passive income to avoid 3.8% tax.

b. Passive income is included in both AGI and net investment income for purposes of the 3.8% tax. However, the 3.8% tax generally does not apply to income generated from a trade or business in which the taxpayer is "active" for purposes of Code § 469.

c. To be treated as income from a non-passive activity, there must generally be (1) a trade or business and (2) material participation by the taxpayer.

(1) Code § 1411 does not provide a definition of "trade or business". However, the proposed regulations incorporate the rules under 162 for determining whether an activity is a trade or business for purposes of Code § 1411.

(a) Real Estate Professionals: The proposed regulations provide that a taxpayer who qualifies as a real estate professional for purposes of 169 is not necessarily engaged in a section 162 trade or business.

(2) Passive activity rules for trusts and estates have never been written. The IRS position is that trusts and estates are not treated as individuals for this purpose and that the *trustee* must be involved directly in the operations of the business (in the boots, in the mud on the cattle ranch, walking the ranch on a continual basis, etc.). In *Carter v. United States*, 256 F. Supp.2d 536 (N.D. Tex. 2003), the trust operated active ranch operations, and the trustee hired a ranch manager (who was not a trustee). The IRS maintained that was not material participation for the trust because the trustee individually did not materially participate. However, the Texas District Court concluded that material participation should be determined by reference to all persons who conducted the business on the trust's behalf, including employees as well as the trustee. The IRS has non-acquiesced in this decision.

(3) Technical Advice Memorandum 200733023 provides that merely labeling a person involved in the business as a "special trustee" will not suffice. The determining factor is whether the special trustee had powers that could be exercised solely without the approval of another trustee. If so, material participation of the special trustee would suffice.

(4) PLR 201317010 (January 18, 2013) – In the most recent IRS ruling on material participation for trusts, the IRS ruled that it would only look to the activities of the trustees, acting in their capacity as trustees, to determine whether the material participation test is met under Code § 469(h).

(a) Trust A and Trust B owned interests in Company X (S corp). Company X was the sole owner of Company Y (Q Sub). Each Trust had a trustee and a special trustee. Special Trustee was the only other shareholder of Company X and also served as president of Company Y. Special Trustee's authority was limited to decisions regarding the sale or retention of Company X and Company Y stock and the voting of such stock.

(b) The IRS said "the sole means for the Trusts to establish material participation in Company X and Company Y is if the fiduciaries, in their capacities as fiduciaries, are involved in the operations on a regular, continuous and substantial basis."

(c) The IRS refused to consider the activities of Special Trustee as a shareholder and president of Company Y, stating that he was not acting as a fiduciary while performing these roles. The IRS stated that the only activities of Special Trustee that could count towards material participation are those involving the voting or sale of stock because this was the extent of his fiduciary authority.

(5) If a trust owns an interest in an active trade or business operation, a planning consideration will be whether to name some individual who is actively involved in the business as a co-trustee. If that is done, income attributable to the business could avoid the 3.8% tax because it would not be passive income.

d. Examples

(1) Trade or business of renting.

(a) Trust A is a member (treated as a "partner" for tax purposes) in a limited liability company ("LLC"); the LLC owns several commercial buildings and provides various services (security, repairs, etc.) for tenants in the building. The trustee is the manager of the LLC and actively participates. Likely, not subject to NII Tax, but could the IRS apply PLR 201317010 to disregard the participation of the trustee as the <u>manager</u> of the LLC versus his participation as trustee of the trust?

(b) Trust B is sole member of an LLC which owns one commercial rental property rented to one tenant on a triple net lease basis with no services provided. Subject to NII.

(2) Net Gains from sale of property

(a) Trust B (from prior example) which owns one commercial real property (which did not constitute a trade or business property in which the Trustee actively participated) decides to sell the real property. Sale of investment real estate - subject to NII Tax.

(b) Trust A (from prior example) with LLC owning several commercial properties decides to sell them all. Sale of real property used in a trade or business is subject to NII Tax for the LLC's passive owners, but is not subject to NII Tax for the LLC's active owners (i.e., Trust A).

e. ***Planning Point:*** Real estate is often held in a separate entity from the operating business to isolate liability. If real estate that is used in the business is held in a separate entity from the operating company, the "self-rental rule" under § 469 generally provides that an owner who materially participates in the operating company will be deemed to materially participate in the entity (having similar ownership) holding the real estate, which means that rental income will not be passive income. However, the income must also be treated as income from a trade or business in order to avoid the 3.8% tax. It is unclear at this point if the IRS will seek to impose the 3.8% tax on these arrangements if the real estate entity is not deemed a trade or business, such as if it holds one property on a triple net lease. Therefore, it is important to consider whether restructuring to avoid the 3.8% tax will be beneficial.

B. Allocation of Capital Gain to Income to avoid 3.8% tax and 20% capital gains rate

If your income tax bracket is . . .	Then your capital gains tax rate is . . .
10% or 15%	0%
25%, 28%, 33% or 35%	15% + possibly 3.8%
39.6%	20% + 3.8%

1. ***Planning Point:*** Reduce capital gains tax by distributing capital gains from a non-grantor trust to beneficiaries in lower brackets. The difference in tax will typically be 5% or 8.8% (23.8% vs. 18.8% or 15%), although it can be as much as 23.8% if the beneficiary is in the 10% or 15% income tax bracket and subject to 0% capital gains tax rate.

2. Capital gains (unless attributable to the disposition of property held in an active trade or business) are an item of net investment income and, therefore, will incur a 20% tax and the 3.8% tax if the trust is in the top income tax bracket (i.e., > $11,950 in 2013). While distributions to beneficiaries generally reduce both adjusted gross income and net investment income, capital gains generally cannot be distributed because

capital gains are allocated to principal, thereby trapping them in the estate or trust. Code § 643.

a. However, Treasury Regulation § 1.643(a)-3 addresses when capital gains can be included in DNI and therefore, distributed to beneficiaries to be taxed at beneficiary rates. Two ways for capital gains to be allocated to income is if the trust instrument or local law either allocates such gains to income (which is rare) or authorizes the fiduciary to allocate such gains to income.

b. Since Florida does not define income to include capital gain, a trust instrument should be drafted to either direct how distributions are allocated against various types of taxable income or give the trustee discretion to allocate capital gains to income that is distributed.

3. A fiduciary can also avoid having capital gains trapped in the trust or estate by creating a limited liability company (LLC) or a partnership to hold trust assets. Distributions of money from a LLC or partnership are properly allocable to an estate or trust's distributable net income (DNI) even if the distributions include capital gains. Therefore, the partnership or LLC could sell assets and distribute the proceeds to the estate or trust. The estate or trust would include the partnership or LLC distribution in DNI, which means the tax items attributable to the partnership or LLC would flow out to the beneficiary if income was distributed from the estate or trust. This effectively shifts the capital gains to individual beneficiaries. Note that the partnership or LLC would need to distribute 100% of the income (i.e., not only the amount needed to pay the income tax) to allow the estate or trust to flow out 100% of the tax items from the partnership or LLC to the individual beneficiary. However, one must be careful to avoid Fla. Stat. § 738.401(7), which could prevent capital gains from an investment entity from being allocated to income under this type of plan if a "private trustee" is serving.

4. The ability to distribute capital gains could result in these gains being taxed at the beneficiaries' lower 15% bracket rather than 23.8% if they remained in the trust. Additionally, beneficiaries may have capital losses to offset capital gains received from a trust distribution.

a. Example: Trust has $20,000 of interest income and $50,000 long term capital gain from the sale of appreciated stock. If the trust distributes $70,000 to beneficiary (without allocating capital gains to income), then the beneficiary will be taxed on $20,000 of interest income, but not the $50,000 distribution of principal because DNI is only $20,000. The trust would pay $11,900 of capital gains tax (23.8% x $50,000). Alternatively, if the $50,000 of capital gains was allocated to income, and the beneficiary was not subject to NII tax, then the beneficiary would be taxed on $20,000 of interest income and $50,000 of capital gains because DNI would be $70,000. Thus, the trust would not pay capital gains tax and the beneficiary would pay $7,500 of capital gains tax ($50,000 x 15%).

b. However, be careful not to let the tax tail wag the dog. Distributions of capital gains will lose the benefits afforded by the trust, such as GST exemption, creditor and marital protections. Further, it may be contrary to the grantor's intent or be a possible breach of fiduciary duty.

VIII. Planning with (Nongrantor) Pot Trusts

A. ***Planning Point:*** Use pot trusts to spread income among beneficiaries in lower tax brackets.

B. Generally, trust income will be taxable to the beneficiaries who receive distributions of trust income. If the beneficiaries are in a lower tax bracket than the trust, then the income tax burden can be reduced. Additionally, the 3.8% tax can be avoided.

1. Example: Trust A has $50,000 of interest and dividends in 2013. The terms of Trust A permit the trustee to make distributions among the settlor's descendants for any purpose. Descendant A is in the 25% bracket; Descendant B is in the 15% bracket; and Descendant C is in the 39.6% bracket. If the Trust retained the income, it would be subject to 39.6% income tax on income above $11,950 plus 3.8% tax on income above $11,950. The total tax due would be $18,157.80 + $1,445.90 = $19,603.70. Alternatively, if the $50,000 of income was distributed equally among Descendant A and Descendant B, then Descendant A would pay a 25% tax on the distribution, while Descendant B would pay 15% tax on the distribution. Thus, the total income tax would be $6,250 + $3,750 = $10,000. The 3.8% tax would no longer apply.

C. 65 day election under Code § 663(b)

1. A fiduciary can elect to treat a distribution made within the first 65 days of a taxable year of an estate or trust as a distribution made of the last day of the preceding tax year. The deadline for making the election is the due date for filing the tax year return, including any extensions.

2. The amount to which the election applies to shall not exceed (1) the greater of (a) the income of the estate or trust for which the election is made, or (b) DNI for the prior year, (2) reduced by any amounts distributed during the tax year (other than amounts treated as paid in a preceding tax year).

3. The fiduciary can pick and choose which distributions the election applies to.

4. The beneficiary is treated as receiving the distribution in the tax year in which or with which the last day of the preceding estate or trust tax year ends.

5. This election allows distribution decisions to be deferred until after year-end when the beneficiaries' income tax situations may be more clear.

IX. Selecting a tax year

A. Estates

1. May select a fiscal year or calendar year. First tax year can be shorter than 12 months, but must end on the last day of a month.

a. Fiscal year can be adopted on a late-filed return if it is the first return filed for the estate. The filing of an extension to time to file or an SS-4 (application for EIN) does not establish an estate's tax year.

2. ***Planning points***:

a. If a return has not been filed for an estate of a decedent who died prior to November 30, 2012, consider electing a fiscal year ending November 30, 2012. The increased income tax brackets under ATRA and 3.8% tax apply to tax years beginning on or after 1/1/2013 and, therefore, would not apply to income of the estate for the year from 12/1/12 to 11/30/13 (unless distributions were made to beneficiaries).

b. Defer income tax payments - The selection of a tax year can have an impact on the amount of tax paid and the timing of payment because beneficiaries are deemed to receive their share of the income on the last day of the estate's fiscal year. For example, a fiscal year end of January 31, 2013 means that a beneficiary will not be required to pay tax on income distributions until April 15, 2014.

c. Select a short year to minimize taxable income to distributees – A short year can be elected to minimize the amount of distributions taxable to beneficiaries. For example, assume D died on May 1, 2013, the estate earned $1,000 during May and also distributed $25,000 during May. The estate could elect a fiscal year end May 31 so that the distributions in excess of $1,000 would not be taxable to the income beneficiaries.

d. Distributing income evenly among multiple years to reduce tax - A fiscal tax year could be selected to divide income into separate tax years. For example, assume D died in January 2013 and income will be collected monthly throughout 2013. The estate could elect a fiscal year end of June 30 to spread out the income over 2 tax years and get the benefit of an additional run-up the tax brackets.

B. Trusts

1. Must be calendar year

2. Exception: The trustee of a Qualified Revocable Trust (QRT) can elect, with the consent of the estate personal representative, to be taxed as part of an estate and, therefore, adopt the fiscal year of the estate. This "645 election" can be made even if there is no estate. § 1.645-1(c)(2).

a. QRT is defined as a trust over which the decedent held a power to revoke under code § 676 at death.

b. 645 election period continues until:

(1) If there is no estate tax return required to be filed, then 2 years from date of death; or

(2) If an estate tax return is required, then 6 months after a final determination of estate tax. Generally the final determination of estate tax is 6 months after issuance of the estate tax closing letter, which means the 645 election would terminate 12 months after issuance of a closing letter.

c. Upon termination of 645 period, estate continues on its fiscal year, but QRT becomes calendar year taxpayer.

d. ***Planning Point:*** The 645 election (Form 8853) must be filed by the deadline for filing the Form 1041 for the first tax year of the estate (regardless of whether an estate Form 1041 is required), including any extensions granted. If there is no estate, then the EIN for the QRT is used on the Form 1041. There is <u>no relief</u> from a missed Code 645 election. Therefore, if you intend to make the 645 election, do not miss the filing deadline.

X. Charitable Income Tax Planning for Estates and Trusts

A. Code § 642(c)

1. Trusts and estates may deduct under Code § 642(c)(1) gross income which, pursuant to the terms of the governing instrument, is distributed during the tax year for a charitable purpose specified in Code § 170(c). Additionally, estates and certain trusts may receive an unlimited deduction for income permanently set aside for a charitable purpose under Code 642(c)(2).

a. Practically, today this deduction is only available to estates. Potentially very useful for probate estates unable to distribute income currently.

b. For a complex trust to qualify for a deduction on the basis that it has "permanently set aside" assets for distribution to charity, it must have been created on or before October 9, 1969. **<u>HOWEVER</u>**, a revocable trust may qualify for the set aside deduction through a Code § 645 election.

2. Code § 642(c)(2) Set Aside Deduction for Testamentary Devises to Charitable Beneficiaries

a. Where a testamentary instrument makes a residuary devise to a charitable beneficiary, the 642(c)(1) deduction would generally not be available for the income attributable to the charity's share. Further, a Code §661(a) deduction would not be available for the income distributed to the charity. This could lead to the estate or Code § 645 Trust paying tax on income ultimately distributed to a charity.

b. The solution is to permanently set aside the income arising from the charity's beneficial share of the estate or Code § 645 trust.

c. Standard to get permanent set aside deduction under Code § 642(c)(2).

(1) Income must be irrevocably appropriated and dedicated for the ultimate distribution for charitable purposes.

(2) Set aside deduction is not available unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible.

(3) There is little authority concerning the effect of potential claims of creditors or pending litigation on the permanent set aside deduction.

(4) The set aside deduction is not permitted where the amount is subject to invasion for non-charitable purposes. Therefore, permanent set aside deduction may not be available for amounts set aside for CRTs and Charitable Lead Trusts (CLTs) because amounts may pass to non-charitable beneficiaries.

(5) Permanent set aside deduction is not available for phantom income received from a pass-through entity.

d. Code § 642(c)(2) deduction is available for IRD items that will ultimately pass to a charitable beneficiary.

3. Fiduciary can elect to treat a charitable distribution as being made in the prior tax year.

4. The deduction provided by Code § 642(c) trumps that allowable under Code § 170. The Code § 642(c) deduction differs from the Code § 170 deduction in several notable ways:

a. The Code § 642(c) deduction is unlimited.

b. Distributions to foreign charities are deductible under Code § 642(c)(1). However, Code § 642(c)(2) set aside deduction is not available for distributions to foreign charities.

c. An election is available to treat charitable distributions as if they were made in the prior year.

5. Gross Income Requirement

a. In order to be deductible, the distribution must be made from gross income.

b. Therefore, when property is sold to satisfy a charitable bequest or corpus is distributed to a charity, the Code § 642(c) deduction is not available. (can you get a deduction for capital gains??)

c. Code § 663(a)(2) provides that a Code § 661(a) distribution deduction is not available where a § 642(c) deduction applies. Even where the Code § 642(c) is not available for a distribution to a charitable beneficiary, the Code § 661(a) deduction STILL does not apply.

6. Planning Point. To accomplish philanthropic goals, individuals can consider requiring a trust otherwise created for a family member to pay a portion of its income for a charitable purpose specified in Code § 170(c). Alternatively, a trustee could be given the discretion to pay trust income for a charitable purpose specified in Code § 170(c).

7. Charitable Contribution for Pass Through Entity.

a. A charitable deduction under Code § 642(c) is available for charitable gifts made from the income of a pass-through entity even though the governing instrument of the trust or estate does not contain a direction providing for the distribution of income to charities.

b. Planning Point. It would appear that a trustee could create and fund a pass-through entity to obtain a charitable deduction under Code § 642(c) if the trust did not authorize distributions to charities.

B. Contribution of Appreciated Assets to a Charitable Remainder Trust (CRT)

1. ***Planning Point***: To defer recognizing long-term capital gain in a single year, contribute appreciated property to a CRT prior to the recognition event and have the CRT sell the property. The gain will be recognized to the donor over time as annuity or unitrust distributions are received instead of recognizing the entire gain in a single year. Moreover, the donor receives a charitable income tax deduction for the value of the remainder interest passing to charity, based on the fair market value of the contributed property.

2. CRT is a trust that provides for an annuity or unitrust interest to be paid out to a non-charitable beneficiary for a specified term, with a remainder interest passing to a charitable beneficiary.

3. Donor receives an income tax and gift tax charitable deduction for the value of the remainder interest passing to charity. If the donor or the donor's spouse is the annuity beneficiary, no taxable gift will be deemed to be made.

a. The amount of the charitable deduction will depend upon the type of property contributed and the type of charitable beneficiary (i.e., 50% charity, 30% charity, private foundation, etc.).

b. Planning Point: Many charitable trusts provide for the ability to substitute the charitable beneficiaries. If the trust instrument does not limit permissible charitable beneficiaries to 50% charities, the trust will be treated as having a 30% charity beneficiary regardless of the status of the actual remainder beneficiary. If consistent with the donor's wishes, the trust should specifically prohibit the selection of any charity other than a 50% charity in order to maximize the available deduction.

c. Type of Asset Contributed

(1) Long Term Capital Gain

(a) To a 50% Charity – Charitable contribution for full fair market value of the contributed asset; however, the charitable deduction is limited to 30% of donor's contribution base (i.e., AGI less NOL carrybacks)

(b) To a 30% Charity – Charitable contribution is generally limited to the donor's basis in the asset, with certain exceptions (such as publicly traded stock); however, the charitable deduction is limited to 20% of contribution base.

(2) Ordinary Income (includes short term capital gain property) – the deduction is limited to the donor's basis in the asset.

4. Planning Alternative

a. Mr. Donor contributes greatly appreciated stock to a Charitable Remainder Annuity Trust. Mr. and Mrs. Donor are the income beneficiaries and receive a generous annuity each year. Upon the death of the survivor, the remainder passes to a hospital (a 50% charity).

b. Assuming Mr. Donor's adjusted gross income is sizable and does not limit the amount of the deduction, he is limited only by the separate 30% deductibility limit for 50% charities and receives a significant income tax deduction for the value of the remainder interest in the year of contribution.

c. He uses the income tax savings to purchase a joint and survivor life insurance policy (in an ILIT) which will pay to his heirs upon the death of the survivor of him and his wife.

d. What has Mr. Donor accomplished?

(1) Income tax deduction

(2) Retained income stream for Mr. and Mrs. Donor

(3) Passed property to charity

(4) Insurance policy payable to heirs will replace the property otherwise passing to charity

(5) No gift tax paid on the contribution to the CRT, but possibly gift tax on the contributions to the ILIT.

(6) No estate tax paid on the asset

e. If he had sold the stock…

(1) Capital gains tax due upon sale at (possibly at 23.8% rate)

(2) No gift to charity

(3) Pay estate tax on after-tax proceeds of sale

5. Special rule for Net Investment Income of a CRT earned prior to 2013.

a. Although CRTs are not directly subject to the 3.8% tax, distributions from a CRT to a beneficiary may be. The character of the distributions in the hands of the non-charitable annuity beneficiary is determined under the tier system of Code § 664.

b. However, income realized by a CRT before the end of 2012 will not be subject to the 3.8% tax, even if it is distributed to beneficiaries after 2012. See Prop. Treas. Reg. § 1.1411-3(c)(2)(i).

C. Nonqualified-nongrantor CLTs

1. A non-qualified non-grantor charitable lead trust (NNCLT) is designed to provide the grantor with an unlimited income tax charitable deduction. It is used by high income grantors whose itemized deductions are significantly cut back under Code § 68..

a. The phase out of itemized deductions applies to taxpayers with AGI above (i) $300,000 for married, joint filers, (ii) $250,000 for married, separate filers, (iii) $250,000 for single filers and (iv) $275,000 for heads of households. These amounts are adjusted for inflation after 2013. The phase out amount is the lesser of 3% of the excess of AGI over the applicable phase out amount, or (ii) 80% of the otherwise allowable itemized deductions.

b. Example: A married couple filing a joint return has $2 million of AGI and $200,000 of itemized deductions. The phase out amount is $51,000 [$2,000,000 - $300,000) x 3% = $51,000; which is less than 80% of $200,000 = $160,000]. The taxpayer's itemized deductions are reduced from $200,000 to $149,000. Note that the reduction comes off the bottom of the itemized deductions, which means that the cut back only affects discretionary itemized deductions (such as charitable contributions) if the non-discretionary items (such as mortgage interest and real property taxes) exceed the cut back amount. For example, it the taxpayers in the above example had $100,000 of non-discretionary itemized deductions and $100,000 of charitable deductions, the $100,000 of charitable deductions would be unaffected by the cut back. In other words, the cut back is the same ($51,000) regardless of the amount of charitable deduction because it is essentially applied against the non-discretionary itemized deductions.

2. Under this technique, the grantor contributes income producing assets to the NNCLT. The NNCLT distributes all income annually to charities and receives an unlimited charitable deduction under Code § 642(c). The grantor's income tax is reduced because the grantor does not receive the income from the assets contributed to the NNCLT. Thus, the grantor receives, in effect, a deduction for the entire amount of income distributed to charities.

3. With the reinstatement of the phase out of itemized deductions under Code § 68, this technique may provide substantial benefits to high-income taxpayers.

4. It can also be used to avoid the 3.8% tax on NII. If the asset contributed to the charitable lead trust produces NII, the high income taxpayer will no longer be subject to the 3.8% tax because income will be incurred by the NNCLT (not the taxpayer) and the NNCLT will receive a 100% charitable deduction under Code § 642(c).

5. This technique works particularly well with assets that produce a consistent stream of income.

6. The NNCLT provides that all income must be annually distributed to charities, which means it is not a qualifying charitable trust under Code §§ 170, 2055 and 2522. Because the NNCLT is non-qualifying, the grantor does not receive an income or gift tax charitable deduction for the contribution to the trust.

7. Because the NNCLT is non-grantor, the trust is subject to normal Subchapter J income tax rules, including the unlimited charitable deduction under Code § 642(g) for income distributed to charities.

8. The NNCLT is designed so that the gift to the trust is incomplete for tax purposes. This avoids gift tax consequences on funding the trust, and the NNCLT will be included in the grantor’s estate for estate tax purposes. This treatment can be accomplished by the grantor retaining the right to annually designate a qualified charitable organization as the recipient of the trust’s income. When the grantor annually designates the charitable recipient of the trust's income, he will be deemed to have made a completed gift. However, the gift will be of money and not an interest in trust, and, therefore, should qualify for the gift tax charitable deduction. If the trust’s income is in excess of the annual exclusion amount (currently, $14,000), the grantor will be required to file a gift tax return.

9. If the grantor does not retain the remainder interest in the NNCLT, he will have made a completed gift of that interest.

10. The NNCLT is not subject to the private foundation rules.

XI. Income tax planning with Retirement Benefits

A. Only certain trusts qualify as a "designated beneficiary".

1. If trust does not qualify as a designated beneficiary, then:

a. If participant died before required beginning date[1] for distributions, then all benefits must be distributed no later than December 31 of the year that contains the fifth (5th) anniversary of the participant's death. Treas. Reg. § 1.401(a)(9)-3, A-2.

b. If participant died after the required beginning date, then benefits can only be extended over the participant's remaining life expectancy at the time of the participant's death (but plan can require faster payout). Treas. Reg. § 1.401(a)(9)-2, A-5.

2. If the trust qualifies as a designated beneficiary, then the benefits may be stretched out over the life expectancy of the oldest trust beneficiary. Treas. Reg. 1.401(a)(9)-4, A-5.

B. Requirements for a trust to qualify as a designated beneficiary (also known as a "see-through trust"):

1. Trust must be valid under state law;

2. Trust is irrevocable or becomes irrevocable upon death of participant;

3. Beneficiaries are identifiable from the trust instrument;

4. Certain documentation is provided to the plan administrator by October 31 of the year following the participant's death; and

5. All trust beneficiaries are individuals. Treas. Reg. § 1.401(a)(9)-4, A-5(b).

a. Caution: Any charitable gift to be paid from the trust at the participant's death, no matter how small, causes the trust to flunk this requirement. If there is a charitable gift to be paid at the participant's death, consider either prohibiting the retirement benefits from being used to fund the charitable gift or, if possible (e.g., a pecuniary devise) distribute the charitable gift prior to September 30 of the year after the year of the participant's death.

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[1] "Required Beginning Date" means April 1st of the calendar year following the later of: (1) The calendar year in which the employee attains age 70.5 years, or (2) The calendar year in which the employee retires.

b. Caution: Powers of appointment that include an estate or charity as a permissible appointee would cause trust to flunk this requirement.

C. Types of trusts to receive retirement benefits

1. "Conduit Trust"

a. A trust under which the trustee is required by the terms of the trust to distribute to the individual trust beneficiary or beneficiaries any distribution the trustee receives from the retirement plan.

b. Trustee has no power to accumulate plan distributions in the trust.

c. Individual trust beneficiary is generally in the same position as if he or she had been named directly, except that beneficiary does not have power to decide when and how to take the benefits. Therefore, benefits are payable over life expectancy of the trust beneficiary, except that if the spouse is the trust beneficiary, he or she can defer distributions until age 70.5.

d. Look only to the conduit beneficiary for purposes of determining whether the trust qualifies as a "see-through" trust. Remainder beneficiaries are not considered and, therefore, do not need to be individuals.

e. Uncertainty exists as to whether distribution of retirement benefits can be made "for the benefit of" the individual beneficiary or whether distributions must be made directly "to" the beneficiary.

(1) There is not any reliable IRS guidance on this point.

(2) This is significant for creditor protection purposes because once benefits are paid to the beneficiary, they can be reached by creditors.

f. Taxable distributions from the retirement plan which flow out to the beneficiary carry out DNI. Therefore, distributions are taxed at individual tax rates, not under the compressed trust income tax brackets.

2. Accumulation Trust

a. Trust has power to accumulate all or part of plan distributions within the trust, which prevents exposure of the assets to creditors of the beneficiary.

b. Current and remainder beneficiaries are generally counted for purposes of determining whether the trust qualifies as a "see-through trust".

(1) Caution: In PLR 201021038, the IRS refused to give retroactive effect for federal tax purposes to a local state court order which permitted reformation of a trust to remove charities as permissible appointees of a limited power or appointment. The purpose of the reformation action was to qualify the trust as a designated beneficiary. Because the reformation was not given retroactive effect for tax purposes, the trust, as it existed on the date of the decedent's death, had a potential beneficiary who was not an individual and thus, the trust failed to qualify as a designated beneficiary.

(2) PLR 201021038 seems to represent a change in the position of the IRS with respect to reformations. See PLRs 200235038 and 200620026. Without the ability to reform a trust post-death to qualify as a designated beneficiary, practitioners must be extremely careful to draft the trust correctly the first time.

c. Trustee can have discretion on when and how much to pay to trust beneficiaries.

d. Assets can be retained inside the trust for later distribution to remainder beneficiaries.

e. In accumulating distributions, consider that amounts accumulated in the trust will be taxed under the compressed income tax brackets for trusts.

(1) Note that distributions from a Roth IRA would not be taxable to the trust. Thus, an accumulation trust which receives distributions from a Roth IRA does not have the income tax disadvantage present when an accumulation trust receives distributions from a traditional IRA.

3. "Toggle" Trust

a. Based on PLR 200537044 - beneficiary designation named nine (9) sub-trusts structured as conduit trusts. Trust Protector had the authority under the trust to convert any conduit trust to an accumulation trust, and an accumulation trust to a conduit trust. Trust Protector also had the power to eliminate contingent beneficiaries who were older than the single beneficiary of the sub-trust, and to restrict the beneficiary's power to appoint trust assets to non-individuals or individuals older than the single beneficiary. Under the trust agreement, the effect of eliminating non-individual beneficiaries and older beneficiaries was to make such interests void ab initio.

(1) Within 9 months of death and prior to September 30 of the year following the death (the "beneficiary determination date"), the Trust Protector exercised the power to convert a conduit trust into an accumulation trust, limited to class of permissible appointees and takers in default to individuals younger than the beneficiary.

(2) IRS ruled that distributions could be stretched out over the life expectancy of the beneficiary of the converted trust.

b. It is uncertain whether this would work if such powers were exercised after the disclaimer period (if any time limit imposed by state law) and after the beneficiary determination date. To be safe, the protector should not be permitted to exercise the power after either date. See PLR 201021038.

4. Both trusts (before and after exercise of the amendment power) must qualify as see-through trusts.

D. Using retirement accounts to fund charitable gifts

1. Retirement accounts (other than Roth IRAs) carry with them built-in income tax liability to the beneficiary receiving them unless the beneficiary is a charity.

2. If a participant wants some of his assets to pass to a charity and some to non-charitable beneficiaries, it is most tax efficient for the participant to fund the charitable gifts with the taxable retirement assets and the non-charitable gifts with other assets which do not have built-in income tax liability.

3. Best to designate charity as beneficiary directly on the retirement account beneficiary designation form. If this is not desired, you can leave the retirement account to a trust and include the charitable gift in the trust. When doing this, the trust should direct that the retirement account be allocated first to the charitable gift before being allocated to gifts to non-charities.

E. Using retirement accounts to fund pecuniary bequests

1. Retirement accounts such as Traditional IRAs and 401(k) plans are known as "income in respect of a decedent" (IRD).

2. In the absence of a specific direction to use the retirement account to fund a pecuniary bequest, the retirement account becomes subject to income tax to the extent it is used to fund the bequest.

3. Consider either using fractional marital formula clauses or paying the retirement account directly to the specific trust to avoid the immediate recognition of income tax on bequest funding.