Tax Tips

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New Tax Landscape for Trusts

Trusts have historically been used for a variety of reasons: to benefit family members, charities, or even pets. They can be "permanent" by making them irrevocable, or they can be changed or terminated at the option of the grantor by making them revocable. They can be set up during life (inter vivos trusts) or at death (testamentary trusts).

Unless trusts are considered to be grantor trusts where income is taxed directly to the grantor, trusts are separate taxpayers, filing their own returns (Form 1041) annually and paying taxes at their own rates on amounts not distributed to beneficiaries. Due to new law changes effective in 2013, several of the tax rules for trusts have changed. Here are the new income tax rules to note.

Higher ordinary income tax rates

While trusts have graduated income tax rates, they are highly compressed. This means that trusts reach the highest income tax bracket of 39.6% by having taxable income in 2013 over $11,950 (Code Sec. 1(e) as changed by the American Taxpayer Relief Act (ATRA) (P.L. 112-240) and Rev. Rul. 2013-15, IRB 2013-5, 444). In effect, most trusts will pay nearly 40% on most of their taxable income.

The higher tax rate may lead some trusts that had been accumulating income to distribute to beneficiaries who are in tax brackets below 39.6%. However, it should be recognized that overall lower income taxes may come at a price: less funds in the trust for future generations. Thus, trustees given the flexibility to determine accumulations and distributions will have to balance tax savings against the grantor's expectations.

Use of the so-called "65-day" rule becomes more critical in light of the higher tax rate. Under this rule, a trustee can elect to treat distributions made within 65 days after the close of the trust's year as having been made in the previous year (Code Sec. 663(b)). For example, distributions made through March 6, 2014, can be treated as having been made in 2013. This is an annual election, so the trustee will have to review the income tax situation each year.

Capital gains and qualified dividends

Once trusts reach the top tax bracket of 39.6% on ordinary income, it means that they also pay the top rate of 20% on long-term capital gains and qualified dividends (Code Sec. 1(h)(1)(D)). The Medicare surtax of 3.8%, as described below, is applied to net investment income once this top bracket is reached. Small trusts with taxable income subject to rates below 39.6% continue to pay a 15% rate on long-term capital gains (or zero if the trusts are in the 15% tax bracket).

Because of the high capital gain rate, some individuals anticipating certain sales may want to use charitable remainder trusts (CRTs). These trusts can defer capital gains on these sales.

Alternative minimum tax

Trusts, like individuals, may be subject to an alternative minimum tax (AMT) at the rate of 26% or 28%, depending on the trust's alternative minimum taxable income. In the past, trusts had the same AMT exemption amount as married individuals who filed separate returns. As a result of the ATRA, the AMT exemption amount for trusts was set at $22,500 (Code Sec. 55(d)(1)). This amount is adjusted annually for inflation, so that the exemption amount for 2013 is $23,100 (Rev. Rul. 2013-15, IRB 2013-5, 444).

Net investment income tax

Starting for 2013, there is a 3.8% additional Medicare tax imposed on net investment income over a threshold amount (Code Sec. 1411). This tax, called the net investment income (NII) tax, is imposed on the lesser of the trust's net investment income or the excess of the trust's adjusted gross income over a threshold (Code Sec. 1411(a)(2)). The threshold is the dollar amount for the start of the top tax bracket ($11,950 for 2013).

Trusts exempt from the NII tax include:

- Charitable remainder trusts and other trusts exempt from income tax
- Trusts where all of the unexpired interests are devoted to charitable purposes
- Grantor trusts
- Trusts not treated as such for federal income tax purposes, such as real estate investment trusts (REITs)

Net investment income. Net investment income casts a wide net, including interest, dividends, capital gains (from the sales of stocks, bonds, and mutual funds; mutual fund distributions; and gains from investment property sales), rental and

royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities. Special rules apply to the sale of closely-held stock and partnership interests.

Net investment income does not include wages, unemployment compensation; operating income from a nonpassive business, Social Security Benefits, alimony, tax-exempt interest, self-employment income, Alaska Permanent Fund Dividends, and distributions from qualified retirement plans and IRAs (those described in Code Sections 401(a), 403(a), 403(b), 408, 408A, or 457(b)).

Investment income is reduced by deductions properly allocable to investment income, such as investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes properly allocable to items included in net investment income.

Proposed regulations clarify the application of the NII tax to specific types of trusts, such as electing small business trusts (REG-130507-11, 12/5/12). Any trust that is exempt from taxation (e.g., those exempt under Code Secs. 501(a), 664(c)(1), 220(e)(1), 223(e)(1), 529(a) and 530(a)), are also exempt from the NII tax under Code Sec. 1411.

Special rules apply for trusts with short taxable years (those that start during the taxable year or terminate before the end of the taxable year) (Prop. Reg. § 1.1411–3).

Planning strategies. Looking ahead, grantors with multiple beneficiaries may prefer to set up separate trusts for each one. This will allow each trust to keep no more than the triggering amount of taxable income ($11,950 in 2013) and, thus, avoid the NII tax. On the other hand, a single trust reduces administrative costs and may enable

better property management. Thus, tax savings from using multiple trusts should be balanced against the cost and practicalities of a single trust. Use of grantor trusts may pass the income to lower bracket beneficiaries. In-kind distributions should also be permitted to shift capital gains out of the trust.

State tax issues

Trusts with sufficient nexus (connection) to a state may owe income taxes and reporting to more than one state. Nexus can arise from owning property in a state or by having a grantor, trustee, or beneficiary within a state. Each state has its own rules for nexus. If income tax is required to be paid in more than one state, credits are usually available as an offset.

Foreign trusts

The overall tax increases on trusts may lead some individuals to conclude that putting money overseas is a solution. Doing so is probably not helpful. Special reporting rules make it virtually impossible to "hide" assets and avoid income taxes if this were the goal:

- Foreign Bank and Financial Accounts (FBAR) reporting is an annual obligation. Serious penalties result from reporting failures and foreign financial institutions are increasingly working with the U.S. to disclose the names of owners of foreign accounts.
- Foreign Account Tax Compliance Act (FATCA) reporting requires beneficiaries with certain interests in foreign trusts to disclose them on their federal income tax returns (and, of course, pay income tax on distributions they receive).

Conclusion

Trusts continue to serve a variety of important financial and personal purposes. They continue to protect vulnerable or incapacitated spouses, provide asset protection, and protect the interests of children from prior marriages. They can provide income and estate tax savings when used to benefit charities (e.g., charitable remainder trusts) or estate tax savings when certain types of gifts are made during life (e.g., grantor retained annuity/unitrusts or qualified personal residence trusts). However, tax law changes must now be taken into account in determining the types of investments held by trusts and the amount of distributions to beneficiaries where such distributions are authorized. These new rules place increased burdens on trustees and their advisors.