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Avoiding the High Post-ATRA Trust Tax Rates

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The 39.6% ordinary tax rate and 20% capital gain tax rate enacted by the American Taxpayer Relief Act of 2012 (ATRA) and the 3.8% Medicare investment surtax now apply when trust income exceeds $11,950. These high rates apply at much lower levels of income for trusts than for individual taxpayers as shown in the Table below. With this disparity in mind, grantors creating trusts and trustees managing trusts should consider the strategies that follow.

Tax Rate Comparison	Single Taxpayers			Trusts and Estates		
Marginal Income Tax Rate	Ordinary Income	Capital Gain	3.8% Medicare Investment Surtax	Ordinary Income	Capital Gain Income	3.8% Medicare Investment Surtax
10%	Below $8,925	0%	N/A	N/A	N/A	N/A
15%	$8,926 – 36,250	0%	N/A	Below $2,450	0%	N/A
25%	$36,251 – 87,850	15%	N/A	$2,451 – 5,700	15%	N/A
28%	$87,851 – 183,250	15%	N/A	$5,701 – 8,750	15%	N/A
33%	$183,251 – 398,350 (Itemized deduction and personal exemption phaseout starts when adjusted gross income (AGI) exceeds $200,000	15%	Applies to investment income when AGI exceeds $200,000	$8,750 – 11,950	15%	
35%	$398,350 – 400,000	15%	Applies to investment income when AGI exceeds $200,000	N/A	N/A	N/A
39.6%	Over $400,000	20%	Applies to investment income when AGI exceeds $200,000	Over $11,950	20%	Applies to investment income when income exceeds $11,950

Income Distributed By A Trust Is Deductible By The Trust

There are two broad types of trusts – grantor trusts and nongrantor trusts. Grantor trusts, best exemplified by the revocable trusts used by estate planners to avoid probate, are not subject to tax. The trust is ignored for tax purposes, and an individual grantor pays tax on the income earned by the assets in the trust on their person Form 1040.

Nongrantor trusts, usually irrevocable trusts such as qualified terminable interest property (QTIP) trusts, bypass trusts, and the spousal lifetime access trusts (SLATs) commonly created prior to the passage of ATRA, are taxable entities for which the trustee must file a tax return (Form 1041). Trusts are taxed similar to individuals, except that they are conduit entities like partnerships and S Corporations. Income distributed by the trustee to beneficiaries is taxable to the beneficiaries and deductible by the trust. Income is taxed either at the trust level or the beneficiary level, but not both.

For example, the Mary Jones Irrevocable Trust received $25,000 of interest and dividend income. The trust paid $7,500 in trustee fees and $500 for the preparation of its income tax return. The trustee has the discretion to distribute the $17,000 ($25,000 – 7,500 – 500) of net income to the individual beneficiaries, Sam and Deb, or retain the income in the trust. Aware that the tax rates applicable to the income retained in the trust exceed the rates applicable to Sam and Deb, the trustee distributes the income to Sam and Deb to be taxed on their personal returns. The trustee reports the distribution to Sam and Deb on a Trust K-1, similar to the K-1 forms used by partnerships and S Corporations. The trust has reduced its income and tax to zero for the year.

Trust Distribution Planning Strategies:

1. Because trusts are taxed similar to individuals, the trustee should take advantage of deductions at the trust level before determining the amount to be distributed to the beneficiaries. Typical deductions include the trust's often-wasted $100 exemption deduction, transaction costs, and appraiser, accountant, attorney, and fiduciary fees.

2. If the beneficiaries are subject to tax, but not at the highest rates, the trustee can spread the income between the trust and the beneficiaries, adjusting the distribution to minimize the tax at the trust and beneficiary levels. For example, if Stan and Deb pay tax at the 25% marginal tax rate, the trustee can take advantage of the 15% marginal tax rate applicable to the trust by retaining $2,450 of net income in the trust.

3. If the beneficiaries are dependents of their parents and the amount of investment income attributable to them exceeds $2,000, the beneficiaries may be subject to their parents' tax rate because of the "kiddie tax." If the parents are at the maximum tax rate, the "kiddie tax" eliminates the benefit of distributing income from the trust to the beneficiaries.

4. Under the 65-day rule, trustees have 65 days after the trust year end (usually March 6th) to think through these strategies, calculate the optimal distribution strategy, and make the distributions to the beneficiaries.

What About Capital Gain Income?

Since its original issuance in 1931, 45 states have adopted some version of the Uniform Principal and Income Act (UPAIA). Under the UPAIA, capital gains are generally allocated to principal, while interest income and dividends are treated as income. The following excerpt from the California version of the uniform act is illustrative:

"A trustee shall allocate to principal: ...(b) Subject to any contrary rules in this article ..., money or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including realized profit." (Section 16355 of the California Uniform Principal and Income Act)

To illustrate the significance of this allocation principle, assume a trust that is required to distribute income receives $25,000 of dividend income and recognizes $15,000 of capital gain income from trading securities. The trust will distribute the $25,000 of dividend income to be taxed on the beneficiaries' personal returns. However, the trust will pay tax on the $15,000 of capital gain income. Because the capital gains exceed $11,950, part of the gain will be subject to the maximum 20% capital gain rate and the 3.8% Medicare investment surtax.

While the UPAIA provides default allocations of income and principal, the defaults can be overridden by the language of the trust. The following excerpt from the California Act exemplifies this language: "Section 16335 (a) In allocating receipts and disbursements to or between principal and income, and with respect to any other matter within the scope of this chapter, a fiduciary:

(1) Shall administer a trust or decedent's estate in accordance with the trust or the will, even if there is a different provision in this chapter."

This provision provides an excellent opportunity for grantors establishing trusts, trustees managing trusts, and trust protectors amending trusts to add language that gives trustees the flexibility to minimize the impact of the current high tax rates. Sample language that might be added to a trust is set out below:

"Our Trustee shall determine how all Trustee fees, disbursements, receipts, and wasting assets will be credited, charged, and apportioned between principal and income in a fair, equitable, and practical manner. Our Trustee may allocate capital gain to income rather than principal."

Giving the trustee the power to distribute capital gain income to a lower-income beneficiary rather than accumulating it as principal in the trust subject to the high trust income tax rates could save the family 8.8% (23.8% - 15%) of the capital gain if the beneficiary is subject to the 15% capital gain rate and 23.8% if the beneficiary is subject to the 0% capital gain rate.

Asset Protection

Over the past few decades of estate planning, clients have flocked to discretionary trusts that hold all property in trust, often for many generations, allowing the trustee to make distributions that are not subject to an "ascertainable standard." The prevailing argument in favor of creating these discretionary trusts is that, because the beneficiaries' interests are not limited to an ascertainable standard, there is nothing for a creditor to attach a judgment against. While there are a few exceptions in some jurisdictions, discretionary trusts created by a grantor for the benefit of another beneficiary are incredibly powerful asset protection vehicles. However, there is an expensive tradeoff between retaining all income in a trust and providing the protections offered by a discretionary trust. If the trust retains the income during a taxable year, the trust may be subject to the maximum income tax rate plus the Medicare surtax. On the other hand, if the trust makes a distribution to the beneficiary, that distribution becomes the beneficiary's property and is thus exposed to potential claims of a creditor. In years that a trust beneficiary has low exposure to creditors and predators, it likely makes sense for the trustee to make distributions to the beneficiary in order to take advantage of the beneficiary's individual tax rate. If the beneficiary is at a higher risk of creditor attachment, then the trustee must consider whether the risk of attachment outweighs the tax liability of the income retained in the trust.

It is easy to see why selecting the right trustee is essential for a successful plan. Our job as advisors is to help clients understand these issues in the initial planning phase and to later guide the trustee through successful and tax-efficient trust administration as the plan matures.

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