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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2930

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From: Steve Leimberg's Estate Planning Newsletter

Subject: **Douglas Blattmachr, Marty Shenkman and Jonathan Blattmachr - How to Reduce the Income Tax Burden on Non-Grantor Trusts**

"Although the Build Back Better bill has not been enacted (yet) which would impose 5% and 8% surcharges on individuals with income over $10 million and $25 million and on decedents' estates and non-grantor trusts at just $200,000 and $500,000, estates and trusts will continue to be subject to very heavy income and net investment income taxes even without the surcharges. We are fortunate to have three of the country's top estate planners share a synopsis of what their upcoming article, which appear in full in the next issue of the ACTEC Journal about the heavy income tax burden trusts face and some of the ways to reduce it.

Some of their suggestions initially may seem downright bizarre: Allow distributions from a trust to charitable remainder trusts and to S corporations. But there is plenty of gold there if you take the time to think their recommendations through."

Douglas Blattmachr, **Martin Shenkman** and **Jonathan Blattmachr** provide members with commentary that examines how to reduce the income tax burden on non-grantor trust. Members who wish to learn more about this topic should consider joining Doug/Marty/Jonathan in their exclusive **LISI** Webinar on January 7th at 1pm titled: "How to Reduce the Income Tax Burden on Non-Grantor Trusts."

Douglas J. Blattmachr is the chair of the board of **Peak Trust Company** with offices in Anchorage and Las Vegas. Doug was instrumental in the enactment of the Alaska Trust Act, passed in 1997, one of the most important laws passed in modern times for estate and tax planning. It has been copied (sometimes with changes) in at least nineteen states.

Martin M. Shenkman is one of the country's most prolific authors and speakers in the country on estate and tax planning and one of the earliest grantors of an Alaska Trust. Marty practices in New York and New Jersey.

Jonathan G. Blattmachr is author or co-author of several books and many articles. He is a director at **Pioneer Wealth Partners LLC**, director of estate planning for the **Alaska Trust Company** and co-developer with Michael L. Graham, Esq., of Dallas, Texas of **Wealth Transfer Planning**, a software system for lawyers, published by Interactive Legal LLC (www.interactivelegal.com).

Now, here is Doug, Marty and Jonathan's commentary:

EXECUTIVE SUMMARY:

Since 1986, non-grantor trusts have faced much higher federal income taxes that an individual would, in most cases. There are many reasons for that phenomenon. One is that such trusts reach the highest federal income tax bracket and must pay net investment income tax (NIIT) on much lower levels of income. Another reason is that trusts (other than disability trusts) are essentially denied any standard deduction for income tax purposes. Trusts may provide enhanced income tax benefits such as being allowed their own state and local tax (SALT) deduction, at least under current law. Moreover, a trust is allowed a deduction for contributions of its gross income for a charitable purpose regardless of the level of adjusted gross income (except when the gross income includes unrelated business taxable income defined in Internal Revenue Code Sec. 512). But by using a discretionary trust under which the trustee may make distributions, not just to the loved ones of the property owner, but also to other trusts, including charitable remainder trusts, qualified subchapter S trusts (QSSTs) and S corporations which have QSSTs as their shareholders, the heavy income tax burden the income tax earned by the trust may be significantly reduced.

COMMENT:

Trusts Usually Pay More Federal Income Tax. Overall, and in general, trusts will face higher taxes on income than would an individual. Here is a list estimating how much more a trust may be burdened by federal income tax compared to a single and or married individual (who has no other income):

- Tax due on $25,000 of income by Single Individual ($1,350), by a Married Couple ($60), and by a Trust ($7,500)
- Tax due on $100,000 of income by Single Individual ($15,250), by a Married Couple ($8,700), and by a Trust ($35,000)
- Tax due on $200,000 of income by Single Individual ($41,500), by a Married Couple ($30,500), and by a Trust ($72,000)

And these comparisons will be worse for trusts (and decedents' estates) if the surcharges that have been proposed in the Congress of 5% and 8% are imposed on non-grantor trusts on income above $200,000 and $500,000, while the surcharges on individuals would not occur until their incomes exceed $10 million and $25 million. Trusts (and decedents' estates) can reduce the amount of taxable income upon which they pay income tax or upon which they pay NIIT by distributing distributable net income (DNI), defined in Code Sec. 643(a), to a beneficiary as described in Code Sec. 651 and 661.

Shifting Trust Income to Others. In general, but subject to exceptions and special rules, any distribution to a beneficiary is treated as consisting of the trust's DNI to the extent of the lesser of its DNI or the distribution. This has the effect of "shifting" the income from the trust to the beneficiary so the trust pays no tax on the distribution and the beneficiary must include it in gross income. Nonetheless, it may not be possible for a beneficiary who is subject to state income tax to avoid that tax while a trust usually can be structured and administered to avoid it. See, generally, Blattmachr & Shenkman, "State Income Taxation of Trusts: Some Lessons of *Kaestner*," 46 Estate Planning 3 (October 2019).

When distributions from a trust are required, as they generally are for marital deduction trusts described in Sections 2056(b) and 2523, the DNI to the extent of the required distribution will be so shifted. In such cases, the ability to shift income will be automatic whether or not that is beneficial from an income tax reduction perspective. In general, DNI is the trust's taxable income for the year determined without regard to the deduction for the distribution of DNI to beneficiaries. In some cases, capital gain income of a trust (or a decedent's estate) does not form part of DNI. (For a discussion of whether capital gain will form or be forced to form part of DNI, see Blattmachr & Gans, "The Final 'Income' Regulations: Their Meaning and Importance," Tax Notes 891, May 17, 2004).

Taxation of a QSST or CRT. A qualified subchapter S trust (QSST), described in Section 1361(d)(3), like most marital deduction trusts, is required to currently distribute its fiduciary accounting income (FAI), described in Section 643(b), to its beneficiary; however, all tax income of the S corporation, to the extent the QSST is a shareholder, is attributed to the trust beneficiary regardless of whether the income would constitute DNI. Distributions are also required for a charitable remainder trust (CRT) described in Section 664. However, a CRT is exempt from income tax; distributions to beneficiaries may be included in their gross income but not using traditional notions based upon DNI. See Section 664(c).

How a Discretionary Trust May Reduce Income Tax

Probably, a majority of large trusts created today, other than most marital deduction trusts, QSSTs and CRTs, do not mandate distributions but grant the trustees the discretion to make or not make distributions either for one or more specific purposes (such as health, education, maintenance and/or support) or for any reason to or among one or more beneficiaries. That discretion may permit the trustees to shift the DNI to a beneficiary who would pay lower taxes on the DNI than would the trust. Although the shift is limited to DNI for the year (and all trusts are required to use a calendar year for tax purposes), Section 663(b) allows the trustees to elect to treat any distribution within 65 days of the close of the year to be treated as made in the prior year up to the extent of the greater of the trust's FAI or DNI for the year to the extent not already distributed.

Hence, if the trust has several beneficiaries (such as all of the descendants of the person whose property was used to fund the trust), the trustees of a discretionary trust may decide as to which descendant or descendants to whom to shift DNI for the year by making distributions only to such beneficiary or beneficiaries. That may reduce the overall income tax on the DNI earned in the trust.

Of course, for one or for several reasons, it may not be appropriate to make distributions to certain beneficiaries. For example, the beneficiary may be subject to a state income tax that the trust would not have to pay or would pay a lower state income tax. (See, generally, Blattmachr & Shenkman, supra.) Another reason it may not be wise to make a distribution to a beneficiary is because the beneficiary will foolishly dissipate the distribution or because the beneficiary is experiencing or is anticipated to experience claims of creditors. Any distribution to the beneficiary might be attached by a creditor of the beneficiary.

Another reason why it may not be appropriate to make a trust distribution is when the beneficiary is receiving certain government payments or benefits. A person may be denied government benefits (such as Medicaid) if the individual's "non-exempt" assets or income exceeds a certain threshold. (The income and asset value levels in some cases are relatively low, subject to exceptions and special rules. See, generally, Feke, "Medicaid Eligibility: MAGI and Your Assets," available at https://www.verywellhealth.com/your-assets-magi-and-medicaid-eligibility-4144975).

Distributions to an individual may also mean subjecting the amount of the distribution at the beneficiary's death to federal or state death tax that otherwise would not be imposed.

It seems that it may be preferable to have a structure so that trust income taxed may be imposed in an efficient way. That might be accomplished by using a discretionary trust where the trustees could distribute DNI to individuals whom the former property owner would wish to benefit (such as his or her descendants), CRTs of which one or more of the same individuals are the beneficiaries, one or more QSSTs of which such individuals are the beneficiaries (note that each QSST may have only one beneficiary who must be a US income taxpayer), one or more S corporations of which a QSST with such a beneficiary is a shareholder. It may also be appropriate to permit distributions to the spouses of the individuals whom the former property owner wishes to benefit, such as his or her descendants, just in case the descendants is under the threat of a creditor claim.

Why Authorize Distributions to a CRT?

Authorizing distributions to a CRT may help avoid, at least temporarily, the income taxation of a trust's DNI. CRTs are income tax exempt. CRT's are subject to a 100% excise tax on unrelated business taxable income (UBTI). However, the character of income as UBTI is lost when distributed from a trust. See Schmolka, "The Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism," 40 Tax L. Rev. 1 (1984).

As detailed in a recent article, a so-called "net income with makeup charitable remainder unitrust," commonly called a "NIMCRUT," may provide significant opportunities to defer income taxation and, if the growth in the assets not so taxed is sufficient, the non-charitable beneficiaries may ultimately succeed to more wealth than if distributions to them had been made earlier. See M. Blattmachr, R. Fox & J. Blattmachr, "Using a Charitable Remainder Trust as the Recipient of Qualified Plan and IRA Interests", 47 Estate Planning 3 (May 2020).

So it may be appropriate to authorize but not mandate distributions to CRTs or NIMCRUTs if one or more of the named or described individual beneficiaries trust of the discretionary trust (such as descendants) are beneficiaries of the CRT or NIMCRUT.

Why Authorize Distributions to a QSST or S Corporation?

A distribution of DNI from a trust (or estate) to a QSST will mean the income will be taxed to the beneficiary of the QSST even if no distribution is made to him or her. To the extent the distribution constitutes FAI of the QSST, it (along with any other FAI the QSST receives) must be distributed, essentially immediately, to beneficiary. That FAI may be subject to claims of creditors of the beneficiary and may cause the beneficiary to have resources so great as to cause a loss of government benefits, such as Medicaid. Therefore, instead of or in addition to authorizing distributions to one or more QSSTs, of which one of the individual beneficiaries of the discretionary trust are beneficiaries, the trustees could be authorized to make distributions to any S corporation of which one or more of the beneficiaries of the discretionary trust are the shareholders or one or more QSSTs are the shareholders and each beneficiary of any such QSST is also an individual beneficiary of the discretionary trust. The S corporation income will be attributed to the beneficiary of any QSST which is a shareholder of the corporation.

In order to be a QSST, its sole beneficiary must be a US individual taxpayer and the beneficiary must elect to be taxed as though the trust were described in Section 678 to the extent of the income of the S corporation. If a beneficiary refuses to make the election, the trustees may simply refuse to make any distribution to or for the beneficiary. Fortunately, the trustees of a QSST may be authorized to and may make payments on behalf of beneficiary, such as paying the income taxes on the income imputed to the QSST beneficiary. (It probably would be wise to have someone other than the beneficiary or the trustee hold the only voting share in the S corporation and who, therefore, would control distributions from the corporation, which should foreclose a state agency from successfully contending the trust is an available resource.) This imputed income should not cause the beneficiary to be treated as having resources for purposes of government benefits and should not be subject to the claims of creditors of the QSST beneficiary. Furthermore, even though S corporation income may be imputed to the beneficiary for income tax purposes, that income, if not distributed, will not become part of the beneficiary's wealth for estate tax purposes.

Conclusion

Grantor trusts have been the main chassis upon which much of lifetime estate planning has been built. Proposals have been made which could make at least "new" grantor trusts adverse. In any case, a trust may be a grantor trust only while the trust's grantor is living. Although, in effect, a grantor trust may be created under Code Sec. 678 for a beneficiary by granting the beneficiary the unilateral right to withdraw property from the trust, such a power, in most jurisdictions, will make the trust assets, to the extent of the withdrawal power, subject to the claims of the creditors of the beneficiary.

In any case, authorizing trust distributions to charity, to the spouse of the beneficiary, to a CRT for the beneficiary or to an S corporation which has a QSST for the beneficiary as the shareholder may avoid attachment by the creditors of a beneficiary and provide opportunities to reduce income taxation of the trust's income.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Doug Blattmachr
Marty Shenkman
Jonathan Blattmachr

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Section 512; Section 643(a); Section 643(b); Section 651; Section 661; Section 664; Section 678; Section 1361(d)(3); M. Blattmachr, R. Fox & J. Blattmachr, "Using a Charitable Remainder Trust as the Recipient of Qualified Plan and IRA Interests", 47 Estate Planning 3 (May 2020); Schmolka, "The Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty Six Years of Astigmatism," 40 Tax L. Rev. 1 (1984); Feke, "Medicaid Eligibility: MAGI and Your Assets," available at https://www.verywellhealth.com/your-assets-magi-and-medicaid-eligibility-4144975; Blattmachr & Gans, "The Final 'Income' Regulations: Their Meaning and Importance," Tax Notes 891, May 17, 2004); Blattmachr & Shenkman, "State Income Taxation of Trusts: Some Lessons of *Kaestner*," 46 Estate Planning 3 (October 2019).

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