

## The Rising Tide of Fiduciary Taxes

### And One Capital Gains Strategy to Help Trusts from Getting Swamped

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“Why does a slight tax increase cost you two hundred dollars and a substantial tax cut save you thirty cents?”

—Peg Bracken

Welcome to 2013 and higher income taxes. The new rules don't apply only to individuals. Taxes also increased on estates and nongrantor trusts (“Trusts”). Tax brackets and related threshold amounts for Trusts have not been modified, however, to the same extent as those for individuals. For 2013, a Trust will be subject to the top marginal income tax rates, 39.6% on ordinary income and 20% on capital gains/qualified dividends, plus the additional 3.8% Medicare tax (technically, the Net Investment Income Tax or “NIIT”) at the low threshold of a modest \$11,950 of taxable income.

This Trust threshold is significantly lower than for individuals, who are subject to the NIIT at \$250,000 (married filed jointly) and \$200,000 (single) and reach top tax rates at \$450,000 (married filing jointly) and \$400,000 (single). This distinction is critical because, in some cases, the trustee may have some control over who is taxed. Further, there are strategies that may assist a fiduciary in structuring for maximum tax efficiency, thus elevating fiduciary income tax planning to heightened importance in 2013.

Most practitioners are well aware that even when interest and dividends are distributed to a beneficiary, capital gains are taxed at the trust level. After exploring the effect of the new rates and 3.8% tax, this article explores one potential shelter strategy of allocating gains to beneficiaries as well.

## **Trusts Are Paying More in 2013**

That Trusts are subject to a low threshold is nothing new. But, as the chart shows, the tax rates are now significantly higher:

### **Understanding the 3.8% Net Investment Income Tax**

The 3.8% Net Investment Income Tax applies to the lesser of a Trust's (1) undistributed net investment income (NII) and (2) excess of adjusted gross income (AGI) over the dollar amount at which the top tax bracket applies (that is, \$11,950 for 2013). For individuals, it applies to the lesser of (1) NII and (2) the excess of modified AGI over \$200,000 (or \$250,000 if married and filing jointly).

Net investment income includes capital gains, interest, dividends, royalties, rents (unless derived from ordinary business activities), nonqualified annuities, and passive business activities. The tax does not apply to wages, unemployment compensation, Social Security benefits, alimony, tax-exempt interest, self-employment income, qualified retirement income, active business income or gain from a sale of such a business, or charitable trusts.

Later we will discuss a strategy relating to capital gains, so here is a good place to parse the definitions. For the NII, net gains from the sale or exchange of property are included unless the property was held in a trade or business that is not a passive activity or generated from the trading of financial instruments, commodities, or working capital. As a result, the gains a trustee typically is focused on, from the sale of publicly traded stock, are included. In contrast, gains from the sale of a principal residence are not included.

The following example illustrates how to calculate NIIT. Assume a Trust has \$260,000 of undistributed net income, comprising \$160,000 of ordinary income (\$100,000 passive, \$60,000 active) and \$100,000 of long-term capital gains. The AGI is \$248,050 and the NII is \$200,000 (excluding the active business income). Thus, the NIIT is \$7,600, because the 3.8% tax rate is applied to the lesser of AGI and NII, which in this case is the NII of \$200,000.

### **Two Examples Highlight Effect**

Seeing the percentage increases in the rates can be enlightening, but the following two examples highlight just how drastic a change has occurred. For illustrative purposes, assume all income to be taxable income and, for ease of comparison, ignore personal exemptions and deductions. The first example demonstrates the increase in tax liability, and the second example analyzes shifting the liability—the effect of a distribution to beneficiaries in 2013.

**Example 1.** Assume the same facts as before—the Trust has \$260,000 of undistributed net income, comprising \$160,000 of ordinary income (\$100,000 passive, \$60,000 active) and \$100,000 of long-term capital gains. The 2012 tax would be \$69,934 versus the 2013 taxes of \$89,318 (\$81,718 income tax and \$7,600 NIIT). This reflects a total tax increase of \$19,384, or a whopping 27.7%.

**Example 2.** Assume a fully discretionary trust beneficiary with an annual income of \$0. Assume the Trust has ordinary (and accounting) income of \$40,000 (\$30,000 passive, \$10,000 active) and long-term capital gains of \$60,000. The following three scenarios reflect the range of results, and the waters are more muddied when a beneficiary has substantial other taxable income or is subject to the “Kiddie Tax,” *that is, taxes on certain unearned income of a child (under age 19 or 24, depending) at the parent’s marginal rate.*

1. No distributions to the beneficiary and capital gains are allocated to principal:

Total Tax: **\$29,278**

-\$14,197 (Income tax on \$40,000).

-\$12,000 (LTCG tax on \$60,000).

-\$3,081 (3.8% NIIT applies against the lesser of the AGI, which is \$88,050 (\$100,000 of total income less the \$11,950) and NII, which is \$90,000 (NII excludes active business income of \$10,000)).

2. Trust distributes \$40,000 of accounting income to beneficiary; capital gains are allocated to principal:
- 2.

Total Tax: **\$19,755**

Trust will pay tax of \$13,825.90:

—\$12,000 (LTCG tax on \$60,000), and

—\$1,825.90 (3.8% NIIT applies against the lesser of the AGI, which is \$48,050 (\$60,000 of total income less the \$11,950) and NII, which is \$60,000).

Beneficiary will pay tax of \$5,929:

—\$5,929 (income tax on \$40,000), and

—\$0 (NIIT; below \$200,000 threshold).

3. Trust distributes entire \$100,000 to beneficiary; capital gains are included in DNI:

Total Tax: **\$14,929**

Trust will pay tax of \$0 (all taxed to beneficiary).

Beneficiary will pay tax of \$14,929:

—\$9,000 (LTCG tax on \$60,000),

—\$5,929 (income tax on \$40,000), and

—\$0 (NIIT; below \$200,000 threshold).

The difference in the results is significant. Total if taxed all to the trust (#1) is \$14,349 (96%) more than if fully distributed and capital gains treated as DNI (#3). Total tax under (#1) is \$9,528 (48%) more than if income distributed and capital gains retained (#2).

### **So Is the Answer to Just Distribute All Income?**

Much is being written about the effect of the additional tax on trusts. Articles have gone so far as to suggest that trustees “must pay out all income” and even “consider eliminating” trusts. Without a doubt, your clients who are beneficiaries have a vested interest in this issue. And, if you or your client is a trustee, you already have asked yourself, what is the appropriate course of action in light of the duties owed to beneficiaries?

The effects of the new tax rules may startle a fiduciary, but it is crucial to keep in mind that there are numerous reasons for, and benefits of, trusts. These benefits can include wealth transfer, tax planning, protection from spendthrift beneficiaries and creditors (and potentially ex-spouses), ease of management, and combined investment opportunity. So, a trustee should perhaps consider the following five “TRUST” touchstones:

1. Tax rates have gone up, dramatically in many cases. Don't stick your head in the sand; crunch the numbers.
2. Revisit with the trustee and beneficiaries why the trust was created. Income taxes are an important, but usually not the only, factor. Often there are many additional critical aspects of a trust, and automatically distributing income or eliminating the trust may be counter to the purpose of the trust. Critical aspects that favor retaining income include estate and GST tax planning and preserving assets in the family line.
3. **Understand** that distributing income may help in some cases, but automatically distributing income may not solve the problem in many others. For example, the “Kiddie Tax” may snare distributions to younger beneficiaries (under 19 and to dependent, full-time students under 24), causing them to be taxed at the parents' marginal rate. Also, distributions to some beneficiaries may find them already at the highest rates, achieving no income tax efficiency. In addition, because planning may have been done to eliminate state income taxation at the trust level, including the state income tax effect on distributions to the beneficiary must be part of the overall analysis.
4. Situational awareness is critical, and the trustee's decisions should encompass the nuances applicable to each distinct family situation. In trust and estate planning, one size rarely (if ever) fits all.
5. Test, when relevant, for strategies that could minimize a Trust's exposure to the “new” taxes and higher rates other than outright distribution. Depending on many factors, including overall asset allocation, such strategies can include (1) using tax-exempt investments, such as municipal bonds; (2) employing tax deferred investments or accounts, such as life insurance, deferred annuities, deferred compensation, or qualified retirement plans; (3) investing in assets that have tax depreciation, such as real estate, oil, and gas; (4) adopting recognition deferral techniques, such as charitable remainder trusts, tax free exchanges, and installment sales; (5) including low turnover as a factor in the investment policy, whether through mutual funds, exchange traded funds, or directly managed individual stocks and bonds; (6) establishing grantor trusts; (7) converting passive into active income, by having the trustee's material participation in the activity (see, for example, TAM 201317010 released April 26, 2013, in which the trustee also served as employee of

the entity and the IRS concluded that only those actions taken in the capacity of trustee are to be measured for determining material participation); and (8) avoiding capital gains being trapped in the Trust.

We now turn our attention to this last strategy to examine whether capital gains can be shifted to beneficiaries.

### **A Capital Gains “Shelter”**

Many are aware of the general rule that, except in the final year of a nongrantor trust or estate administration, capital gains are taxed at the trust level, even when the trust requires all income to be distributed. But fiduciaries and counsel to fiduciaries must take the opportunity to garner a deeper understanding of the applicable rules. On doing so, we learn that it is possible to avoid capital gains' being taxed to a Trust three ways: (1) treating capital gains as part of the DNI deduction; (2) using a unitrust; or (3) taking advantage of IRC § 678(a) by having someone other than the grantor hold a power to appoint trust property, or the income from it, to him- or herself.

These three avenues can shift most or all of the capital gains to the beneficiary. In many circumstances, however, the first solution likely will be the option of choice. In short, it treats capital gains as part of the DNI deduction, causing them to be carried out on a K-1 and ultimately taxed to the beneficiary while the Trust enjoys a corresponding deduction.

The second and third strategies also can be effective, yet they subsume disadvantages such as less creditor protection or increased estate tax. For example, a unitrust can distribute more or less than what is needed to address the optimal result for surtax avoidance and optimal use of tax brackets. Further, IRC § 678(a) could make the trust a partial grantor trust, and that may be undesirable in a particular circumstance.

So, the question becomes how to escape the default rule that capital gains are excluded from DNI. Treas. Reg. § 1.643(a)-3(b)(1)-(3) provides that capital gains will be included in DNI if one of the following is true: (1) the trustee allocates gains to income; (2) the default allocation to principal applies, but gains consistently are treated by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or (3) the default rules apply, but gains are actually distributed to the beneficiary or used by the fiduciary to determine the amount that is distributed or required to be distributed to a beneficiary.

1. Under Treas. Reg. § 1.643(a)-3(b)(1), for a trustee to be able to allocate capital gains to income, the drafting attorney must have crafted a provision to trump the Uniform Principal and Income Act's default rules and give the trustee broad discretion to allocate between income and principal. This option can get complicated, however, because it may alter the allocation rules between principal and income. Nevertheless, it provides the most flexibility.
2. Under Treas. Reg. § 1.643(a)-3(b)(2), passing out of capital gains may be accomplished by fiduciary behavior. Thus, this may be the least complicated to implement because it only requires the trustee consistently to treat capital gains as part of the beneficiary's distribution. This option would be very easy, and probably the preferred method, for new Trusts, but has barriers for exist-

ing Trusts because the question remains whether a Trust can change its practice for 2013 and beyond (or “flip” back at some point in the future). One possibility could be to decant into a new Trust wherein the practice would be consistent with the regulation.

3. 3. Under Treas. Reg. § 1.643(a)-3(b)(3), gains can be shifted to beneficiaries so long as the trustee “actually distributes” capital gains. This subjects the trustee either to the challenges of tracing proceeds or the inflexibility of always using capital gains as part of a distribution. Very few trusts would include such a distribution provision, as it has various disadvantages including asset protection issues.

**Planning Pointer:** Whether any of these approaches is available and relevant to existing trusts, drafting attorneys should review boilerplate provisions that govern how capital gains are to be characterized and what, if any, discretion the trustee has or should have over making the determination.

### **Conclusion**

The income tax burden on Trusts has risen substantially. But there is a strong argument against blindly distributing income outright to beneficiaries. It may save some tax yet possibly squander the assets or defeat the overarching purpose of the trust—think GST exempt trusts—but other factors include if the beneficiary is a spendthrift or has asset protection issues, and if the assets would serve to increase the beneficiary’s taxable estate. Without a doubt, a fiduciary must consider the effect of taxes on the Trust but also must consider all relevant factors to determine the prudent course of action, and that may include shifting capital gains to beneficiaries, when possible.