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Trust Taxation Basics

Nancy Hall, CPA, AEP®

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ABOUT THE COURSE

Course Description: Trust Taxation Basics

Prerequisites and Advanced Preparation Required: None

Level of Course: Basic

Method of Delivery: Group-Live

CPE Information:
Estimated Number of CPE Credits Awarded, by Field of Study:
1.0 Credit

ABOUT YOUR PRESENTER

Nancy Hall, CPA, AEP®

Shareholder

Nancy specializes in providing tax and strategic planning advice to closely held businesses and related individuals. She works with a variety of small and medium sized businesses primarily in the areas of real estate, medical practices, construction, manufacturing and distribution. She also focuses on individual taxation issues which include trust and estate planning.

Nancy leads the firm's tax department and the Construction Client Service Team.

Email: nhall@wec-cpa.com
Office Phone: 757-625-4700
Direct Phone: 757-533-4128

OBJECTIVES

After Completing this course, you will be able to:

- **Differentiate** between the most common types of trusts.
- **Identify** most common tax planning strategies regarding trust taxation.

AGENDA

Types of Trusts:

- Revocable
- Irrevocable
- Simple
- Complex
- Grantor
  - Intentionally Defective Grantor Trust

Planning Strategies:

- IRC § 645 Election
- 65-Day Rule (IRC § 663(b) Election)
- Intentionally Defective Trust (IDGT) asset substitution

TRUSTS

In General:

- Trusts can be taxed on income, or the income can be passed out to beneficiaries on Schedule K-1, depending on the type of trust.
- Capital gains are generally taxed at the trust level, with a few exceptions.
- Trusts have compressed tax brackets, with income taxed at the maximum 37% after $12,500.
- Trust income can be subject to Net Investment Income Tax.
- Resident state income taxation, varies.

REVOCABLE TRUST

Definition:

Trust in which provisions can be altered or canceled dependent on the Grantor (creator). During life, income is distributed and reported to the Grantor.

- Grantor is often the trustee.
- Assets transferred to the trust are NOT considered a completed gift for transfer tax purposes.
- Income reported directly on the Grantor's individual income tax return (including capital gains).
- Trust is not used to avoid or reduce estate taxes.

REVOCABLE TRUST

Probate:

- Signing a Revocable Trust agreement does not avoid the probate process. The Grantor must “fund” the Revocable Trust.
- Merely having the Will “pour over” the assets to the Revocable Trust upon date of death does not avoid the probate process.
- Options to avoid the probate process:
  - Funding Revocable Trust
  - Joint Ownership with right of survivorship
  - Beneficiary designations
  - Transfer on Death and Payable on Death accounts

IRREVOCABLE TRUST

Definition:

Trust in which provisions cannot be altered or canceled by the Grantor. The Grantor no longer has dominion and control of the assets.

- Trustee is most often NOT the Grantor.
- Main reasons for use are asset protection and assets in the trust, including any future appreciation, are not included in the gross estate of the Grantor. Drawback, no step up in asset value at Grantor's date of death.
- Assets transferred to the trust are considered a completed gift for transfer tax purposes.
- Assets must stay in the trust until distribution occurs by the terms of the trust.

SIMPLE TRUST

Definition:

An irrevocable trust that is required to distribute all of its income at least annually (normally not capital gains) to the income beneficiary.

- The trust instrument cannot allow amounts to be paid, set aside or used in tax year for charitable purposes.
- The beneficiary pays tax on the income and the trust pays the tax on the capital gains.

Example Wording:

"…The Trustee shall distribute to, or for the benefit of, such beneficiary all of the net income of such trust annually…."

COMPLEX TRUST

Definition:

An irrevocable trust that is NOT required to distribute all of its income annually.

- Income retained by the trust and capital gains are taxed to the trust.
- The beneficiary is taxed only on income distributed.

Example Wording:

"…The Trustee shall distribute to, or for the benefit of, such beneficiary so much or all of the net income and principal of such trust as the Trustee considers desirable for the support, maintenance, health, medical care, education and best interests of such beneficiary…."

GRANTOR TRUST

Definition:

A trust that reports all income and deductions directly on the grantor's personal income tax return.

- All revocable trusts are grantor trusts.
- Trust does not pay income tax.
- Some irrevocable trusts are grantor trusts. Used as an estate planning strategy to reduce the Grantor's estate further by having the Grantor pay the income tax.

INTENTIONALLY DEFECTIVE GRANTOR TRUST

Definition:

An irrevocable trust that is a complete transfer to a trust for transfer tax purposes, but an incomplete “defective” transfer for income tax purposes.

- Taxed to the grantor on their personal income tax return.

Trustee Authority:

- Good strategy is to include an additional provision in the trust agreement which allows the “defective” power to be “turned off” by the trustee.

INTENTIONALLY DEFECTIVE GRANTOR TRUST (CONT.)

Most Common Defective Powers:

1. Identifying the grantor's spouse as trustee and granting the trustee the power to add beneficiaries IRC § 674(a)).
2. Retaining nonfiduciary power to reacquire or substitute assets in the trust (IRC § 675(4)(c)).
3. Permitting an independent trustee to make loans to the grantor with no adequate security (IRC § 675(2)).
4. Allowing the use of trust income to pay life insurance premiums on the grantor or grantor's spouse's life under IRC § 677(a)(3).
5. Make the grantor's spouse as an income beneficiary.

QUALIFIED S CORPORATION SHAREHOLDER

Under IRC § 1361(c)(2)(A), trusts that may be qualified S Corporation shareholders are:

- Grantor trusts;
- trusts that immediately before the death of the deemed owner were treated as owned by a US citizen or resident individual under IRC § 671-679, but only for two years after the individual's death. However, if an IRC § 645 election was made to treat the trust as part of the estate, then the estate may hold the S Corporation stock for the entire election period;
- trusts to which stock has been transferred by a will but only for the 2 years from the date of transfer.
- If a trust does not fall under the previous categories, either one of two following elections must be made in order to qualify as a S Corporation Shareholder:

QUALIFIED S CORPORATION SHAREHOLDER

- Qualified Subchapter S Trust (QSST):
  - Each shareholder reports his or her portion of income and the following conditions must be met:
    - Subchapter S income must be distributed at least annually to the trust's income beneficiary and any principal distribution may only go to current income beneficiary;
    - A QSST may only have one income beneficiary who must be a US citizen or resident, during the lifetime of the beneficiary;
    - Current income beneficiary's income interest terminates at the earlier of the current beneficiary's death or termination of the trust;
    - One trust document may create multiple trust QSST shares;
    - Current income beneficiary must make the QSST election.

QUALIFIED S CORPORATION SHAREHOLDER

- Electing Small Business Trust (ESBT):
  - All beneficiaries must be individuals, estates or charitable organizations;
  - May have multiple beneficiaries;
  - Trust income can be accumulated.
  - Income taxation:
    - S portion – income taxed at the maximum 37% rate.
    - Non S portion – either taxed at the effective trust tax rate (if not passed out to the beneficiary) or the beneficiary's tax rate.
  - Trustee must make the ESBT election and file with the IRS within the two month 15 day period beginning on the day the trust received the S Corporation stock.

RESIDENT STATE

Definition:

The definition of a "resident trust" varies between states. A trust or estate is typically considered a taxable resident when it meets one or more of the following conditions:

- The estate of a resident decedent;
- A trust created under the will of a state resident;
- A trust created by, or consisting of property of, a state resident;
- Trust beneficiaries are state residents in the current year;
- The trustee is located in the state.

Note: even if deemed a nonresident trust or estate, the fiduciary must file a return in a state in which there is income or gain from a state's sources.

COMMON TAX PLANNING STRATEGIES

IRC § 645 Election

Allows the executor of an estate and the trustee of a qualified revocable trust to elect to treat the estate and the trust as a single filing for tax purposes. Must check a box on page 1 of Form 1041 and attach Form 8855 to make the election.

Example: The grantor of a revocable trust passes away July 12th which creates a latest year-end of June 30th. Normally a irrevocable trust (created at Grantor's death) has a calendar year end. If a IRC § 645 election is made, the trust and the estate may elect to file together and have a year-end of June 30th.

COMMON TAX PLANNING STRATEGIES

IRC § 645 Election (cont.)

Benefits of making the IRC § 645 Election:

- Opportunity for trust to shift income and defer tax on a fiscal year-end.
- Estates are allowed charitable deduction for amounts permanently set aside for charitable purposes, whereas trusts are allowed charitable deduction only for amounts actually paid to charities during the year.
- Estate is allowed to own S-Corporation stock for longer time period that a trust before having to make a QSST or ESBT election.
- Estates have greater exemption that trusts ($600 exemption instead of $100 or $300 for trusts).
- Estates are not required to make estimated tax payments until the tax year ending two years after decedent's death.

COMMON TAX PLANNING STRATEGIES

65-Day Rule (IRC § 663(b) Election)

A compex trust may make a distribution within the first 65-days of the tax year and have it count as a distribution for the previous year. To make the election, you must check a box on page 2 of the Form 1041.

For example: A trust with calendar year-end of 12/31/2019 may make a distribution through March 5, 2020 and apply it to the 2019 tax year.

This is especially helpful to consider if a complex trust did not pass out all of the income for the prior year, and the beneficiary is paying tax at a lower rate than the trust. This mechanism of rate arbitrage helps create the most tax efficient manner of paying taxes.

COMMON TAX PLANNING STRATEGIES

Intentionally Defective Trust Asset Substitution

- Assets transferred to IDGT take the Grantor's carryover basis in the assets transferred.

- Offers the Grantor the chance to substitute the IDGT's appreciated assets for liquid assets with limited or no appreciation – at a later date.
  - If the appreciated assets are later included in the Grantor's estate – the beneficiaries would receive a stepped-up basis for income tax purposes.

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QUESTIONS?