Income Tax Planning with Trusts

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Objectives of Presentation

• Understanding what a grantor trust is and how it can be used to achieve beneficial income tax results.
  – What are the income tax ramifications of a grantor trust.
  – How to create a grantor trust.
  – Why the grantor paying the income tax usually is beneficial, and the ins and outs of tax reimbursement clauses.
  – Whether – and how – a grantor can toggle grantor trust status on and off.
• Planning opportunities for estate tax purposes with grantor trusts.
  – Utilizing the swap power.
• Gain a basic proficiency in the 3.8% surtax as applicable to trusts.
  – How to calculate the surtax.
  – Having capital gains taxed to beneficiaries rather than at the trust level.
What is a Grantor Trust?

- A “grantor trust” is a trust where the grantor is treated as the owner of the trust income and/or principal for federal income tax purposes.
- There are three ways that a grantor can “own” the trust assets for income tax purposes:
  - A power conferring ownership to the grantor can extend to income only or principal only.
  - The power can apply to a fractional share of the trust if it is a grantor trust with respect to only particular individuals of the whole trust, or if the power does not fully extend over all of the trust assets.
  - Finally, the power could apply to only specific assets in the trust rather than all trust assets.

What is a Grantor Trust?

- A grantor trust may be created by incorporating one of the powers listed in Sections 671-677 of the Internal Revenue Code:
  - Reversionary Interests (673): When the grantor retains a reversionary interest, the value of which, at the time of creation of the trust, exceeds 5% of the value of the trust. This is not often used, because it can result in estate tax inclusion.
  - Power to Control Beneficial Enjoyment (674): When the grantor retains a power of disposition of the trust (analogous to a power of beneficial enjoyment). This power must be exercisable by the grantor or a non-adverse party without the consent of an adverse party (a person with a substantial beneficial interest in the trust who would be adversely affected by the disposition). There are eight exceptions to this rule.
What is a Grantor Trust?

- **Administrative Powers** (675): When the grantor retains certain administrative powers. For the trust to be a grantor trust, the power has to be exercisable by the grantor or a non-adverse party without the consent of an adverse party.
  - **Power to Deal for Less than Adequate and Full Consideration**: This is not often used, because it puts the trust assets at risk of being included in the grantor’s estate for estate tax purposes.
  - **Power to Borrow Trust Property Without Adequate Interest or Security**: The instrument has to be explicit in granting this power (not just a typical lending power). It’s also good practice to include the requirement for adequate interest to be paid to avoid gift tax issues.

What is a Grantor Trust?

- **Administrative Powers** (675) (Cont.):
  - **Grantor Borrows Trust Property Without Adequate Interest/Security**: This is basically the exercise of the previous power in the absence of the instrument providing for this power. If the grantor actually borrows from the trust for less than adequate interest/security and has not repaid the loan by the start of the next taxable year, the trust will be considered a grantor trust.
  - **Power to Vote Stock, Control Investments, or Substitute Property**: These powers must be exercised by the grantor or a non-adverse party in a non-fiduciary capacity.
What is a Grantor Trust?

- **Power to Revoke** (676): When the grantor retains the power to revoke a trust and return title to the grantor. This is why this power is used for purposes of revocable management trusts.

- **Income for the Benefit of Grantor** (677): If the income of the trust can be, or actually is, used for the benefit of the grantor or the grantor's spouse. This powers include:
  - Discretion to distribute (or actual distribution of) income to the grantor or grantor’s spouse;
  - Discretion to hold/accumulate (or actual holding/accumulation of) trust income for the benefit of the grantor or grantor’s spouse; and
  - Discretion to apply (or actual application of) trust income to pay insurance premiums on life of grantor or grantor’s spouse.

What is a Grantor Trust?

- Most frequently used powers to create a grantor trust, because they are generally “safe” from inclusion of the trust assets into the grantor’s estate for federal estate tax purposes, are:
  - Power to add a charitable beneficiary (under Section 674);
  - Power to make loans to the grantor without adequate interest or security (under Section 675(2));
  - Power of substitution of trust assets for non-trust assets (under Section 675(4)); and
  - Power to use income to pay premiums on insurance on the life of grantor or grantor’s spouse (under Section 677(3)).
What is a Grantor Trust?

• Why is it advantageous for a grantor of a trust to pay the income tax liability rather than the trust itself to foot the bill?
  – Likely, if the grantor pays the tax, there will be less total tax. See the following example:
    • Grantor and Trust Each Pay Their Own Tax:
      – Grantor has a taxable income of $100,100 for 2013.
        (Single filer) Tax due = $21,321
      – Trust has taxable income of $100,100 for 2013. Tax due = $37,957
      – Total tax liability for both = $59,278
    • Grantor Pays All Tax:
      – Grantor taxed on $200,200. Tax due = $50,196
      – Less total tax paid

What is a Grantor Trust?

• Why is it advantageous for a grantor of a trust to pay the income tax liability rather than the trust itself to foot the bill? (Cont.)
  – By paying the taxes associated with the trust, the grantor effectively is making an additional gift-tax free gift to the trust. In other words, if the trust had to pay the tax itself, then the grantor would have to gift that much more to the trust in order to restore it to its pre-tax level of assets.
• What are tax reimbursement clauses and how should they be structured?
  – Tax reimbursement clauses give the trustee the ability to repay the grantor’s payment of the income tax associated with trust.
What is a Grantor Trust?

- What are tax reimbursement clauses and how should they be structured? (Cont.)
  - If a reimbursement clause is included, it should NOT require the trustee to reimburse the grantor for the tax paid.
    - Revenue Ruling 2004-64 held that in such a case, the entire value of the trust would be includible in the grantor’s estate for Federal estate tax purposes under 2036.
  - If a reimbursement clause is included, it’s better to make such reimbursement discretionary to the trustee. And, make sure that there’s no express or implied agreement between the trustee and the grantor that the reimbursement will be made.
    - Under those circumstances, the trust will not be includible in the grantor’s estate for estate tax purposes.

What is a Grantor Trust?

- Tax reimbursement clauses (made discretionary to the trustee) may be a good idea in two particular circumstances:
  - If there is any concern of cash-flow problems for the grantor in creating a grantor trust.
  - If there is concern about the tax liability of the trust growing substantially in the future (due to either a large appreciation in trust value or changes in the tax law).
- Still, tax reimbursement clauses should be used with caution...and handled with care. A central reason for creating a grantor trust in the first place is so that the grantor can effectively keep more money in the trust without making additional transfers. By reimbursing the grantor for taxes, this planning opportunity is undone.
What is a Grantor Trust?

- Can a grantor create a “toggle switch” to go between grantor trust status and non-grantor trust status? If so, how is that done?
  - Yes, it is possible to toggle back and forth.
  - There are two ways to accomplish this:
    - First: The trust instrument can allow the flexibility for the grantor to relinquish the power used to make the trust a grantor trust.
      - It is trickier to then switch it back on. The instrument should not let the grantor reacquire a relinquished power because this could be seen as the grantor amending the trust, which would cause it to be a grantor trust for the entire duration.
      - However, it is not required that a non-adverse party hold this re-acquiring power, so even the grantor’s spouse could be the one empowered to turn back on the power.
    - Second: The grantor can simply borrow income or principal from the trust and not repay the borrowed amount before the start of the trust’s taxable year in order to make the trust a grantor trust. To turn the switch back off, the grantor just repays the borrowed amount.
      - The only catch to this toggle power is that the grantor trust status is set on the first day of the taxable year, and the grantor may not know on that particular date whether or not he or she will want grantor trust status for that year.

What is a Grantor Trust?

- There are two ways to accomplish this: (Cont.)
  - Second: The grantor can simply borrow income or principal from the trust and not repay the borrowed amount before the start of the trust’s taxable year in order to make the trust a grantor trust. To turn the switch back off, the grantor just repays the borrowed amount.
    - The only catch to this toggle power is that the grantor trust status is set on the first day of the taxable year, and the grantor may not know on that particular date whether or not he or she will want grantor trust status for that year.
Planning Opportunities with Swap Powers

• Now that we know all about what a grantor trust is, let’s look at some great planning opportunities with grantor trusts that leverage income tax planning into estate tax planning.

• On of our Firm’s favorite methods to create a grantor trust is by giving the grantor the power to substitute trust assets.

• Remember that the grantor holding this power needs to ensure that the non-trust assets substituted for trust assets have identical value.
  – Appraisals are necessary!
  – It might even be good to have a written agreement between the grantor and the trustee that if the ultimate values are changed, the parties will be equalized accordingly.

• We’ll look at four ways that the swap power can be a valuable planning technique and might be advisable for a given client.

Planning Opportunities with Swap Powers

• Planning opportunity #1: **Leveraging the Basis Step-up Pre-death**
  – If we’ve structured the grantor trust right, then the assets held in it are not going to be includible in the grantor’s estate for Federal estate tax purposes.
  – Because of that, then those trust assets wouldn’t benefit from the 1014 rule that all assets in a decedent’s estate get a step-up in basis as of the date of death.
  – But, what if the assets the grantor put in the trust are very low basis assets?
  – Swap high basis assets of equal value with the low basis trust assets to get a step-up on the low basis assets.
  – This avoids the 1014(e) rule that if a donor gifts an asset within a year of death there will be no step-up in basis. There is no “gift” – just a swap!
Planning Opportunities with Swap Powers

• Planning opportunity #2: Preserving Loss Near Death
  – 1014 doesn’t just apply to step-UP basis, but may also step-DOWN basis if the asset on the date of death is valued lower than the decedent’s basis.
  – If there is a loss asset held by the grantor individually, they can swap that with a low basis asset in the grantor trust.
  – The low basis asset then gets the step-up in basis, and the loss is preserved in the trust.

Planning Opportunities with Swap Powers

• Planning opportunity #3: Escaping the Three-Year Rule
  – If a grantor owns a life insurance policy individually, likely the death benefit is substantially higher than current fair market face value.
  – If the grantor’s death is imminent, then he or she can’t create an ILIT and transfer the policy there because he or she won’t likely survive three years from the date of transfer.
  – Instead, if there’s a grantor trust, then the grantor can simply swap the life insurance policy with assets of equal value from the trust.
  – There’s no application of the three year rule because the transfer is for “full and adequate consideration.”
Planning Opportunities with Swap Powers

- Planning opportunity #4: **Residence Swaps**
  - Normally with a residence, you hear about qualified personal residence trusts (QPRT’s).
  - The problem with QPRT’s is that to be effective at keeping the residence outside of the gross estate, the grantor has to survive the applicable term of the QPRT.
  - If there’s concern about surviving the term, the grantor could swap the house with assets of equal value in the grantor trust.
  - If the grantor keeps living in the home post-swap, he or she will need to pay rent to the trust. This is potentially good news in that more assets can be transferred into the trust (and out of the grantor’s gross estate) without gift tax implications.

The 3.8% Surtax

- How is the 3.8% surtax calculated for a trust?
  - The surtax is imposed on “net investment income” (NII).
  - NII is composed of three categories of income:
    - Gross income from interest, dividends, annuities, royalties, and rents.
    - Gross income from passive activity (a trade or business that you do not materially participate in), or a trade or business of trading in financial instruments or commodities.
    - Net gain to the extent taken into account in computing taxable income.
  - After computation of these income categories, it is then reduced by deductions properly allocable to such gross income or net gain.
The 3.8% Surtax

• What is not subject to the 3.8% surtax?
  – Retirement plans (pension plans, annuity plans, IRA's [regular and Roth], deferred comp plans)
  – Net unrealized appreciation (attributed to employer securities)
  – Incentive stock options
  – Other income not within the definition of NII, including:
    • Wages, salary, other compensation;
    • Income on exercise of compensatory options;
    • Income on vesting of restricted stock;
    • Social Security benefits;
    • Alimony
  – Note that those “other income” items would be included in modified AGI.

The 3.8% Surtax

• A non-grantor trust is taxed on income either at the trust level or at the beneficiary level, depending on whether it’s held or distributed.
• To determine whether income is held or distributed, the trust tracks its “distributable net income” (DNI). Distributions to beneficiaries then carry out DNI, and the items of income that make up DNI are reported by the beneficiaries on their individual returns.
• DNI is basically the same as taxable income, but there are two main exceptions:
  – Municipal bond interest is not included in taxable income, but is included in DNI; and
  – Capital gains are included in taxable income, but generally are NOT included in DNI (but we’ll talk more about that in a moment).
The 3.8% Surtax

- These are the steps to determine the surtax:
  - Trust calculates DNI under the usual rules;
  - Trust calculates whether each item of DNI is NII or not;
  - Income items that are both (1) considered distributed for regular income tax purposes under DNI rules, and (2) considered NII, then those items are considered distributions of NII;
  - The beneficiary includes distributed NII in his/her individual NII;
  - The trust’s undistributed NII will be (1) the total NII of the trust, less (2) the amounts deemed distributed to the beneficiary.

The 3.8% Surtax

- Let’s look at an example (straight from the final Regs) on this calculation. Assume a trust has the following income (no expenses):
  - Dividend income = $15,000
  - Taxable Interest income = $10,000
  - Capital gain = $5,000
  - IRA taxable distribution = $75,000
  - TOTAL = $105,000
  - Trust makes a discretionary distribution of $10,000 to the beneficiary.
The 3.8% Surtax

• Steps 1 and 2 (from previous slide) – Calculate DNI and Determine whether items of income of DNI are also NII:

<table>
<thead>
<tr>
<th></th>
<th>Total Income</th>
<th>In DNI</th>
<th>In NII</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>$15,000</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Interest</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Capital Gain</td>
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<td>$5,000</td>
<td></td>
</tr>
<tr>
<td>IRA Distr.</td>
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<td>$75,000</td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>$105,000</td>
<td>$100,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

The 3.8% Surtax

• Step 3 - Income items that are both (1) considered distributed for regular income tax purposes under DNI rules, and (2) considered NII, then those items are considered distributions of NII.
  – In our example, only items that are both considered DNI and NII are dividend income ($15,000) and interest income ($10,000).
  – There is a $10,000 distribution to the beneficiary. That is 10% of the trust’s total DNI.
  – For DNI purposes, that is considered a distribution of 10% of each item of income that comprises DNI. So, for regular income tax purposes, the beneficiary includes in his/her individual return:
    • $1,500 of dividend income
    • $1,000 of interest income
    • $7,500 of IRA distribution
The 3.8% Surtax

• Step 4 - The beneficiary includes distributed NII in his/her individual NII
  – In our example, the beneficiary includes $1,500 of dividend income and $1,000 of interest income as his/her NII in his/her individual return.

• Step 5 - The trust’s undistributed NII will be (1) the total NII of the trust, less (2) the amounts deemed distributed to the beneficiary.
  – So, the trust’s undistributed NII will be the total NII ($30,000) less the $2,500 NII considered distributed to the beneficiary, which equals a total of $27,500.

The 3.8% Surtax

• How much NII is actually surtaxed? (Not all of it necessarily will be!)
  – To calculate what is surtaxed, we need to understand what the taxpayer’s “threshold” is. The “thresholds” for 2014 are:
    • Married, filing jointly - $250,000
    • Single, head of household - $200,000
    • Married, filing separately - $125,000
    • Trusts and Estates - $12,150
  – For individuals, we also need to know the “modified adjusted gross income” (MAGI) (adjusted gross income increased by the net amount of foreign-sourced income that was exempt for regular tax purposes).
The 3.8% Surtax

- For an individual, the surtax is assessed on the lesser of (1) NII, or (2) the excess of MAGI over the threshold.
- For a trust/estate, the surtax is assessed on the lesser of (1) undistributed NII, or (2) the excess of AGI over the threshold.

The chart below shows results for an individual. NII is set at $100,000 in each example.
The 3.8% Surtax

- Columns 1 and 2: Surtax is not triggered because combined other income and NII reach the threshold ($250K).
- Columns 3 and 4: Now there's sufficient other income to push the NII above the threshold. But, only the excess over the threshold is surtaxed.
- Column 5: Now, all of the NII is pushed over the threshold. All of the NII is surtaxed.

The 3.8% Surtax

- The chart below shows results for a trust. Remember a trust is just taxed on NII retained. NII is set at $10,000 in each example.
The 3.8% Surtax

- Column 1: Surtax is not triggered because combined other income and NII do not reach the threshold ($12,150).
- Columns 2 and 3: Now there's sufficient other income to push the NII above the threshold. But, only the excess over the threshold is surtaxed.
- Column 4: Now, all of the NII is pushed over the threshold. All of the NII is surtaxed.

The 3.8% Surtax

- Looking at how much lower the trust’s threshold is, it might be tempting to try and automatically push as much income out to the beneficiaries as possible. Beware of this approach. The trustee is first bound by the fiduciary duty, and below are just a few examples of reasons additional distributions to beneficiaries may not be good:
  - Distributing out from a bypass trust could increase a gross estate of the beneficiary;
  - Ability to contribute to a Roth IRA is phased out after modified AGI hits certain limits;
  - Deductibility of contributions to traditional IRA’s can be affected by AGI;
  - Taxability of Social Security benefits is affected by AGI;
  - Medical expenses are deductible as itemized deduction only to the extent they exceed a floor of 7.5% of AGI.
The 3.8% Surtax

• Distributing out capital gains to the beneficiary. This can be a good result. Here’s an example:
  – Bypass Trust for the benefit of the surviving spouse (“SS”). Trust requires income be paid to SS, and allows for discretionary principal distributions to SS. Trustee decides to make a discretionary $100 distribution of principal to SS. Assume that there’s the ability to include capital gains into DNI or not. Is it a better result to have the distribution carry DNI or not?
    • Scenario 1: Trust does not carry out capital gain with DNI, so $100 capital gain is taxed to the trust. Assume a top capital gain rate of 20% and a surtax of 3.8%. The trust pays $23.80.
    • Scenario 2: $100 distribution does carry out capital gain into DNI so SS is taxed on the capital gain. Assume top rate of 20% and 3.8% surtax. SS pays $23.80.

• Continuation of Example:
  – Tax ($23.80) is the same in both scenarios.
  – But, in Scenario 2, the trust doesn’t have to foot the bill. So, just like a grantor trust, the SS has effectively paid the tax for the trust or made a non-gift transfer to the trust.
• How do we get capital gains carried out with DNI?
The 3.8% Surtax

- Treasury Regulation 1.643(a)-3 governs.
  "(a) In general. Except as provided in 1.643(a)(6) [DNI of a foreign trust] and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) –

  (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph section 1.643(a)-3(b);

  (2) Allocated to corpus but treated consistently by the fiduciary on the trust’s books, records, and tax returns as part of a distribution to a beneficiary; or

  (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.”
The 3.8% Surtax

- There are TWO requirements under the Regulation to be able to carry out capital gains:
  - First: The capital gain must be properly allocated:
    - Allocated to income;
    - Allocated to income – discretionary in case of unitrust amount;
    - Allocated to corpus, and treated consistently as part of distribution to a beneficiary;
    - Allocated to corpus but actually distributed to beneficiary;
    - Allocated to corpus but used by the trustee in determining the amount distributed to the beneficiary.

The 3.8% Surtax

- Second: The capital gain must be properly authorized:
  - Pursuant to the terms of the trust and under local law (no discretion here);
  - Pursuant to a reasonable exercise of discretion by the trustee (in accordance with a power granted by the fiduciary by local law or the trust document if not prohibited by local law).
- The Regulation lists 14 examples of how this can work. Here are just a few:
  - The capital gains are allocated to fiduciary accounting income by the trust instrument.
  - Discretionary distributions of principal pursuant to discretion granted by the trust document. (The facts assume that the trustee has power under the document to deem discretionary distributions be made from capital gains. This is not a common term to see in a document, but could be added intentionally.)
The 3.8% Surtax

- The Regulation lists 14 examples of how this can work. Here are just a few: (Cont.)
  - Discretionary distributions of gain from sales of certain specific assets or a particular class of assets.
  - Utilizing the amount of capital gain to determine principal distributions. (Capital gains may be able to be somewhat controlled by the trustee in a given year, based on what is sold and when.)
  - Trustee utilizes the proceeds from a sale of assets to determine distributions.

Objectives of Presentation

- We hope you are coming away with an understanding of our presentation objectives:
  - Understanding what a grantor trust is.
    - What are the income tax ramifications of a grantor trust.
    - How to create a grantor trust.
    - Ins and outs of tax reimbursement clauses.
    - Toggle powers.
  - Planning opportunities for estate tax purposes with grantor trusts.
    - Utilizing the swap power.
  - Gain a basic proficiency in the 3.8% surtax as applicable to trusts.
    - How to calculate the surtax.
    - Having capital gains taxed to beneficiaries rather than at the trust level.
Questions??

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