# Marketplace
## An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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**TOPIC: Non-Grantor Trusts Can Be Taxing.**

**MARKET TREND:** Higher income tax rates and compressed rate schedules can require trustees to pay close attention to the management of non-grantor trusts.

**SYNOPSIS:** Income tax rates are an important aspect of administering non-grantor trusts. Trustees and their advisors should have a general understanding of the taxation of non-grantor trust income and the availability of deductions for distributions to beneficiaries in order to properly structure and implement procedures to monitor the impact of taxes at the trust level. Considerations that may be helpful for trustees of non-grantor trusts include distributions to beneficiaries in lower tax brackets, adjustments to the trust investment portfolio, the acquisition of life insurance, and coordinating the trust's gains and losses.

**TAKE AWAYS:** Higher income tax rates and compressed rate schedules applicable to nonl grantor trusts, combined with the imposition of the net investment income tax on passive trust income, are key considerations in the administration of nonl grantor trusts. Evaluating the impact of distributions to beneficiaries in lower tax brackets, the acquisition of life insurance, and the re-configuration of investment portfolios are all important management tools available to trustees. Advisors can assist clients and the trustees of their non-grantor trusts with implementation of these options to help preserve the trust's wealth for future beneficiaries.

**PRIOR REPORTS:** 14-12; 14-33; 15-22.

The vast majority of irrevocable trusts are non-grantor trusts (as even grantor trusts eventually will become non-grantor trusts). Given higher income tax rates and the bracket compression for non-grantor trusts, proper legacy management demands that more emphasis be placed on income tax considerations. A basic understanding of how non-grantor trusts are taxed can help trustees make optimal decisions for the trust and its beneficiaries.

***OVERVIEW:  NON-GRANTOR TRUST TAXATION***

***Income Tax Rate***.  A non-grantor trust is a separate tax-paying entity, which typically pays tax at the highest marginal rate (39.6%) on its income in excess of $12,300 (for 2015).  The trust pays tax on any taxable income retained by the trust, while distributions will pass taxable income out to the beneficiaries to be taxed at their individual income tax rates.

***General Deductions***.  Generally, non-grantor trusts are allowed the same deductions as individuals and also may deduct ordinary and necessary expenses incurred in carrying on a trade or business, in the production of income, the management of income producing property, and in the determination, collection and refund of any tax.  Further, the trust can deduct reasonable expenses, including trustee's fees and litigation expenses, incurred in the administration of the trust.[1]  If the trust instrument authorizes distributions to charity, the trust is allowed an unlimited deduction for amounts paid out of gross income (other than unrelated business income) to recognized charities.  Only limited deductions are available for charitable distributions of unrelated business income.

***Deductions for Distributions to Beneficiaries.***  In addition to general deductions, non-grantor trusts receive a deduction for distributions of taxable income to trust beneficiaries.  The amount of the deduction is based on a variety of factors, including the character of the income, whether a receipt or expense is allocated to income or principal, whether the trust is required to distribute income currently, and, importantly, the trust's distributable net income ("**DNI**").[2]

Application of the distribution deduction and determination of DNI are both highly technical, and a full discussion of determining the deduction is beyond the scope of this report.  Generally, however, a trust's distribution deduction will equal the lesser of the trust's taxable DNI (e.g., that portion of DNI that consists of taxable income) and the actual income distributed.[3]  The beneficiaries, and not the trust, then bear the tax on the income they received from the trust, at their applicable personal income tax rates.

***Highest Tax Bracket***.  Due to the compressed tax rate schedules, non-grantor trusts reach the maximum federal income tax rate, along with the higher capital gains tax rate and the 3.8% net investment income tax, at relatively modest income thresholds.  The table below illustrates the income and capital gains tax rates applicable to trusts for 2015.

| Income Thresholds | Income Tax Rate | Capital Gains Rate |
|---|---|---|
| $2,500 and under | 15% | 0% |
| $2,501 to $5,900 | 25% | 15% |
| $5,901 to $9,050 | 28% | 15% |
| $9,051 to $12,300 | 33% | 15% |
| $12,301 and over | 39.6% | 20% |

The combined impact of the various taxes applicable to non-grantor trusts has raised federal tax exposure on a trust's passive investments to as much as 43.3% (the tax liability is even higher when coupled with state income taxes), highlighting the

importance of addressing income taxes issues at both the trust and beneficiary level.

***PLANNING CONSIDERATIONS***

***Dispensing Trust Income through Distributions***. As noted, non-grantor trusts are subject to the highest income tax rates at fairly low income thresholds. The trust beneficiaries, on the other hand, may be in lower income tax brackets, and, in particular, may not be subject to the net investment income tax, depending on their personal income and investments. Thus, trustees can analyze the impact of income taxes on the trust as well as on the beneficiaries and consider making income distributions to beneficiaries.

***Life Insurance***. Life insurance products may make an appealing asset for non-grantor trusts. Growth that remains within the policy is not subject to current income, capital gains or net investment income tax under appropriate and long-standing tax laws and principles. Further, if the policy is not a modified endowment contract, the trust can access cash value up to its basis in the policy without current income tax.

***Investment Portfolio Management***. Another planning opportunity is to restructure the trust's investment portfolio. For some trusts, this may mean investing for growth rather than income (as with large cap dividend paying stocks), thereby deferring income taxes until securities are sold (and triggering long-term capital gains rates rather than higher ordinary income rates). For other trusts, a focus on after-tax income may mean shifting investments into tax-free bonds.

***Focusing On Gains and Losses***. A trust's unused losses do not carry out to the beneficiaries until the year the trust terminates. Accordingly, during any year the trust has high capital gains, the trust can take the opportunity to divest itself of those assets that are selling at a loss, thereby reducing income subject to capital gains taxes (and the corresponding net investment income tax). Similarly, during any year the trust has large losses, consideration should be given to selling assets that have large built-in gains.

***Election to Realize Gain on In-Kind Distributions***. In-kind distributions of property to beneficiaries generally do not trigger capital gain. Rather, the distribution carries out income to the beneficiaries equal to the lesser of the trust's basis in the asset or the fair market value of the asset. Code § 643(e)(3) provides an election to treat the in-kind distribution of appreciated property to a beneficiary as a sale, thereby triggering capital gain that can offset otherwise unused capital losses. The beneficiary is considered to have received a distribution of income equal to the fair market value of the property, thereby passing more income out to the beneficiary.

***The 65-Day Election***. Code § 663(b) allows the trustee of a complex trust (i.e., one allowed to accumulate income) to elect to treat distributions of income made within the first 65 days of a trust's tax year as being paid or credited on the last day of the prior tax year. This gives the trustee flexibility and time to analyze the prior year's tax situation and the anticipated tax issues for the upcoming year and make necessary adjustments to benefit beneficiaries.

## *TAKE AWAYS*

- Higher income tax rates and compressed rate schedules applicable to non-grantor trusts, combined with the imposition of the net investment income tax on passive trust income, are key considerations in the administration of non-grantor trusts.
- Considering the impact of distributions to beneficiaries in lower tax brackets, the acquisition of life insurance, and the re-configuration of investment portfolios are all important management tools available to trustees.
- Advisors can assist clients and the trustees of their non-grantor trusts with implementation of these options to help preserve the trust's wealth for future beneficiaries.

## NOTES

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[1] Deductible expenses that are directly attributable to one class of income (do-called "direct expenses") are allocated to that income (for example, repairs to a rental property are allocated to rental income). Any excess direct expenses and deductible expenses that are not directly attributable to a specific class of income (so-called "indirect expenses") may be allocated to any item of income (including capital gains). Direct expenses related to the production of tax-free income are not deductible. Indirect expenses related to the administration of the trust which are allocable to income must be pro-rated between taxable and tax-free income and the portion allocated to tax-free income is not deductible. Note, however, that non-grantor trusts are subject to the two-percent floor on miscellaneous itemized deductions. The two-percent floor does not apply to (i) expenses incurred in the administration of the trust that would not have been incurred had the property not been in the trust, (ii) the personal exemption allowed the trust, or (iii) the deduction for distributions to beneficiaries.

[2] The trust's DNI caps both the amount of the trust's distribution deduction and each beneficiary's taxable income resulting from a distribution, and determines the character of the income received by each beneficiary. In general, a trust's DNI is equal to (i) the trust's taxable income after deductible expenses (but without any allowed personal exemptions and the distribution deduction), plus (ii) tax-exempt income reduced by expenses allocated to such income, less (iii) net capital gains that are allocable to principal and are not paid, credited or required to be distributed to the trust's beneficiaries during the trust's tax year. Capital gains (whether long or short term) are generally treated as principal and are excluded from DNI unless they are (i) required by the trust instrument or state law to be allocated to income, (ii) allocated to corpus but consistently treated as part of a distribution to a beneficiary, or (iii) allocated to principal put actually distributed to a beneficiary. Capital gains excluded from DNI will be taxed to the trust. Capital losses can be used to reduce the trust's taxable income.

[3] For <u>simple trusts</u> (e.g., trusts that are required to distribute all of its income currently), the distribution deduction will equal the lesser of the trust's <u>taxable</u> DNI (e.g., that portion of DNI that consists of taxable income) and the actual income distributed. Note that each class of income retains the same character (e.g., interest, dividends, tax-free income, etc.) in the hands of the beneficiaries as in the hands of the trust and each beneficiary is treated as receiving a proportionate share of each class of income. If the income required to be distributed to the beneficiary exceeds taxable DNI, the trust's distribution deduction is limited to the taxable DNI - the trust (and not the beneficiary) pays the tax, if any, on the excess.

For <u>complex</u> trusts (i.e., trusts that are not simple trusts), the distribution deduction also will equal the lesser of the trust's taxable DNI and actual income distributions. the distribution deduction also will equal the lesser of the trust's taxable DNI and actual income distributions. Complex trusts, however, allocate the deduction between so-called "**first tier distributions**" and "**second-tier distributions**." Income distributions that are required to be made currently by the trust instrument (e.g., the trust requires that ½ of the trust's net income be distributed to a specific beneficiary at least annually), are first-tier distributions. Any other distributions are second-tier distributions.

- If distributions are either all first-tier or all second-tier, then the beneficiaries will be taxed proportionately on each class of income as for a simple trust.
- If both first-tier and second-tier distributions are made, then DNI is first allocated among the first-tier distributions, with each beneficiary deemed to receive a proportionate share of each class of income.
    - If total first-tier distributions exceeds DNI, each beneficiary of a first-tier distribution is taxed on his or her proportionate share of taxable DNI and the second-tier distributions are tax-free.
    - If total DNI exceeds total distributions, then each beneficiary is taxed on his or her proportionate share of taxable DNI.
    - If total distributions exceed DNI, but the first-tier distributions are less than DNI, then taxable DNI is first allocated among the first-tier distributions and the excess taxable DNI is allocated proportionately among the second-tier distributions.

Each beneficiary who receives a distribution of taxable income is treated as receiving a proportionate share of each class of income.

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