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Income Tax Options Run Out December 31 for Non-Grantor Trusts

(Content provided by The Advisors Forum; edited by James W. Garrett, Esq.)

Earlier this year our law firm presented a series of workshops on the Tax and Non-Tax Changes Affecting Trusts and Estates in 2013 as a result of the passing of the American Tax Payer Relief Act of 2012. While the impact this new law would have on raising the income tax rates on high wage earners was very clear, the impact on the taxation of trusts was largely ignored. Now, late in 2013 many advisers, like us, are "waking up" to the realization that many non-grantor trusts are going to take a big tax hit.

And if we, as advisors, are largely unaware, certainly most of our clients have not yet caught up to the impact of soaring income tax rates on non-grantor trusts and on estates in administration. Trustees and estate administrators must be informed immediately to implement strategies to mitigate the 2013 tax rate, eliminate the tax through distribution strategies in 2013, and deploy investment strategies and grantor trust solutions in 2014 and future tax years. Failure to act now will deliver a great shock to trust and estate beneficiaries – a shock that can be drastically reduced or eliminated if smart decisions get made now.

The combination of the increase in capital gains tax (now 20%) and the Affordable Care Act's Net Investment Income surcharge (an additional 3.8%) means that the tax impact on capital gains and dividends has gone up by an astonishing 60%! Those rates increased from 15% in 2012 to 23.8% in tax year 2013.

Although the top tax rate (including the 3.8% surcharge) was increased in 2013 for individuals and married couples, the highest rate affects taxpayers until they reach an Adjusted Gross Income of $400,000 to $450,000, respectively. *Non-grantor trusts and estates reach the highest tax rate at only $11,950, meaning that very modest trusts and estates will bear a heavy tax burden.*

Distribution Strategy

The surest way to minimize the impact of the trust tax rate is to distribute net investment income to the beneficiaries. Those distributions will be income taxable to the beneficiaries but will be taxed at the beneficiaries' individual rates.

First, trustees must examine the trust to determine to whom distributions can be made. Many trusts created at the death of a spouse allow distributions to be made to the surviving spouse and descendants of the trust maker. This flexibility allows the trustee to effectively "shop brackets" for income taxes and prioritize distributions of net investment income to beneficiaries at lower marginal rates. For example, the top tax bracket of a graduate student grandchild is likely lower than the trust maker's surviving spouse or another older beneficiary.

The trustee should consider making strategic trust distributions before year-end December 31, 2013. This essential timing will allow the taxable income to be taxed to the beneficiary as 2013 income, allowing the trust to take an offsetting deduction of the income distributed in 2013.
Alternatively, the trustee can decide to wait to make an early distribution in 2014, while preserving the

offsetting income tax for the trust in 2013 if desirable. This is a textbook application of the "65-day rule" which allows tax election for a distribution made to a beneficiary within 65 days of the calendar year. The trust will be able to take a deduction on 2013 taxes. (Planning Tip: It's often best to make these distributions by the end of February to be safely within the 65-day rule.)

Professional advice and coordination for properly timing distributions are critical. Income tax strategic planning for trusts and estates needs to be carefully coordinated with the beneficiary's overall tax situation. The trustee must take into consideration the 2013 taxable income and future 2014 taxable income of each beneficiary. For example, if a married beneficiary sold a highly valued asset for substantial taxable capital gain in 2013, driving up her adjusted gross income to above $450,000 where her top rate is already 23.8% on her personal joint return, it will be best to delay distribution until early 2014 when her adjusted gross income is likely to be lower.

The annual tax reduction for making a distribution taxable to a beneficiary rather than to a trust is substantial. By distributing $50,000 of capital gains and dividends to a beneficiary who is still in a 15% tax bracket for capital gains and dividends, the federal tax savings will be at least $4,500 per $50,000 distributed. The beneficiary will pay Federal Income tax of only $7,500 versus nearly $12,000 if held and taxed in the trust.

Distributing ordinary income such as short-term gains and interest income from corporate or government bonds, tax savings is much greater and can be more than $15,000 per $50,000 of income distributed. Ordinary income and short-term gains are now taxed to the trust at a top federal rate of 43.8%, for all income greater than the $11,950 threshold. The 2013 tax law has a married couple at a 25% bracket above $72,500 of taxable income, so a $50,000 distribution of ordinary income will create a $12,500 tax on a joint return versus about $22,000 if retained by the trust. Of course, if the beneficiary chosen is at a lower tax bracket, it is possible the income tax may be far less or nonexistent.

Savvy advisors will also be alert for the kiddie tax, which would cause distributions to be included on the tax returns of parents if the distributions are made to a full time student age 24 or under.

Investment Strategies

In many cases, distributions to beneficiaries may not be the best solution from an asset protection perspective. If there are compelling reasons to hold funds within the trust to protect beneficiaries, the trustee should consider changing the character of the investments to tax free investments.

For example, it may be wise for the trustee consult with investment advisors to combine a municipal bond portfolio balanced with other investment strategies for taxable investment assets held and owned outside the trust by the beneficiary. Municipal bond investments should be fully vetted with experienced financial professionals but the tax free nature of these tools should be taken into consideration as part of an overall investment and income tax planning strategy.

Life insurance and the growth of assets within a life insurance policy is another truly tax free asset and is an underused strategy. The trustee should consider investing in life insurance on the life of one or more of the beneficiaries.

As part of a long-term investment strategy a life insurance policy that qualifies as a non-modified endowment policy, referred to as a “non-MEC” policy, will allow the trustee the option to borrow tax free from the policy and distribute or lend funds to beneficiaries on a tax free basis. (Importantly, the trustee must not be an insured covered by the policy.)

If there is no perceived need for funds from the policy, the policy could even be purchased as a modified endowment policy – a “MEC" policy – that essentially will cause income taxation on growth of policy values if withdrawn or borrowed in the same fashion as an annuity or bond portfolio. Nevertheless, both MEC and non-MEC policies allow the entire death benefit to be tax free to the trust on the death of the insured.

Grantor Trust Solutions

Distribution of income is for “Dynasty” or “Multigenerational” Trusts only a partial solution and contrary to the intention of the original creator of the trust. There is, as stated above, a delicate balance a trustee must measure in determining whether to distribute income from the trust to a beneficiary, and thus losing the benefits of the asset protection, divorce protection and future state and federal estate tax avoidance of the trust, or retaining the assets in trust and paying income taxes in the trust’s more compressed income tax brackets. Estate planners and advisors should understand that this is not an “either/or” proposition. Income tax strategic planning can be coupled with powerful trust protections envisioned by the original maker of the trust and also to achieve both the income tax flexibility and the asset protection a client desires.

For example, a beneficiary may choose to create a special grantor trust into which he or she can annually deposit the net after tax distributions he or she receives from the original trust or the beneficiary’s spouse may create a grantor trust on behalf of the beneficiary spouse. Under both grantor trust solutions all of the protections of the original trust are preserved but in the normally lower personal income tax brackets.

Self-Settled Asset Protection Trust

Currently 14 states have statutes allowing a trust maker to create a self-settled asset protection trust and to remain a beneficiary. The net after tax distribution from the non-grantor trust can be placed into a trust created in one of those jurisdictions by the beneficiary who is the grantor of the new “grantor” trust.

These strategies will use some of the beneficiary’s lifetime gift credit (inflation adjusted to $5,340,000 in 2014) but because the trust is a grantor trust for income tax purposes, the income will be taxed at the beneficiary’s individual income tax rates, as opposed to the non-grantor trust rates.

If the beneficiary needs funds, he or she can still look to the undistributed income or corpus of the original tax challenged non-grantor trust under which he or she is a beneficiary and often sole or co-trustee. Of course, the trustee can distribute or loan funds to the beneficiary from the new, smaller grantor trust as well. Thus complete access is assured. If no funds are ever needed then the current and subsequent beneficiaries will enjoy lower income taxes during their lifetimes, while preserving asset protection, divorce protection, and by allocating Generation Skipping Tax (GST) Exemption the avoidance of estate tax and administrative expenses for multiple generations as envisioned by the creator of the original trust.

Family Bank Trust
Another practical grantor-trust-driven long-term solution is the Family Bank Trust (sometimes called "Spousal Access" trust). If the beneficiary of the non-grantor trust is married, and if the beneficiary and their spouse file a joint tax return, the non-beneficiary spouse can create a grantor trust for the benefit of the beneficiary spouse and descendants and fund it annually with an amount *equal to the after-tax proceeds paid to the beneficiary spouse from the original trust*.

The non-beneficiary spouse as grantor (that is, the trust maker of the Family Bank Trust) may then appoint the beneficiary spouse as either a co-trustee or sole trustee of the Family Bank Trust, mimicking and honoring the terms created within the initial trust as to beneficiaries and trustees. Since it is a "third party trust" it is asset protected, and since GST normally will be allocated it provides estate tax protection for multiple generations. The Family Bank Trust has the additional advantage that it can be created in every jurisdiction and is far simpler administratively than a self-settled trust. Of course, the income tax results are ideal. Since all income is taxed to the grantor/trust maker spouse it is taxed to the couple, since it will appear on their jointly filed 1040 income tax return, achieving the result of avoiding the higher trust income tax rates for years to come.

Time is running out!
The time is NOW for clients, prospective clients, financial professionals, attorneys and CPAs to take action and eliminate or substantially reduce the impact of the higher 2013 tax rates. Smart strategies allow clients to reduce tax liability and enjoy protective benefits of trusts, but they must act swiftly with intelligent counsel to accomplish their goals.