Avoiding the Squeeze: Trusts, Estates, and the New ATRA Tax Regime

Higher income tax rates and the net investment income tax change the rules for trust and estate planning.

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Trusts and estates are recognized as separate taxable entities for federal income tax purposes. The estate or trust must file a return on Form 1041, U.S. Income Tax Return for Estates and Trusts, on or before the 15th day of the fourth month following the close of the tax year if it has gross income of $600 or more. A trust generally must have a calendar tax year, but an estate may have a fiscal year.

An estate or trust is generally regarded as a conduit of its income and is allowed a deduction for the portion of income that is currently distributable or distributed to the beneficiaries. Income allocated to a beneficiary is taxed to the beneficiary, retaining the same character that it had in
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the estate or trust. This concept of income’s retaining its character in the hands of trust and estate beneficiaries is very important under the provisions of the American Taxpayer Relief Act of 2012 (ATRA), P.L. 112-240.

It is important to understand how taxable income is computed for an estate or trust. Gross income is reduced by (1) deductions for expenses paid or incurred in connection with the administration of the trust or estate that would not have been incurred if the property were not held in a trust or estate, (2) deductions for income distributions to beneficiaries, and (3) personal exemptions. Income is determined under the governing instrument and local law. The regulations recognize the importance of local state provisions in determining the income of a trust or estate (Regs. Sec. 1.643(b)-1).

2012 Legislation
ATRA raised tax rates on individuals, estates, and trusts by raising the maximum tax bracket from 35% to 39.6%. The capital gains tax on the highest income tax bracket increased from 15% to 20%. These maximum brackets are effective for individual taxpayers once taxable income exceeds $400,000 for an individual and $450,000 for taxpayers married filing jointly. The threshold for head-of-household filing status is $425,000, and for married couples filing separately it is $225,000 (Sec. 1).

In contrast, the income tax brackets for trusts and estates are extremely condensed. For 2014, once the estate or trust has taxable income in excess of $12,150, the top rates of 39.6% for ordinary income (Sec. 1(e) and Rev. Proc. 2013-35) and 20% for long-term capital gains apply (Sec. 1(h)).

In addition, the Health Care and Education Reconciliation Act, P.L. 111-152, (part of 2010’s health care reform legislation) ushered in a complicated new unearned income Medicare contribution tax of 3.8% on net investment income in excess of certain thresholds. The tax is effective for tax years beginning after Dec. 31, 2012. For most trusts, the tax will generally be effective for the year beginning Jan. 1, 2013. An estate, which can have a fiscal year, can adopt, for example, a Nov. 30 year end, in which case the 3.8% surtax would not be imposed until the tax year beginning Dec. 1, 2013.

Net Investment Income
Net investment income consists of gross income from interest, dividends, annuities, royalties, and rents, other than those arising in the ordinary course of a trade or business other than a trade or business that is a passive activity or a trade or business.
of trading in financial instruments or commodities (Sec. 1411(c)(1)). It also includes other gross income from a passive activity or a trade or business of trading in financial instruments or commodities (Sec. 1411(c)(2)). In addition, it includes net gain attributable to the disposition of property other than property held for use in a trade or business that is not a passive activity or a trade or business of trading in financial instruments or commodities. Deductions that are properly allocable to condensed income tax brackets for estates and trusts will result in many entities’ being subject to the highest tax brackets and the surtax. In contrast, many individual beneficiaries will be in lower income tax brackets and not be subject to the surtax.

**PLANNING OPTIONS**

The primary planning objectives for trust and estate administrators are to avoid the condensed trust and estate income tax brackets, benefit from the beneficiaries’ interest in a passive activity, because income from a passive activity is subject to the 3.8% surtax. If the fiduciary materially participates in the activity, it might be possible to avoid having the activity labeled as passive. Although the issue is beyond the scope of this article, the IRS has stated that it recognizes that the activities of a fiduciary having sufficient discretion and control over the affairs of the trust may qualify as material participation (IRS Technical Advice Memorandum 201317010).

It may be possible to either (1) distribute appreciated property directly to the beneficiary so that the beneficiary recognizes the capital gain upon sale or (2) include capital gains in distributable net income.

**DISTRIBUTABLE NET INCOME**

Estate and trusts use the concept of distributable net income (DNI), which governs the allocation of taxable income between the trust/estate and the beneficiaries. DNI will determine the character and the amount of the distribution deduction and the associated income that flows through to the beneficiaries under the conduit theory. The deduction for distributions will act to reduce the trust’s taxes. The beneficiary’s tax is based on the amount and character of the DNI distributed.

In its essence, DNI reflects the taxable income of the estate or trust with certain modifications (Sec. 643). Capital gains and losses are generally excluded from

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**EXECUTIVE SUMMARY**

- Taxes rose significantly in 2013, with new top rates of 39.6% on ordinary income and 20% on capital gain income and the new 3.8% net investment income tax.
- These taxes apply to trusts and estates at much lower income levels than for individuals, changing the tax planning that must be done to maximize the income that is distributed to beneficiaries.
- Distributing income subject to the 3.8% net investment income tax to beneficiaries may avoid the tax entirely because the tax applies to individuals at much higher income thresholds than for trusts and estates. Those beneficiaries are also subject to the top income tax rate of 39.6% at much higher income levels, so distributing more income to beneficiaries will further reduce income taxes.
- Capital gain income, which is normally taxed to the trust and estate and not distributable to beneficiaries, may be distributable, in some circumstances, to beneficiaries and deductible from gross income, another planning technique to lessen taxes.

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To comment on this article or to suggest an idea for another article, contact Sally P. Schrader, senior editor, at sschrader@aicpa.org or 819-302-8928.
DNI (Sec. 643(a)(3)), which means they are subject to tax at the estate or trust level. Because of the condensed tax brackets, a minimal amount of capital gains will quickly result in a 3.8% net investment income tax and a higher tax bracket.

The reason for separating income from capital gains in calculating DNI is the differing interests of the income beneficiaries and the residuary beneficiaries. Generally, capital gains are considered corpus and pass to the residuary beneficiaries. Therefore, capital gains are generally taxed to the trust and reduce the amount passing to the residuary beneficiaries.

**Distribute Net Investment Income**

To reduce income taxes, consideration should be given to distributing income from the trust or estate. The objectives are to use the lower brackets of the beneficiaries and to avoid the surtax. The first opportunity is to distribute income that would be included in net investment income, which in many instances consists of interest and dividends. Interest and dividends are included in DNI, and therefore the distribution reduces all of the trust’s taxes.

It might also be possible to distribute capital gains. Capital gains are included in net investment income but, as mentioned above, they are normally not included in DNI. Therefore, capital gains are generally taxed to the estate or trust. As described below, it may be possible to include the capital gains distributions in DNI and thereby allocate the gain to the beneficiaries. Capital gains are generally excluded from DNI and are allocated to principal. Therefore, they are typically taxed to the trust, which will increase the trust’s income taxes. However, under Regs. Sec. 1.643(a)-3, capital gains may be included in DNI to the extent they are, under the terms of the governing instrument.

A trust or estate may reduce taxes by distributing income that would be included in net investment income, which often consists of interest and dividends, and applicable local law, or under 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).

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1. Allocated to income;
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 (Regs. Sec. 1.643(a)-3(b)).

The fiduciary should be permitted to distribute trust principal and to allocate receipts and disbursements between income and principal.

A great deal of attention must be focused on the governing instrument and the law of each jurisdiction. Each state may differ in this regard.

**Achieving Tax Savings**

First and foremost, the provisions within the governing instrument are critical. In the planning stage, attention should be given to the allocation of capital gains and giving the fiduciary sufficient discretion. The fiduciary should be permitted to distribute trust principal and to allocate receipts and disbursements between income and principal. In appropriate instances, capital gains may even be included in income. If the instrument is silent, state law generally provides the governing rules.

The documents should clearly allow for in-kind distributions. Under the tax rules, when appreciated property is distributed to a beneficiary, the beneficiary will report the capital gain when he or she sells it later. This treatment will avoid the trust level taxation and reduce the net investment income tax. It is important that the executor avoid the Sec. 643(c)(3) election, which permits the trust to elect to recognize gain or loss upon the distribution of property to the beneficiary.

Estates and certain trusts have another special rule under Sec. 663(b) that distributions paid within the first 65 days of the tax year may be treated as paid on the last day of the previous fiscal year. The fiduciary makes the election by checking a box on Form 1041 on page 2 under the “Other Information” heading, line 6, which says, “If this is an estate or a complex trust making the section 663(b) election, check here,” and then taking care to make the distributions within the first 65 days of the next year. This election gives fiduciaries enough time to compute the

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