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Trusts From A to Z

Overland Park, Kansas - August 18, 2017

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Tax Reduction with Trusts

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Trusts From A to Z, NBI (18 August 2017)

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III. Tax Reduction with Trusts - Stephen M. Johnson[1]

"Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." – *Helvering v. Gregory*, 69 F.2d 809, 810-11 (2nd Cir. 1934) (Hand, J.).

People want to pay as few taxes as possible, while maximizing their income and net worth. Trusts can be a great way to reduce taxes, but they don't always completely avoid income and transfer taxes, so we must be ready to navigate the tax mists to serve our clients well. We explore trusts and fiduciary and inheritance taxes to see both the big picture and how each tax's parts interact. A trust can have assets and liabilities, income and expenses. America, Kansas, and Missouri tax trust income. Income comes in two flavors: ordinary (cash) or capital (stock or land).[2] A trust can be treated as part of an individual or as a separate tax entity.

Let's start our tax discussion by looking at the U.S., Kansas, and Missouri tax regimes.

A. Current State and Federal Tax Regime

Income and transfer tax regimes apply to trusts. The U.S., Kansas, and Missouri tax trust income. The U.S. also imposes three transfer taxes which relate to trusts: the estate tax, the gift tax, and the generation-skipping transfer (GST) tax.[3] Trust (or estate) income

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[1] Copyright, 2017, Stephen M. Johnson. B.A., Kansas State University; J.D., University of Kansas. Email Steve at steve@johnsonlawkc.com; Twitter @fountainpenlaw, LinkedIn, or Johnson Law KC LLC on Facebook.
[2] Blattmachr, *Income Taxation of Estates and Trusts* (16th ed., 2016) ("Trusts"), §3:2.1.
[3] Bittker, et al., *Federal Taxation of Estates, Trusts and Gifts* (3rd ed. 2005).

taxes are fiduciary income taxes, often paid by the trustee (as fiduciary) on behalf of the trust from the trust's assets.

Tax law changes give trust lawyers a fresh canvas, ripe with creative opportunities to serve clients. With the estate tax limited to large estates, we are witnessing a paradigm shift from avoiding estate taxes to income tax planning. Where estate plans used to have A-B credit shelter and marital trusts, and clients wanted to get rid of assets during life to avoid the estate tax, giving the recipients a carryover basis, now client often want to keep assets until death to give the heirs a stepped-up basis.[4]

State Taxes

Kansas and Missouri have fiduciary income taxes, but no state level estate, gift, or generation skipping transfer (GST) taxes.[5]

Kansas Fiduciary Income Tax

The trustee of a Kansas trust files a K-41 return for Kansas income.[6] The trustee of a non-Kansas trust must file a return for Kansas source income.[7] Kansas follows the IRS' treatment of grantor trusts and trustees of non-grantor trusts can take a distribution deduction.[8] Non-grantor trusts have a Kansas income tax rate of 4.60%.[9]

Missouri Fiduciary Income Tax

The trustee of a Missouri trust files a MO-1041 return for Missouri income. The trustee of a Missouri trust must file a Missouri MO-1041 return if a federal Form 1041 is due.[10] The trustee of a non-Missouri trust must file a return for Missouri source taxable income

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[4] Code §§1014(a)(1), 1015(a).

[5] K.S.A. §79-3220(c) et seq.; V.A.M.S. §143.311. Andres et al, *Probate and Trust Administration After Death* (7th ed. 2008) ("Kansas Probate Handbook"), §§5.2-5.4. K.S.A. §79-15,253; V.A.M.S. §§145.011 – 145.955.

[6] K.S.A. §79-32, 109(d); see Nenno, *State Income Taxation of Trusts* (BNA no. 869, 2013), A-58 – A-59.

[7] K.S.A. §§79-3220(c); 79-32, 110(d); 79-32, 134; 79-32, 136; 79-32, 1375.

[8] K.S.A. §§79-32, 116, 79-32, 117; 79-32, 134.

[9] K.S.A. §§79-32, 110(a)(2)(B)-(G). Andres, *Kansas Probate Handbook*, §5.2.12.

[10] Nenno, *State Income Taxation of Trusts*, A-61 – A-62. V.A.M.S. §§143.481(3), (5).

or $600 or more gross income.[11] Missouri follows the IRS' grantor trust rules and trustees of non-grantor trusts can take a distribution deduction.[12] Non-grantor trusts have a Missouri income tax rate up to 6% on Missouri source income over $9,000.[13] Missouri trusts do not have estimated tax payments.[14]

U.S. Taxes

The IRS Code taxes trust income (a fiduciary tax), along with the estate, gift, and GST transfer taxes. We will explore these four U.S taxes in more detail shortly. Before we do delve into U.S. taxes, let's briefly look at disclaimers, powers of appointment, and *Crummey* powers.

Disclaimers

A disclaimer - refusing a gift or inheritance – can be helpful for tax planning and is important tool to think about in our tax repertoire. The tax law calls it a "qualified disclaimer," while Kansas and Missouri call it a "disclaimer."[15] U.S. and state disclaimer laws are woven together, so a disclaimer must be done under state *and* federal law to be valid. Disclaimers must be signed and notarized in writing, filed and recorded with the Probate Court handling the estate within 9 months after the decedent's death.[16]

Powers of Appointment

General – in estate - can use/enjoy/give asset to you, estate, creditors, or creditor's estate

Limited – <u>not</u> in estate - <u>can't</u> use/enjoy/give asset to you, estate, creditors, or creditor's estate

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[11] V.A.M.S. §§143.481(3), (5).
[12] V.A.M.S. §§143.011, 143.111, 143.121; 143.431.
[13] V.A.M.S. §§143.011, 143.061.
[14] MO-1041 instructions, pg. 1.
[15] Code §2518; K.S.A. §§59-2291 et seq.; V.A.M.S. §§469.010.1 *et seq.*
[16] K.S.A. §§59-2291, -2292; V.A.M.S. §§469.010.1 *et seq.*

Powers of appointment (POA) are either general or limited. A general POA means you can distribute an asset or beneficial use and enjoyment to yourself, your estate, your creditors, or your estate's creditors – the asset is under control, so it's in the estate.[17] A limited POA means you can distribute an asset to anyone *except* you, your estate, your creditors, or your estate's creditors – the asset is not controlled, so it's not in the estate.[18] A POA in a will is created as of the testator's death.[19] A general POA doesn't include (1) a power to consume, invade, or appropriate property for the decedent's benefit, where the power's limited by an ascertainable standard of the decedent's health, education, maintenance, or support,[20] (2) a power made on/before 21 October 1942 that's exercisable only by the decedent with another person, or (3) a power made after 21 October 1942 that's exercisable only by the decedent with the power's creator (or someone having a substantial property interest that's under the power) if the property interest is adverse to exercising the power in the decedent's favor. Exercising or releasing a POA during the recipient's lifetime is a transfer for gift taxes.[21] And exercising or releasing a POA causes estate taxes if doing so with one's assets would cause taxes under Code §§2035-2038.[22]

Releasing a POA, even accidentally or informally, or failing to exercise a POA so that it lapses causes taxes.[23] But the POA release rules have a silver lining, the 5 and 5 power: a POA lapse during a calendar year while the decedent's alive only triggers estate taxes if the property exceeded the greater of (a) $5,000 or (b) 5% of the value (at lapse) of the assets the POA could've been exercised from.[24]

[17] Code §2041(b)(1); Reg. §20.2041-1(c).
[18] Code §2038.
[19] Reg. §20.2041-1(e).
[20] Reg. §20.2041-1(c)(2).
[21] Code §2514(b).
[22] Code §2041(a)(2).
[23] Code §2041(b)(2).
[24] Turley, "The Five or Five Power," 33 Wash. & Lee L. Rev. 701 (1976) http://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=2249&context=wlulr

Crummey rights

Crummey rights are a great way to make a future interest and current interest. The annual gift tax exclusion only applies to current interest gifts. The Rev. Clifford Crummey was a San Francisco minister who cared for poor and homeless people, and gave money to a trust for his four children's benefit, which the court upheld upon IRS challenge.[25] A *Crummey* trust involves (1) the donor making a gift to trust for recipient's benefit, (2) the recipient has right to withdraw gift from trust, (3) but the recipient waits about 30 days, so right to withdraw lapses, (4) so the donor's gift to trust is a current interest gift, and the annual gift tax exclusion applies.

A trust may grant a beneficiary *Crummey* power withdrawal rights. If the beneficiary's withdrawal from the trust was within her *Crummey* powers (as specified in the trust document itself), it would be a trust distribution and gift to her. The client's *Crummey* rights mean she can receive a trust distribution each year as a gift. If the withdrawal fell outside of her *Crummey* rights, then it would be taxable income.

Crummey held that a gift of the right to demand part of the trust corpus is a present interest gift so long as the beneficiary is aware of the right to make the demand. *Crummey* withdrawal rights are designed so that a parent or grandparent's contribution to the trust is a present interest, not a future interest, bringing the gift to the trust under the annual gift tax exclusion.

Now that we have explored the current state and federal tax regimes, let's focus in on income and transfer taxes as they apply to trusts.

[25] *Crummey v. Commissioner*, 379 F.2d 82 (9th Cir. 1968).

B. Taxation of Trusts: Transfer and Income

As we have seen, a trust's income can be taxed by Kansas, Missouri, and the U.S. The U.S. also imposes transfer taxes - estate, gift, and GST taxes – in the trust realm. Let's explore these tax landscapes in more depth.

Fiduciary Taxes: The U.S. Trust Income Tax

The tax law views trusts in two ways, depending on who pays the taxes: (1) grantor trusts or (2) non-grantor trusts. A Form 1041 fiduciary income tax return reflects trust income and may need to be filed with the IRS.[26] The IRS can audit Form 1041.[27] A trustee files Form 1041 if the trust had: (1) any taxable income for the tax year, (2) gross income over $600 for the tax year, or (3) a nonresident alien beneficiary.[28] Schedule K-1 (of Form 1041) is used to report a trust beneficiary's share of income, deductions, credits, or other items.[29] One Form 1041 is filed for each trust, so a trustee of multiple trusts "must file a separate return for each trust."[30] When the Form 1041 is filed, each beneficiary's share shows on their individual Schedule K-1 (of Form 1041), which flows into their Form 1040 income tax returns, regardless of what property form their share takes.[31] Form 1041 and Schedule K-1 have a tax symmetry: Form 1041 reports the trust's macro income tax picture, while Schedule K-1 tells each beneficiary (1) who received a distribution or (2) to whom an allocation was made during the tax year, his or her micro income tax picture, to wit, what she needs to report on her income tax return.[32] If the trust's deductions would zero out income that should be taxed, the alternative minimum tax may apply.[33]

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[26] Sembler et al., *Planning an Estate* (4th ed., 2017), §§15:3-15:4.
[27] Blattmachr, *Trust*, Ch, 10.
[28] Code §§641, 6012(a)(3), (4); Reg. §1.6012-3(a)(1)(i)-(ii); Form 1041 instructions, pg. 4; Blattmachr, *Trust*, §9:3.
[29] Code §6034A(a)(2); Regs. §§1.6041-1(a)(2), -1(a)(1)(ii)(A); Form 1041 instructions, pp. 36-40.
[30] Reg. §1.6012-3(a)(4); Blattmachr, *Trust*, §3:7.1.
[31] Code §6034A(c).
[32] Code §6034A(a). A symmetry arises between returns for other entity level and individual level taxpayers.
[33] Blattmachr, *Trust*, §3.2.1[c].

Filing 1041

Form 1041 can be paper or e-filed.[34] The trustee must file Form 1041 within 3.5 months after the tax year closes.[35] Starting in 2016, a trust can get an automatic 5.5 month filing time extension by filing Form 7004.[36] Taxes due on Form 1041 must be paid by the 1041's due date.[37] The trustee or beneficiary can be "personally liable for the unpaid tax," up to the final distribution amount from the trust, if before the distribution, the trustee or beneficiary had "notice" of "tax obligations or failure to exercise due diligence" to see if taxes were owed.[38]

The IRS has a 3 year statute of limitations on trust income taxes.[39] But if a 1041 significantly omitted income, the limit is up to 6 years.[40] A trust may be required to make estimated income tax payments,[41] but a decedent's estate or grantor trust is usually exempt for 2 years after a decedent's death.[42]

Usually the trustee pays the trust's income taxes, as reported on Form 1041. But trusts can be designed so the beneficiary or the grantor pays the trust's income taxes, while the trust assets are not included in the beneficiary or grantor's estate. This trust quirk arose in the 1954 IRS Code, a gap between America's income and estate tax laws. Some irrevocable trusts need a third-party trustee to avoid income tax issues when making distributions to a beneficiary, but a beneficiary can guide the trust's investment strategy, even as the investment trustee.

Control is the key: if a person can exclude assets from their estate, the person can't control the assets. Just after Christmas in 1922, a wealthy businessman named Charles

34 Pub. 1437; Blattmachr, *Trust*, n.837.
35 Code §6072(a); Reg. §1.6072-1(a); Blattmachr, *Trust*, §3.7.1.
36 Code §6081; Reg. §1.6081-6(a)(1); Blattmachr, *Trust*, §3.7.1.
37 Blattmachr, *Trust*, §3.7.1.
38 Blattmachr, *Trust*, §3.7.1.
39 Code §6501; Blattmachr, *Trust*, §3.7.2.
40 Blattmachr, *Trust*, §3.7.2.
41 Code §6654(l)
42 Code §6654(l)(2)(B)(ii).

Corliss (of Lamont, Corliss, & Co) made a revocable trust of personal property in New York, which paid income to his wife for her life, with the remainder to his children.[43] Corliss' trust distributed $124,325.97 of income to his wife in 1924, so the New York IRS office's agent (Frank Bowers) charged Corliss $44,687.43 of income taxes plus interest, so Corliss sued in New York City federal court, then the 2nd Circuit, and finally appealed to the U.S. Supreme Court.[44] Justice Oliver Wendell Holmes wrote that Corliss' power to revoke a trust as grantor (and "stop payment to the income beneficiary") meant he owned the trust property: "if a man disposes of a fund … [so] another is allowed to enjoy the income" he has the power "to appropriate," "it does not matter" if "permission is given by assent or by failure to express dissent. The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as income, whether he sees fit to enjoy it or not."[45] Holmes wrote substance matters over form: "Taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed--the actual benefit for which the tax is paid."[46]

Basis is a foundation of the tax law edifice and comes into play with trusts and tax planning. Normally, assets only get a stepped-up basis when they are sold to a third party or inherited from someone's estate.[47] But irrevocable trusts can give the beneficiaries a stepped-up basis (without including the assets in the grantor's estate) by either (1) substituting or swapping assets trust assets (swapping out highly appreciated assets for liquid assets with minimal (if any) appreciation) or (2) selling the trust appreciation assets in exchange for the grantor's assets or cash. A sale between a grantor trust and the grantor is disregarded and not taxable.[48]

[43] Case facts; Geisst, *Encyclopedia of American Business History*, Vol. 1.
[44] *Corliss v. Bowers*, 30 F.2d 135 (S.D.N.Y. 1929); 34 F.2d 656 (2nd Cir. 1929); 281 U.S. 376 (1930).
[45] Chirelstein, *Federal Income Taxation* (13th ed., 2015), 238.
[46] *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).
[47] Code §1014(a)(1).
[48] Rev. Rul. 85-13; Blattmachr, *Trust*, §9:2.

Beneficiary Defective Inheritor's Trust (BDIT)

A beneficiary could have a beneficiary defective trust, where the trust income is taxable to the beneficiary/recipient, but the trust money is not included in the beneficiary's estate, since the trust is irrevocable and outside the beneficiary's control, while the beneficiary pays the trust's income tax bills (the trust is defective – creates income tax liability – for the beneficiary).[49]

Intentionally Defective Grantor Trust (IDGT)

An IDGT is older and more traditional than a BDIT, but accomplishes similar goals for the grantor. The grantor could start an intentionally defective grantor trust, where the trust income is taxable to the grantor and the trust money is not included in the grantor's estate, since the trust is irrevocable and outside the grantor's control, while the grantor pays the trust's income tax bills.[50] BDIT and IDGTs are widely used in sophisticated tax and family business planning to transfer wealth across generations, achieve asset protection for assets, freeze values for highly appreciating assets, reduce estate taxes, and efficiently using gift and GST tax exemptions.

U.S. Estate Tax

America's estate tax began in 1916 to help fund the Great War, as America got "prepared" for the trench warfare raging across France, before President Woodrow Wilson sent the Doughboys "over there" to help win the "war to end all wars."[51] Estate taxes are owed when a person dies with a gross estate that exceeds the estate tax's lifetime threshold.[52] For 2017, an estate's first $5.49 million is exempt from estate tax.[53] The estate tax is 40% of the amount the gross estate is over the threshold. The estate tax

[49] Oshins, et al., "The Beneficiary Defective Inheritor's Trust" (CCH, 2008); Alexander, "The Beneficiary Defective Inheritor's Trust" (Estate Planning, 2010).

[50] http://www.journalofaccountancy.com/Issues/2008/Nov/Intentionally+Defective+Grantor+Trusts.htm.

[51] Ross, *World War I & the American Constitution* (Cambridge, 2017), 91; *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921) (Holmes, J.) (estate tax valid as direct tax).

[52] Code §§2033-2044; Andres, *Kansas Probate Handbook*, §5.14; Price, *Price on Estate Planning* §2.13; Sembler, *Planning an Estate*, §§2:3-2:35.

[53] Rev. Proc. 2016-55.

is computed by subtracting certain deductions from the gross estate and reported on Form 706.[54] A prior transfer credit is allowed against the estate tax.[55]

QTIP Trusts and the Marital Deduction

The marital deduction helps married couples save on estate taxes. A qualified terminable interest property (QTIP) trust qualifies for the marital deduction.[56] A QTIP is (1) a trust where (2) the surviving spouse is entitled to the trust's income for life[57] paid annually,[58] and (3) the property cannot be appointed to anyone but the surviving spouse.[59] A contingent income interest yields a QTIP trust.[60]

A reverse QTIP election treats the first spouse as the GST transferor.[61] A partial QTIP election allocates assets between (1) the QTIP trust for the surviving spouse's benefit and (2) the deceased spouse's estate.[62] A QTIP trust (or a trust electable as a marital QTIP) is often better than a general power of appointment trust or an outright bequest for estate planning after death.[63] The surviving spouse's trust is a QTIP if the surviving spouse has the exclusive and unrestricted right for life to use the house.[64]

Form 706 includes various schedules depending on the estate's facts. Form 706 is filed in person at the local IRS office, or by mail to Cincinnati, Ohio, but cannot be e-filed.[65] Late filing a Form 706 may create substantial penalties.[66]

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[54] Code §§2001(b), 2051, 2053-2058. Form 706 instructions; Andres, *Kansas Probate Handbook*, §5.1.5(a). Schiller, *Art of Estate Tax*, §§2.3-2.4.

[55] Code §2013.

[56] See e.g. http://files.ali-aba.org/thumbs/datastorage/skoob/articles/Ch03%20MDTrusts_2006Supp-4_thumb.pdf.

[57] Code §2056(b)(7)(B)(ii).

[58] Code §2056(b)(7)(B)(ii)(I).

[59] Code §2056(b)(7); Regs. §§20.2056(b)-5(f)(4), -7(b)(2), -7(d)(2), 26.2652-2(a); Price, *Estate Planning*, §5.23.

[60] Regs. §§20.2056(b)-7(d)(3)(ii), -10.

[61] Code §2652(a)(1); Price, *Estate Planning*, §2.28.

[62] Price, *Estate Planning*, §5.23.4.

[63] Schiller, *Art of Estate Tax*, §3.2.

[64] Reg. §20.2056(b)-7(h), Ex. 1.

[65] Schiller, *Art of Estate Tax*, §5.2.

Estate beneficiaries receive a stepped-up basis in each asset.[67] Valuation disputes can trigger estate tax audits.[68] A protective special use valuation election is available.[69] No payment extension is available.[70] Estate tax liens may be imposed if the full tax owed is not paid promptly.[71] The marital deduction and charitable deduction are powerful tools to reduce estate tax owed.[72] The marital deduction only applies to a U.S. citizen surviving spouse; otherwise, a qualified domestic trust can be used.[73]

The Form 706 is due within 9 months after the decedent's date of death.[74] Filing Form 706 by the due date is a non-delegable fiduciary duty.[75] If extra time is needed, the Form 706 deadline can be extended: Form 4768 gives an extra 6 months to file Form 706, and 12 months more to pay any estate tax owed. Form 4768 extensions are routine, but an explanation letter may be helpful.[76] A sample cover letter and required documents checklist should be consulted.[77]

Mind the Gap: U.S. Estate and Income Taxes

Estate and income taxes interact in some interesting ways in trust law.[78] There are three trust roles (grantor, trustee, and beneficiary) and a three trust tax routes: a trust's income taxes can be paid by the trust's (a) grantor, (b) trustee, or (c) beneficiary. Most trusts are designed so the trustee pays income taxes out of the trust's income and/or principal. But trusts can be designed so the grantor or beneficiary pays the taxes.

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[66] Schiller, *Art of Estate Tax*, §§5.6, 5.8, Ch. 27. Blattmachr et al., *The Circular 230 Deskbook* (PLI, 2017), §3:2.2.
[67] Code §1014(a)(1); Price, *Price on Estate Planning* §2.15.
[68] Schiller, *Art of Estate Tax,* §4.6.
[69] Id., Ch. 9.
[70] Code §§6151(a), 6311; Reg. §301.6311-2.
[71] Code §§6321, 6323.
[72] Code §§2055(a), 2056.
[73] Code §2056A; Blattmachr, *Trust*, §2:3.5.
[74] Code §6075(a); Reg. §20.6075-1.
[75] *U.S. v. Boyle*, 469 U.S. 241 (1985); Schiller, *Art of Estate Tax*, §§5.1, 5.4 – 5.5.
[76] Schiller, *Art of Estate Tax*, §2.5.
[77] Reg. §20.6016-4; Andres, *Kansas Probate Handbook*, §5.1.5(b), (c).
[78] Schiller, *Art of Estate Tax,* §§6.10, 15.11; Blattmachr, *Trust*, Ch. 5.

U.S. Gift Tax

America's gift tax debuted during the Great Depression in 1932, and dove tails with America's estate tax in the unified credit.[79] William Ramseyer, a Congressman and attorney from Iowa, wrote America's estate and gift tax laws.[80] A gift occurs when one person hands an asset to someone else for less than fair market value.[81] A complete gift has 3 elements: (1) intent to give up control, (2) delivery of the gift to the recipient, and (3) acceptance of the gift by the recipient. State common law defines gift elements, while tax consequences are the federal law's realm. Gifts can be outright or in trust, but a gift to a minor must be held in trust until the minor becomes an adult. Gifts must be completed before the client's death, as incomplete gifts are included in the client's estate at death.[82]

Annual Exclusions & Lifetime Exemption

A person can give $14,000 per year to any individual gift tax free.[83] By gift splitting, a married couple can give $28,000 per year to any individual, but must file a Form 709. [84] Gift splitting is done by checking a box on Form 709 and filing the 709, even where gift tax is not due.[85] The lifetime gift tax exemption - the maximum amount someone can give away to other people tax free - is $5.49 million.[86] The lifetime gift tax exemption isn't portable between spouses, so any unused lifetime gift tax exemption dies with the decedent.

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79 Code §2505.
80 Soled et al., "Asset Preservation," 72 Wash. & Lee L. Rev. 257 (2015); Cooper, "Ghosts of 1932: The Lost History of Estate and Gift Taxation," 9 Fla. Tax. Rev. 875 (2010).
81 Code §§2503(b), 2505(a), 2511(a); Reg. §§25.2511-1(a), (c); Andres, *Kansas Probate Handbook*, §5.1.7; Price, *Estate Planning*, §2.4; Sembler, *Planning an Estate*, §§2:36-2:48.
82 Code §§2036-2038.
83 Code §2503(b)(1). Rev. Proc. 2016-55.
84 Code §2513(a)(1), (2). Price, *Estate Planning*, §2.7.
85 Price, *Estate Planning*, §§2.10, 2.10.4; Schiller, *Estate Tax,* §6.2.6.
86 Code §2505. Rev. Proc. 2016-55.

Depending on the amount involved and the timing, gift tax could be owed.[87] Gift tax is up to 40% on any gift over the annual exclusion amount or the lifetime exclusion amount ($5.49 million in 2017), along with filing a Form 709 to report the gift's taxable portion.[88] Gift tax is paid by the donor, not the recipient. A gift recipient receives the donor's carryover basis.[89] A QTIP election can be made for lifetime gifts via Form 709.[90] Creating a revocable trust does not trigger gift taxes, nor does later adding property or money to the trust, since the grantor keeps "dominion and control" of the revocable trust.[91]

U.S. GST Tax

The GST tax began in 1976 to deter dynastic wealth.[92] The GST tax is triggered 3 ways: by (1) a taxable termination, (2) a taxable distribution, or (3) a direct skip.[93] A taxable termination happens when a trust interest ends (by death, time lapse, or power of appointment release), causing a skip person to receive the trust interest.[94] The child whose generation is skipped over is called a "skip person."[95]

A taxable distribution happens when trust income or principal are distributed to a skip person other than by a taxable termination (e.g. a normal trust distribution to a skip person).[96] A direct skip is a property transfer subject to the estate or gift tax which is made to a skip person, such as a grandparent giving a grandchild property taxable by the estate or gift taxes.[97] The GST also has exclusions and exemptions.[98] The GST tax rate is

[87] Schiller, *Estate Tax*, Ch. 6; Blattmachr, *Circular 230 Deskbook*, §3:2.3.
[88] Rev. Proc. 2016-55.
[89] Code §1015; Price, *Estate Planning*, §2.4.5.
[90] Schiller, *Estate Tax*, §3.2.
[91] Blattmachr, *Trust*, §9.2, n.23; Reg. §1.2511-2(c).
[92] Schiller, *Estate Tax*, Ch. 25; See GST history (https://www.naepc.org/journal/issue01f.pdf).
[93] Price, *Estate Planning*, §§2.24 – 2.41.9.
[94] Code §2612(a); Regs. §§26.2612-1(b), -1(d), 26.2651-1; Price, *Estate Planning*, §§2.25.2, 2.32.3.
[95] Code §2613(a).
[96] Code §2612(b); Reg. §26.2612-1(c); Price, *Estate Planning*, §§2.25.3, 2.32.2.
[97] Code §2612(c); Reg. §26.2612-1(a); Price, *Estate Planning*, §§2.32.1, 2.38.1.
[98] Code §§2611(b), 2642(c); Price, *Estate Planning*, §2.30.

the maximum estate tax rate (40%) times the GST inclusion ratio.[99] As a formula, it's GST = .4 x GST inclusion ratio.

The GST tax is triggered by a transfer from one generation (a grandparent) to another (a grandchild), where a generation (the child) is skipped.[100] Gifts to grandchildren or other cross generational gifts in trust may cause GST liability.[101] GST taxes are reported on Form 709, but the GST "is the only transfer tax" often "assessed many years after the transfer."[102] For 2017, the first $5.49 million is exempt from GST tax, but the GST exemption is not portable.[103] The GST design is often used in wealthy families to transfer monies from one generation to another when the middle generation (children) is already wealthy and does not want the older generation's (grandparents) inheritance, so the inheritance skips to the younger generation (grandchildren). In a wealthy family, each spouse's GST exemption should be carefully allocated.[104]

Transfer Tax Reporting: Forms 706 & Form 709

The Form 1041 fiduciary income tax return is distinct from the Form 706 estate tax return and the Form 709 gift tax return. Form 706 needs to be filed if (1) estate tax is owed or (2) the surviving spouse elects portability. And Form 709 needs to be filed if the decedent made a gift to a family member or friend of more than annual exclusion amount or beyond the lifetime gift tax exemption, or non-exempt generation skipping gifts.[105] Inheritance taxes are paid by the donor, not the recipient. We will explore portability shortly.

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99 Code §§2641, 2642(a).
100 Code §§2601-2663; Harrington, *Generation-Skipping Transfer Tax* (BNA, 850-2nd, 2014); Sembler, *Planning an Estate*, §§5:27-5:36; Abendroth, "Ticking Timebombs of the GST Tax," KCEPS 2015.
101 Harrington et al., *Generation Skipping Transfer Tax*.
102 Abendroth, "Ticking Timebombs," 127.
103 Rev. Proc. 2016-55; Price, *Estate Planning*, §2.27.
104 Price, *Estate Planning*, §§2.29, 2.41.
105 Code §§2503(b), 2505(a).

The Form 709 GST tax return is filed by the responsible party to report GST tax due.[106] GST tax triggered by a direct skip (not in a trust) is due when estate or gift tax returns are due.[107] All other GST tax returns are due by the 15th day of the 4th month of the tax year close for the return year – usually April 15 after the GST triggering event.[108]

GST and Income Taxes

If GST tax is due, two income tax deductions exist. First, for a taxable termination or direct skip, an income tax deduction is allowed for GST taxes paid.[109] Second, if GST taxes arise on income distributions, an income tax deduction can apply.[110]

To Port or Not to Port: Do We File Form 706?

Form 706 is the fount of portability.[111] Portability is a great estate planning tool for married couples.[112] Portability began in 2010 and is now a permanent part of the estate planning landscape.[113] Portability is the "deceased spousal unused exclusion amount" or "DSUE amount."[114] The applicable exclusion amount is "the sum of (a) the basis exclusion amount, and (b) [for a surviving spouse], the deceased spousal unused exclusion amount."[115]

Just as estate planning has undergone a sweeping paradigm shift from an estate tax focus to an income tax focus, so "portability may be viewed as a paradigm shift in estate planning for married couples."[116] Portability is part of Congress' marriage preference, along with the marital deduction and unlimited gifting between married spouses. Portability is not available for a spouse's unused gift or GST tax exemptions. This may

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106 Code §2662(a)(1); Reg. §26.2662-1(c); Price, *Estate Planning*, §2.38.
107 Code §2662(a)(2)(A); Price, *Estate Planning*, §2.39.
108 Code §2662(a)(2)(B); Blattmachr, *Circular 230*, §3:2.2[A].
109 Code §691(c)(3); Blattmachr, *Trust*, §2:3.6.
110 Code §164(a)(4), (b)(4); Blattmachr, *Trust*, §2:3.6.
111 *Hamlet*, III:i, 57. Blattmachr et al., "Portability or No," J. of Tax., 118:5 (2013); Schiller, *Art of Estate Tax,* §§4.5A, 7A.8; Reg. §20.2010-2T(a); Schiller, *Estate Tax*, §4.5A.
112 Schiller, *Estate Tax*, Ch. 7A.
113 Thanks to the American Taxpayer Relief Act (2012).
114 Code §2010.
115 Code §2010(c)(2); Price, *Estate Planning*, §§2.12, 12.27.
116 Blattmachr,"Portability or No," 233.

be due to dynastic wealth concerns. Portability has triggered "an explosion" of estate tax filings "where no estate tax is due."[117] Indeed, few estates need to file a Form 706 to pay estate taxes, but many states file Form 706 to claim portability.[118] Portability provides that upon filing a Form 706 (federal estate tax return), a surviving spouse retains the deceased spousal unused exclusion amount (DSUEA).[119]

Often portability helps - especially for spouses whose net worth is close to or could become close to the federal estate tax exemption during their remaining lifetime.[120] But portability may not be as useful to spouses with lower net worth or income where there is no possibility of reaching the federal estate tax exemption. For those clients, portability may actually be uneconomical – the pursuit of a phantom tax benefit, which incurs more time and expenses than it is worth.

Portability presents a choice between inheriting outright or inheriting in trust. Portability has numerous advantages vis-à-vis using trusts in an estate plan, including: (1) simplicity, (2) stepped up basis when the surviving spouse dies, (3) use with depreciating assets, (4) use with retirement assets, (5) use with a residence, (6) IRD tax efficiency (by not funding the first spouse's unused estate tax exemption with IRD), (7) market declines after the first spouse's death, (8) lower state exemption amount (for states with an estate tax), (9) avoid state estate taxes, (10) create a grantor trust for descendants, and (11) avoiding complex tax funding formulas.[121]

But trusts also have some advantages over portability: (1) using the first spouse's GST exemption (which can be wasted with portability), (2) creditors' claims of the surviving spouse, (3) protection from unwise financial decisions, (4) no DSUE indexing for

[117] Schiller, *Estate Tax*, §1.2.
[118] Schiller, *Estate Tax*, §5.3.
[119] Code §2010(c)(4).
[120] Schiller, *Estate Tax*, §1.3 (Portability is "outstanding insurance" against estate and income taxes for most married couples). The martial deduction and QTIP trusts are useful. Schiller, *Estate Tax*, §1.10, n.118, Ch. 2).
[121] Blattmachr,"Portability or No," 234-236.

inflation, (5) estate tax credits (which can be wasted with portability), (6) remarriage forfeiture if the surviving spouse remarries and survives the new spouse, (7) shelter of appreciation and income, and (8) avoiding potential audit issues with filing Form 706.122 By using portability (and not a trust), various issues arise: (1) income tax consequences, (2) Form 706 must be filed, (3) the effect of inherited exemptions, and (4) second marriages.[123] A trust can shift income to any beneficiary, so that it is not taxed in the surviving spouse's hands.[124] If a trust is used instead of portability, Form 706 may not be required. A trust can be beneficial for a surviving spouse is the first spouse did not use their gift tax exemption and left a large unused estate tax exemption. And a QTIP trust would work better in a second marriage scenario.[125]

Portability helps where: (1) a small first estate exists, (2) with very wealthy clients to fund a grantor trust for descendants, (3) to achieve stepped up basis flexibility, (4) state death tax planning, (5) for a small non-marital share, (6) to avoid funding the non-marital share with IRD assets, or (7) for older couples without children.[126] Portability is elected by filing a Form 706 estate tax return for the deceased spouse, but there is no short Form 706-EZ.[127]

Tax Planning for Large and Small Estates

Large Estate >$5.49 million

If the federal estate tax is owed, Form 706 deductions should be taken first, as the federal estate tax is up to 40% of the estate's value. Second, Form 1041 deductions would be taken, since the fiduciary income tax rate reaches the highest individual income tax level at just $12,500 of income.[128] Third, the final Form 1040 deductions would be taken, since

[122] Id., 236.
[123] Id., 238-240.
[124] Id., 239.
[125] Id., 240.
[126] Id., 241-242.
[127] Code §2010(c)(5).
[128] Rev. Proc. 2016-55;
http://www.ustrust.com/publish/content/application/pdf/GWMOL/USTp_2017_tax_rate_guide.pdf.

the individual income tax rate applies to a decedent's estate.[129] And last but not least, gifts or GST trusts should be used to reduce the estate as much as possible.

Small Estate <$5.49 million

If the federal estate tax is not owed (and regardless of whether portability is elected on the federal estate tax return), Form 1041 deductions would be taken first, since the fiduciary income tax rate tops out at only $12,500 of income. And second, the final Form 1040 deductions would be taken, since the individual income tax rate applies to a decedent's estate.[130] Gifts or GST trusts can be used, but may not be needed for tax reasons.

Now that we have explored the taxes that apply in the trust realm, let's move on to discuss accounting and taxable income.

C. Accounting vs. Taxable Income

The accounting vis-à-vis taxable income distinction is vital to grasp for trust tax issues. Accounting income is income received, to wit, "income derived through historical accrual based accounting."[131] Accounting income is a metric estimating a trust's performance.[132] Accounting income includes realized gains or losses, but doesn't include unrealized gains or losses. Accounting income focuses on a trust's cash increasing or decreasing, not a mere change in market value or economic income.[133]

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[129] Price, *Estate Planning*, §12.11.
[130] Price, *Estate Planning*, §12.12.
[131] https://www.ventureline.com/accounting-glossary/A/accounting-income-definition/
[132] Blattmachr, *Trust*, §3:3.1.
[133] strategiccfo.com/accounting-income-definition.

Taxable income is a distinct creature. Taxable income drives the trust income tax calculation.[134] Taxable income is gross income[135] or adjusted gross income (AGI) minus deductions or exemptions for a given tax year.[136] Taxable income includes wages, salaries, bonuses, tips, plus investment income and unearned income.

A trust, and its fiduciary, will focus on taxable income over accounting income. Accounting income is helpful for beneficiary to know, and may reflect on a trustee's effectiveness as a fiduciary or steward. But taxable income is the key for the beneficiary and the trustee – how much will the trust have to pay in taxes?

Trust Tax Year

Most trusts are required to use calendar tax years.[137] If a trust's terms call for its termination upon an event's occurrence, the trust tax year does not end when the event occurs. Instead, the trustee has a reasonable time after the event's occurrence to finish trust administration.[138] While a trust must use a calendar year, a trust beneficiary is not required to use a calendar year for its tax year, so the trust and its beneficiary could each have a distinct tax year. If the §645 election is made, the estate and the trust use the same fiscal year.[139]

NIIT

A good new example of taxable income is the net investment income tax (NIIT).[140] Passive activities may trigger NIIT for a trust.[141] Form 8960 is filed with the IRS to report NIIT. The NIIT was added to the U.S. income tax landscape by the Affordable Care Act (2010). For individuals, the NIIT applies if a U.S. citizen or legal resident has

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[134] Garner, *Black's Law Dictionary* (10th ed., 2014), 882.
[135] Code §61(a).
[136] Blattmachr, *Trust*, §3:1.3, 3:2.1; Code §641(b).
[137] Code §644(a); Blattmachr, *Trust*, §§3:7.3, 9:3; Price, *Estate Planning*, §10.4.15.
[138] Reg. §1.641(b)-3(b); Blattmachr, *Trust*, §3:7.3.
[139] Blattmachr, *Trust*, §9:3.
[140] Blattmachr, *Trust*, Ch. 4.
[141] Code §1411; Regs. §§1.1(i)-1T, 1.1411-4; Form 8960 instructions; Acker, *Income Taxation*, A-64 – A-75.

net investment income (NII) and modified adjusted gross income over $250,000 if married filing jointly, $200,000 if single and head of household, or $125,000 if married filing separately. Individual taxpayers report NIIT tax from Form 8960 on Line 60, box b (page 2) of Form 1040.

The NIIT can apply to individuals, estates, and trusts. The NIIT is a 3.8% Medicare contribution tax on some taxpayers' NII starting in 2013.[142] NII includes interest, dividends (including constructive dividends, and distributions treated as dividends), non-qualified annuities, royalties, rents (other than income from the ordinary course of a trade or business), trades and businesses the client is passively involved in or trades or businesses of trading financial instruments or commodities, investment of working capital, and some capital gains.[143] NII does *not* include: sale of some active partnership and S corporation interests, or a couple other items.

Estates and trusts, unless specifically exempt, have NIIT liability if they have undistributed net investment income *and* their adjusted gross income is over the dollar amount at which the highest tax bracket for the trust begins for the tax year. For estates and trusts, the 3.8% NIIT tax applies to the *lesser* of (a) undistributed net investment income or (b) AGI amount over the dollar amount at which the highest tax bracket applicable to the trust begins for the tax year. Estates and trusts report and pay NIIT on Form 1041.

NIIT Trust Exemptions

The NIIT doesn't apply to trusts (1) exempt from U.S. income tax, (2) with charitable unexpired present or future interests, (3) grantor trusts, (4) or trusts not classified for U.S. income taxes.[144]

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142 Blattmachr, *Trust*, §4:2.1.
143 Pub. 550; Pub. 559, pp. 15-24; Pub. 925.
144 Code §§170(c)(2)(B), 671-679, 1411(e)(2); Reg. §1.1411-3(b).

Now that we've explored facets of the accounting and taxable income distinction, let's move on to tax consequences of trust distributions.

D. Tax Consequences of Distributions

What happens when a trust spends money? What tax impact do trust distributions have? Trust distributions have tax consequences, and trust income taxes can be complicated. But there's a basic symmetry arising from a "basic premise": all trust distributions come from income and are taxable up to a limit or ceiling, so trust distributions are "deductible by the trust and income to the recipient."[145]

Five IRS Code provisions come into play with trust distributions: giving a (1) deduction for trusts distributing income currently,[146] (2) a tax symmetry of including the currently distributed income in the beneficiary's income,[147] (3) a deduction for trusts accumulating income or distributing corpus,[148] (4) a corresponding tax symmetry of including accumulating income or distributing corpus in the beneficiary's income,[149] and (5) some special trust tax rules.[150] Most tax deductions are limited by the 2% floor. But trusts can deduct amounts paid, credited, or which must be distributed to the trust beneficiaries during the year.[151] Under §661, income is "properly … credited" to a trust beneficiary only if the income is irrevocably allocated to the beneficiary.[152] But any trust distribution deduction is limited to DNI.

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145 Blattmachr, *Trust*, §3:5.4.
146 Code §651.
147 Code §652.
148 Code §661.
149 Code §662.
150 Code §663.
151 Code §§651(a), 661(a).
152 *IRS v. Stearns*, 65 F.2d 371 (2nd Cir. 1933); Price, 10.4.5.

A trust is not taxed if it distributes, or is required to distribute, its income to beneficiaries, but a trust is taxed on net income that is not distributed or distributable to the beneficiaries. Like a partnership, trust beneficiaries are taxed on trust income that passes through to beneficiaries as distributions. But if the trust earns income that's not distributed, the trust is taxed on that income like a corporation. When trust income flows through to trust beneficiaries, the income retains its character in the beneficiaries' hands.[153] So all trust distributions are included in the beneficiary's gross income to the extent of (1) the distribution amount, (2) the trust's net income, or (3) the separate trust share's net income.[154]

DNI

Distributable net income (DNI) is the trust income ready to distribute to trust beneficiaries.[155] DNI is also income ceiling taxable to a trust beneficiary. DNI is reported on Schedule B (of Form 1041), as determined by the trust instrument. A trust's income distribution deduction is the lesser of (a) DNI or (b) distributions to beneficiary (excluding distributed tax exempt interest). Trusts must take the income distribution deduction, so trusts cannot elect to pay taxes on distributions for beneficiaries.[156] DNI is the upper limit of the income distribution deduction, which a trust can take.

Trust Distributions: Two Tiers of Taxes

Tier 1 - Trust's Annual Required Income Distribution

Tier 2 - All Other Required Income or Corpus Distributions, Payments, or Credits

The tax law views trust distributions as two tiers: the first tier is the amount of income the trust must distribute annually, while the second tier is all other income or corpus that must be distributed, properly paid, or credited.[157] But the trust beneficiary's tax bill is

[153] Code §§652(h), 662(b).
[154] Code §§652(a), 662(a)-(b).
[155] Code §643; Regs. §§1.643(a)-0 – 1.643(a)-7; Price, *Estate Planning*, §10.4.4.
[156] Code §§652, 662.
[157] Code §662(a); Blattmachr, *Trust*, §3:5.2.

limited to the DNI ceiling. The first tier – the trust's annual income which it must distribute – is "taxed in full," to the DNI ceiling, before the second tier amounts get "taxed at all."[158] So if first tier distributions are less than DNI, second tier distributions are taxed to the beneficiary. But if first plus second tier distributions "exceed DNI," each second tier distribution beneficiary only reports income for a proportion of the distribution after reducing DNI by the first tier distribution – e.g. each second tier beneficiary only reports income for their portion of the second tier distribution.[159] Regardless, a beneficiary is only taxed on the DNI amount that's taxable income.[160] And the logical symmetry of the beneficiary's tax limit is the trust's distribution deduction limit: DNI's taxable income.[161] The beneficiary cannot be taxed for more income than the trust can deduct as a distribution.

Separate Share Rule

The separate share rule keeps multiple trust beneficiaries from paying taxes on each other's money.[162] When separate shares exist, DNI must be calculated separately for each share. The separate share rule says a beneficiary is taxed only on the income belonging to and distributed to that beneficiary's separate share. Without the separate share rule, a beneficiary would be taxed on all DNI being distributed, including income paid to another beneficiary – the beneficiary would be taxed on someone else's income. Separate share calculations and each beneficiary's DNI should be reported on separate statements attached to Form 1041.

[158] Blattmachr, *Trust*, §3:5.2.
[159] Code §662(a); Blattmachr, *Trust*, §3:5.2.
[160] Code §§652(a)-(b), 662(a)-(b); Blattmachr, *Trust*, §3:5.2.
[161] Code §§651(b), 661(a), (c); Blattmachr, *Trust*, §3:5.2.
[162] Code §663(c); Regs. §§1.663(c)-1 - -5; Price, *Estate Planning*, §12.37; Blattmachr, *Trust*, §3:5.3, 9:3.

Tax Free Corpus Distributions

But not all trust distributions get taxed. Corpus distributions or trust principal distributions are not taxed, and are exempt from the two tier system and DNI.[163] Tax free corpus distributions include: (1) the decedent's real estate passing directly to the heirs under local law, (2) right to received IRD, (3) gifts or specific bequests paid from income and corpus, or (4) a martial deduction payment or amounts distributed to eliminate estate taxes.[164]

E. Tax Implications of a Trust Becoming Irrevocable

A trust becomes irrevocable upon either the trust's creation or the grantor's death.[165] When a trust becomes irrevocable, tax implications arise, as the trust becomes a separate tax entity. An irrevocable trust often can't be changed or amended, although some exceptions, including "decanting" exist.[166] Trust income taxes are mainly focused on irrevocable trusts, since the tax law views revocable trusts the same as the taxpayer.

Revocable Trust Tax Treatment

A revocable or living trust (also called a grantor trust) is one and the same with the client for tax purposes during the client's life.[167] A living trust becomes irrevocable (a separate taxpayer/entity) upon the client's death, and the trust assets receive a stepped-up basis to fair market value at the client's death, as if being inherited from the client's estate, while avoiding probate. A revocable or living trust does not require its own EIN until the client dies. A revocable trust can have income tax effects.[168]

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[163] Blattmachr, *Trust*, §3:5.4.
[164] Blattmachr, *Trust*, §3:5.4.
[165] K.S.A. §58a-813(b)(3); ; V.A.M.S. §§456.021, 456.8-813.2(3).
[166] K.S.A. §§58a-411, -412, -416; V.A.M.S. §456.4-419; Culp, et al., *Trust Decanting* (BNA no. 871, 2012).
[167] *Jones v. Clifton*, 101 U.S. 225 (1879) (Field, J.) ("a revocable trust vests in the beneficiary a present estate … until … revo[ked]")
[168] Blattmachr, *Trust*, Ch. 9.

A revocable trust is a stand-alone estate planning document, usually executed with a pour-over will.[169] A revocable trust may be minimally funded during life, and receive an inheritance for surviving family members' benefit from the pour-over will. A testamentary trust is within a will and only starts after death when the will is probated. A revocable trust can be changed over time.[170] Revocable trusts can be modified as tax laws develop.[171] A revocable trust becomes irrevocable upon the settlor or grantor's death.[172]

Irrevocable Trust Tax Treatment

An irrevocable trust is a separate taxpayer/entity and requires its own EIN and must file a 1041 if the trust has enough income. An irrevocable trust usually reports its income on the Form 1041 income tax return. But an irrevocable trust can report income on an individual return (the settlor's or the beneficiary's return). If the settlor or the beneficiary could report the income on their respective Form 1040, the income would go on Schedule E (of Form 1040), Part III, Line 33, with the trust's name and EIN used (not the settlor's or the beneficiary's Social Security number).

If the trust was an irrevocable trust during the client's life (and so continued after the client's death), trust assets would have a stepped-up basis during the client's life and after the client's death, since the trust is a separate taxpayer/entity and would have a basis equal to the asset's fair market value when it was given to the trust. An irrevocable trust will have its own EIN from the moment the trust begins. Irrevocable trust assets are not included in the grantor's/settlor's estate at their death, which can be useful for inheritances or estate planning.

Now that we've explored some income tax issues for irrevocable trusts, let's look at complex trusts and accumulation distributions.

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169 Andres, *Kansas Probate Handbook*, §1.4.2(c).
170 K.S.A. §§58a-601, 602.
171 K.S.A. §58a-416.
172 K.S.A. §58a-813(b)(3); V.A.M.S. §§456.021, 456.8-813.2(3).

F. Accumulation Distribution for Some Complex Trusts

For many years, trust distributions were often staggered or grouped carefully to lower taxes for the trust or a beneficiary.[173] The accumulation distribution rules for complex trusts closed this loophole.

Trust: Simple or Complex?

First, what's a complex trust and what's a simple trust? The IRS Code defines simple and complex trusts by exclusion: a complex trust meets the criteria, and everything else is a simple trust. A trust could be simple one year and complex the next: the trust analysis is done annually.

Complex Trust

A complex trust is a trust (1) where not all income has to be distributed currently, (2) that allows income to be distributed or set aside for charitable contributions, or (3) that distributes principal (including a simple trust in its final year).[174]

Simple Trust

A simple trust has the opposite tax design of a complex trust. A simple trust is where (1) all income is distributed currently, (2) no income can be distributed or set aside for charitable contributions, and (3) the trust does not distribute principal, while any trust that does not fit those criteria is a complex trust.[175]

Now that we have distinguished simple and complex trusts, what's an accumulation distribution? An accumulation distribution is the annual amount that second tier trust distributions "exceed" DNI after taking out first tier distributions.[176] When a trust makes

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[173] Blattmachr, *Trust*, §3:6.
[174] Reg. §1.661(a)-1.
[175] Code §§651-652; Reg. §1.651(a)-1; Price, *Estate Planning*, §10.49. Code §§661-663, Price, *Estate Planning*, §16.4.10. Allocate a simple trust's deduction. Reg. §1.652(b)-3.
[176] Blattmachr, *Trust*, §3:6.3.

an accumulation distribution, it's "deemed a second tier distribution made on the last day of the earliest preceding taxable year" where "there was undistributed net income," but only to the "amount of undistributed net income for th[e] year."[177] In accounting lingo, it's a "first-in, first-out" rule.[178] Undistributed net income is how much the DNI for a year exceeds the sum of (a) that year's distributions and (b) the federal income taxes due traceable to the DNI.[179]

The accumulation distribution rules move the beneficiary's income (and the trust's deduction) from one tax year to another, ensuring the trust's tax situation is accurately reported year to year.

Now that we have explored the accumulation distribution rules for complex trust, let's move on to examine the 2% floor on miscellaneous itemized deductions.

G. The 2% Floor on Miscellaneous Itemized Deductions

The U.S. income tax imposes a 2% floor on miscellaneous itemized deductions, which are reported on Schedule A (Form 1040).[180] Miscellaneous items can only be deducted if they "exceed" 2% of the taxpayer's adjusted gross income.[181]

What are some expenses the 2% rule applies to in the trust arena? We have several examples. A non-grantor trust's cost or expense falls under the 2% rule if (1) "included in [67(b)'s] definition of miscellaneous itemized deduction" and (2) "commonly or customarily would be incurred by a hypothetical person holding the same property."[182] A cost or expense would be "commonly or customarily" incurred if it's a "product or

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[177] Id.
[178] Id.; Code §666(a).
[179] Id.; Code §665(a).
[180] Code §67; Pub. 529.
[181] Blattmachr, *Trust*, §3:2.1[G][3].
[182] Reg. §1.67-4(a); Blattmachr, *Trust*, §3:2.1[G][3].

service" given to a "non-grantor trust in exchange for the cost."[183] A trust's "ownership costs" for property – "condominium fees, insurance costs, and property maintenance and lawn care fees" are under the 2% rule.[184] But the 2% rule doesn't apply to property costs used in a trade or business.[185] If a property ownership expense is fully deductible elsewhere (e.g. §§62(a)(4), 162, or 164(a)), the 2% rule doesn't apply.[186]

And what about tax preparation fees? It depends on the tax return.[187] Tax preparation fees for estate and GST returns, 1041s, or the decedent's final 1040 are fully deductible (exempt from the 2% rule), but a gift tax or the individual return *does* fall under the 2% rule.[188]

And how about investment advisory fee, for a corporate trustee or an investment trustee? The IRS regulations say "yes."[189] But the Supreme Court in *Knight* said "no," if the fees are higher than for an individual.[190] So if a client's trust pays extra for advice on a complex or unique transaction, the extra fee would be fully deductible.[191]

Fiduciary fees are deductible on both Form 706 and Form 1041. Under *Knight*, a trust's fiduciary fees are often subject to the 2% itemized deduction floor.[192] A person may take a miscellaneous itemized deduction to the extent the item's cost exceeds 2% of the person's adjusted gross income.[193] Some itemized deductions are deductible in full, but any costs outside Code §67(b)'s ambit are miscellaneous itemized deductions, so the 2% floor applies.[194] An estate's fiduciary fees, including for investment advisory services, are

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183 Reg. §1.67-4(b)(1); Blattmachr, *Trust*, §3:2.1[G][3].
184 Reg. §1.67-4(b)(2); Blattmachr, *Trust*, §3:2.1[G][3].
185 Id.
186 Id.
187 Reg. §1.67-4(b)(3); Blattmachr, *Trust*, §3:2.1[G][3].
188 Blattmachr, *Trust*, §3:2.1[G][3].
189 Reg. §1.67-4(b)(4); Blattmachr, *Trust*, §3:2.1[G][3], n.183.
190 Blattmachr, *Trust*, §3:2.1[G][3].
191 Id.
192 *Knight v. IRS*, 552 U.S. 181 (2008); Pub. 559, p. 23; Blattmachr, *Trust*, §3.2.1[G].
193 Code §§63(d), 67(a).
194 Code §67(b) (fully deductible itemized deductions a/k/a 2% AGI floor exceptions).

not on the §67(b) list, so the 2% floor applies.[195] An individual's investment advisory expenses are fully deductible costs.[196] Using this logic, an estate can only fully deduct fiduciary fees if the money was (a) "paid or incurred in connection with" the estate's administration and (b) "would not have been incurred if the property" was not in the estate.[197] *Knight* teaches that the 2% floor often applies to an estate's fiduciary fees.

So the *Knight* case offers some potential tax savings on extra deductions for trusts, but it's not necessarily a panacea: to achieve tax savings on fees, the trust may have to pay more fees.

Appraisal fees could be fully deductible or could full under the 2% rule of capped deductibility.[198] Some trustee expenses don't arise much for individuals: probate court fees and costs, fiduciary bond premiums, publication of notice to creditors or heirs, certified copies of the death certificate, or fiduciary account costs.[199]

Next, we arrive at the martial participation rules for trusts: what happens when a trust has investments or owns a business.

H. Material Participation by Trusts - Recent IRS Changes

Income drives taxes. But different kinds of income generate varying taxes. Trust income taxes hinge on if the trust is a material participant or a passive investor. As with people, a trust can be an active and material participant, vital to a business or income stream, or it can take a background role, invest capital and be along for the ride to reap the rewards of sowing capital. The IRS Code limits deductions from a passive business activity if the

[195] Code §67(e).
[196] Code §212.
[197] Code §67(e)(1).
[198] Id.
[199] Reg. §1.67-4(b)(6); Blattmachr, *Trust*, §3:2.1[G][3].

deductions exceed income from the passive business activity: a trust can't invest in a passive business and wipe out its income with a slew of deductions.[200]

The IRS made some recent changes and there has been some case law on material participation by trusts.[201] The material participant rules arise under §469's passive loss rules, and apply for passive losses and the 3.8% net investment income tax (or Medicare tax).[202] Material participation means "both (1) a trade or business, and (2) material participation by the taxpayer."[203] The NIIT does not define "trade or business" apart from §162.[204] Any interest, dividends, or capital gains earned on investment assets held by the business (including "working capital") is net investment income, regardless of (1) the business reason for the holding investment assets (2) if the trust is materially participating in the business.[205]

So what's a passive (non-material) participant? §1411 applies §469 to see if there's a passive activity. And non- passive business income is not subject to the 3.8% NIIT.[206]

Material participation as an activity where the taxpayer participates on a "regular, continuous, and substantial basis."[207] An individual can apply 1 of 7 tests to see if they're a material participant, including the 500 hour rule. Alas, the trust rules are more complicated.[208] The IRS has not issued regulations for trusts as material participants. The IRS says only a trustee or other fiduciary can be a material participant: "An estate or trust

[200] Code §469; Blattmachr, *Trust*, §3.2.1[H].
[201]Blattmachr, *Trust*, §3.2.1[H]; See Steve Aker's June 7, 2013 Memo (http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Material%20Participation%20by%20Trust%20-%20FINAL.pdf).
[202] Id., pg. 1.
[203] Id., pg. 1; Prop. Reg. §1.1411-5(a-b).
[204] Id., pg. 1.
[205] Id., pg. 1; Code §1411(c)(3); Prop. Reg. §1.1411-6.
[206] Aker's April 2014 Memo, pg. 4.
[207] Code §469(h)(1).
[208] Aker cites a good perspective: "it is difficult to establish a framework for material participation by a trust (or an estate)." Blattmachr et al., *3.8% Medicare Tax on Estates and Trusts*, 40 EST. PL. 3, 9 (2013); Id., pp. 2-3

is treated as materially participating in an activity if an executor or fiduciary, in his capacity as such, is so participating."[209] There's an exception: a grantor trust or a qualified subchapter S trust where the beneficiary is the owner for income tax purposes, the grantor's or QSST's beneficiary's material participation decides the issue.[210]

A passive investor is a trust (or trustee or beneficiary) who fails the material participant test. The first case comes from Texas, where the court found "material participation should be determined by reference to all persons who conducted the business on the trust's behalf, including employees as well as the trustee."[211] But the IRS rejected the Texas court's decision in *Mattie K. Carter Trust* via a Technical Advisory Memo.[212]

The trust material participation rules were unclear, but the Frank Aragona Trust case helped clarify a bit.[213] The case involved a real estate rental business, which was wholly owned by the trust, and the Court found that the trust was a material participant in the business.[214] The court factored in "activities of three of the co-trustees as employees," but didn't consider "activities by two co-trustees who also owned minority interests in some of the rental entities."[215] The Mattie Carter Trust teaches that "activities of non-trustee employees can be considered in determining whether a trust materially participated in a ranching activity."[216] Among unresolved questions: after losing in *Aragona Trust,* will the IRS "change its harsh attacks on seemingly every effort by a trust to materially

[209] Id., pg. 1; S. Rep. No. 99-313, at 735.
[210] Id., pg. 1.
[211] Id., pg. 2; *Mattie K. Carter Trust v. U.S.*, 256 F. Supp.2d 536 (N.D. Tex. 2003); Blattmachr, *Trust*, §3.2.1[H].
[212] TAM 200733023; Blattmachr, *Trust*, §3.2.1[H].
[213] *Frank Aragona Trust v. Commissioner,* 142 T.C. No. 9 (2014); Blattmachr, *Trust*, §3.2.1[H]; see Steve Aker's April 2014 Memo (http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Frank%20Aragona%20Trust%20Material%20Participation%20by%20Trusts%20Summary_April%202014.pdf)
[214] Id., pg. 1.
[215] Id., pg. 2.
[216] Id., pg. 2.

participate in a business?"[217] While the trust material participation question lurks, more resources are available to help guide the practitioner in best advising a client.[218]

A trust should seek material participant status to reduce income taxes as much as possible. If the trust must be a passive investor, the trust should seek a passive investment that will yield tax efficient income or useful deductions or exemptions for the trust's Form 1041.

Finally, we look at the tax impacts of having a trust involved in the probate estate administration process.

I. Tax Consequences of Trusts in Estate Administration

A major tax consequence of having a trust in an estate administration is the §645 rule. Another deep impact is where trusts come into play with the estate, gift, or GST taxes, as we have discussed. An irrevocable trust should not have too many impacts on estate administration, since the irrevocable trust is a separate tax entity. And as we have seen, a revocable trust may have some income or local tax impacts on estate administration.

The §645 Election: Treating a Trust as Part of an Estate

Code §645 looks at treating an estate and a trust as one - an estate and trust's income tax returns need not be filed separately, despite having distinct EINs.[219] A qualified revocable trust (QRT) may elect to be treated as part of the decedent's estate using Form 8855. A QRT is a revocable trust created before death. While the decedent is alive, the QRT's income is taxable under the grantor trust rules.[220] The trust agreement will specify QRT

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[217] Id., pg. 6.
[218] Id., pg. 6; Blattmachr, *Trust*, §3.2.1[H]; Gorin, *Structuring Ownership of Privately-Owned Business: Tax and Estate Planning Implications* (2017); Dees, "20 Questions," Tax Notes 683, 688-700, 785 (Aug. 2013).
[219] Andres, *Kansas Probate Handbook*, §5.5.7(d); Price, *Estate Planning*, §10.15.
[220] Code §§671-679.

status.[221] This treatment is desirable if reporting trust income on a fiscal year basis would be beneficial, as estates may file on a fiscal year basis, but trusts cannot. The §645 election is irrevocable and must be made by the filing deadline for the estate's first Form 1041.[222]

The trust's trustee and the estate's executor make the §645 election by filing Form 8855.[223] If there's no executor of the client's estate, the trustee can make the §645 election unilaterally.[224] While the §645 election stands, the estate's executor files one Form 1041 for the estate *and* the trust under the estate's name and EIN.[225] But the §645 election doesn't affect the estate's and trust's separate treatment for tax procedure and administration questions, only for income tax purposes. An estate's 2 year estimated tax payment exception applies to a trust making the §645 election.[226]

The §645 election stands until the "applicable date," which is the later of (a) 2 years after the decedent's death or (b) 6 months after estate tax liability is determined.[227] When an estate makes a valid §645 election, the estate doesn't terminate until the earlier of (a) the "applicable date" or (b) the day when the qualified revocable trust *and* the estate have distributed all their assets.[228] The final estate tax day is (the applicable date's prong "b") is the earliest of (a) 6 months after an estate tax closing letter is issued, (b) the final disposition of a refund claim resolving estate tax liability, (c) execution of a settlement agreement resolving estate tax liability, (d) a court decision or order resolving estate tax liability, or (e) the statute of limitation expiring for collecting estate taxes.[229]

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221 Code §645(b)(1).
222 Code §645(c); Regs. §§1.645-1(c), 1.645-1(1)(e)(1).
223 Reg. §1.645-1(c)(1)(i).
224 Reg. §1.645-1(c)(1)(i).
225 Reg. §1.645-1(e)(2)(ii).
226 Code §6654(1)(2)(A); Reg. §1.645-1(e)(4).
227 Code §§645(a), 645(b)(2); Reg. §1.645-1(f)(2)(ii).
228 Reg. §1.641(b)-3.
229 Code §6501; Reg. §1.645-1(f)(2)(ii).

The §645 election doesn't relieve the trust from filing an initial Form 1041 for the tax year ending with the client's death, but the trustee doesn't need to file Form 1041 for the short year of the trust (from the client's death until December 31).[230]

§645 Impacts on Form 1041

The §645 election has five impacts on Form 1041. First, the estate's and trust's income, deductions, and credit are combined, and only one personal exemption is allowed.[231] Second, the executor and trustee must reasonably apportion tax liability between the estate and trust.[232] Third, the executor and trustee must timely pay the estate and trust's shares of the tax bill.[233] Fourth, the estate and trust are treated as separate shares for calculating distributable net income (DNI) and certain distributions.[234] The separate share rule allocates DNI.[235] Fifth, a charitable deduction is granted to the estate and trust.[236]

§645 Advantages and Disadvantages

The §645 election has various advantages and disadvantages, which must be weighed. A §645 election does not allow (a) splitting income with another taxpayer and (b) allocating depreciation or depletion between the fiduciary and beneficiaries may be better for a trust than an estate. But the §645 election allows (a) the ability to use a non-calendar year, (b) to deduct some passive losses, (c) to deduct and amortize some reforestation expenses, (d) to receive a charitable deduction beyond unrelated business income.[237]

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[230] Reg. §1.645-1(d)(2)(i).
[231] Reg. §1.645-1(e)(2)(ii).
[232] Reg. §1.645-1(c)(1)(ii).
[233] Reg. §1.645-1(c)(1)(ii).
[234] Reg. §§1.645-1(e)(2)(iii)(A); 1.663(c)-4; Code §§661, 662.
[235] Reg. §1.663(c)-1.
[236] Code §642(c); Reg. §1.645-1(e)(2)(iv). Blattmachr, *Trust*, §9:3 (usually a trust takes "an unlimited income tax deduction for gross income paid to a charity" under the trust document).
[237] Passive activity losses (Code §469(i)) and charitable deduction beyond unrelated business income (Code §681(a)). A §645 election can also affect the trust's state and local taxes where state fiduciary taxes are driven by federal AGI or federal taxable income.

Conclusion

We have explored trust taxes. Regardless of a trust's size, careful tax planning is vital for the fiduciary to satisfy the trust's (or beneficiary's) best interests. Tax planning is vital during the client's life and after the client's death via their trust. Portability, various other tax elections, and/or allocating different credits and deductions could be appropriate or tax efficient in some cases for clients, but not in others. A fiduciary should make the decisions in consultation with an accountant and an attorney to ensure optimal tax treatment.

A trust tax idea could be a once in lifetime opportunity: We should serve clients by seizing beneficial opportunities, since these moments of possibility "vanish at the morning's breath!"[238]

[238] Kipling, "Possibilities," *Complete Verse* (Doubleday, 1989), 44.