Peak Trust Company

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SIOUX FALLS ESTATE PLANNING COUNCIL

Flex Your Beneficiaries:

Reducing the Income Tax Burden on Non-Grantor Trusts

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What We Will Try to Cover

- Explain How Trusts Can Protect Assets from Creditor and Marital Claims More Than Ever
- Explain Why the Beneficiary’s Spouse and Descendants Should (Almost) Always Be Co-Beneficiaries
- Explain How Trusts Can Reduce Income Taxes in Many Ways
- Explain How a Special Trust Can Reduce Income Taxes and Avoid Medicare Disqualification for a Disabled Beneficiary
- Explain Why (Almost) All Trusts Should Authorize Distributions of Gross Income to Charity
- Explain How a CRT Can Increase the Value of Distributions from an IRA or Retirement Plan

Some Background

- For many decades, dividing or splitting income reduced overall income taxation.
- Until the mid 1980s, non-grantor trusts faced the same income tax rate structure as did individuals. That lead to individuals creating many trusts. But Section 643(f) has changed that causing more than one trust to be treated as one if the grantor and the beneficiaries are essentially the same.
- Moreover, also since the mid 1980s, each trust reaches the top income tax bracket at only $7,500(now about $14.000) of taxable income (which has been and will continue to be inflation adjusted). An Individual doesn’t reach that bracket until income exceeds $500,000.
- Does that mean we should not use trusts? Hardly. Trusts provide unique benefits for asset protection, foolish dissipation of wealth and property management.

Trusts That Are Not Grantor Trusts

- Trusts are either grantor trusts or not grantor trusts (in whole or in part).
- The income, deductions and credits against tax are attributed under Section 671 to the trust's income tax owner, basically as though the trust did not exist and its assets were owned by the grantor (or under Section 678 owned by the trust's beneficiary).
- A trust's taxable income is determined in the same way as it is for an individual with exceptions and special rules.
- Under one of these special rules, the income of a trust (through the mechanism of distributable net income or DNI) may be taxed to a beneficiary rather than the trust. Individuals cannot do that on account of the "anticipatory assignment of income" doctrine. And a trust can shift this income to a beneficiary by making the distribution within the year or, by a special election, within 65 days after the year ends.
- Under another special rule (Section 642(c)), a trust only gets an income tax deduction for its gross income paid to charity pursuant to the terms of the trust instrument. This allows the trust to reduce its taxable income (other than for UBI) to zero.

Reduce Income Tax on Trust Income by Distributing Gross Income to Charity

- Section 642(c) allows an unlimited income tax deduction but only for gross income paid, pursuant to the terms of the governing instrument, for a charitable purpose.
- However, Section 681 imposes the same percentage limits tied to an individual's contribution base (essentially, AGI) to the extent the distribution to charity from the trust constitutes essentially of unrelated business [taxable] income (under Section 512). But the taint of UBTI seems to be washed away when distributed from a trust to charity. See Schmolka, "Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism," 40 Tax Law Rev. 1, 294, n. 653.
- The Section 642(c) deduction is allowed not only if the governing instrument directs payments for a charitable purpose but also if it merely authorizes them.
- In addition, if a trust is a partner is a partnership that makes a donation to charity from its gross income, the trust, as a partner, may deduct its proportionate share of the charitable donation. Rev. Rul. 2004-5.

Why Distribute Gross Income to Charity Instead to a Beneficiary

- Beneficiaries face a limitation on the deduction for gifts to charity but trusts do not.

- Also, a trust can distribute its gross income in the following year and have it treated as though it was distributed in the year it was earned. (This is like a retroactive deduction)

- A trust can currently deduct gross income paid in the current year even though it was earned but not distributed in a prior year. (This is like preserving a deduction from one year to another)

Reduce Income Tax on Trust Income by Distributing Gross Income to a Charitable Lead Trust

- In lieu of distributing the trust's gross income to charity, it seems quite certain it could be distributed to a charitable lead trust (if authorized by the governing instrument) and, to the extent of charity's actuarial interest in the trust (which could be 100% with a zeroed out CLAT), be deductible under Section 642(c). This might enhance what family members ultimately receive from the "main" trust.

Reduce Income Tax on Trust Income by Distributing DNI to Beneficiaries

- Although, in general, a non-grantor trust is taxed as an individual is, in addition to a different deduction for charitable contributions, a trust is entitled to a deduction for distributions of its distributable net income (DNI) to its non-charitable beneficiaries, subject to exceptions and special rules
- DNI is defined in Section 643(a) and is the trust's taxable income for the year with special rules and exceptions. For example, except for the year of termination of the trust, capital gain is not included in DNI unless it is actually distributed (or deemed distributed). The regulations explain ways for that to happen, such as allocating capital gain to fiduciary accounting income or by "deeming" a distribution of corpus as consisting of capital gain
- In any event, distributing DNI to a beneficiary shifts the income to the beneficiary and away from the trust. And to that extent, the trust's tax brackets and other income tax attributes will not apply
- Also, the trust may be able to avoid state income tax that a beneficiary who receives DNI cannot. See *North Carolina v. Kaestner* (USSC 2019)

Distributing DNI Among a Class of Beneficiaries that May Include the Spouses of Descendants

- Subject to exceptions and special rules, DNI can be distributed to any discretionary beneficiary (that is, a beneficiary who is eligible in the discretion of a non-beneficiary trustee to receive trust distributions; if the trustee may distribute to himself or herself, he or she may be a deemed owner trust under Section 678)
- A beneficiary may be any beneficiary other than charity (for which a shift of income out of the trust to the beneficiary is allowed only under Section 642(c)) and may include other trusts or any other non-charitable "person," including a corporation
- Hence, distributions may be authorized to be made to the spouses of the primary beneficiaries (such as the spouses of descendants of the person whose wealth funded the trust)
- It may make sense to include such spouses as discretionary beneficiaries for at least two reasons:
    - First, the descendant may be under the threat of a creditor claim
    - Second, the descendant may have an addiction or spendthrift problem or be incompetent
- Distributions to the descendant's spouse can be conditioned on the spouse being married to and living as a married couple with the descendant and/or obtaining the descendant's consent (only minimal risk of any real risk tax exposure to the consenting descendants as the gift would likely be de minimus and/or qualifying for the gift tax marital deduction, or the expanded annual exclusion if the spouse is not a US citizen).

Distributing DNI Among a Class of Beneficiaries that Includes Other Trusts, Such as CRTs for Descendants

- Subject to exceptions and special rules, DNI can be distributed to any discretionary beneficiary (that is, a beneficiary who is eligible in the discretion of a non-beneficiary trustee to receive trust distributions)
- A beneficiary, who may receive DNI, may include any other non-charitable “person” *including another trust*
- Before making the distribution to another trust, consideration should be given to the tax attributes of the “receiving” trust, such as whether the receiving trust is GST exempt or subject to a particular rule against perpetuities or subject to state income tax
- A distribution to a charitable remainder trust (CRT) described in Section 664 might be considered, as CRTs are income tax exempt (but are subject to a 100% excise tax on their unrelated [taxable] business income, essentially as defined under Section 512)
- However, a trust is a CRT described in Section 664 only if it meets the definition of a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT) including an income only unitrust such as a NIMCRUT (a CRUT with make-up provisions) and has property for which an income tax charitable deduction was allowable under Section 170, 2055, 2106 or 2522. Reg. 1.664-1(a)(1)(iii)(*a*)
- It seems that if a distribution is made from one “regular” trust to a CRT, the paying trust will receive a deduction under Section 642(c) for its gross income so paid and a distribution deduction under Section 661 for its DNI so paid.

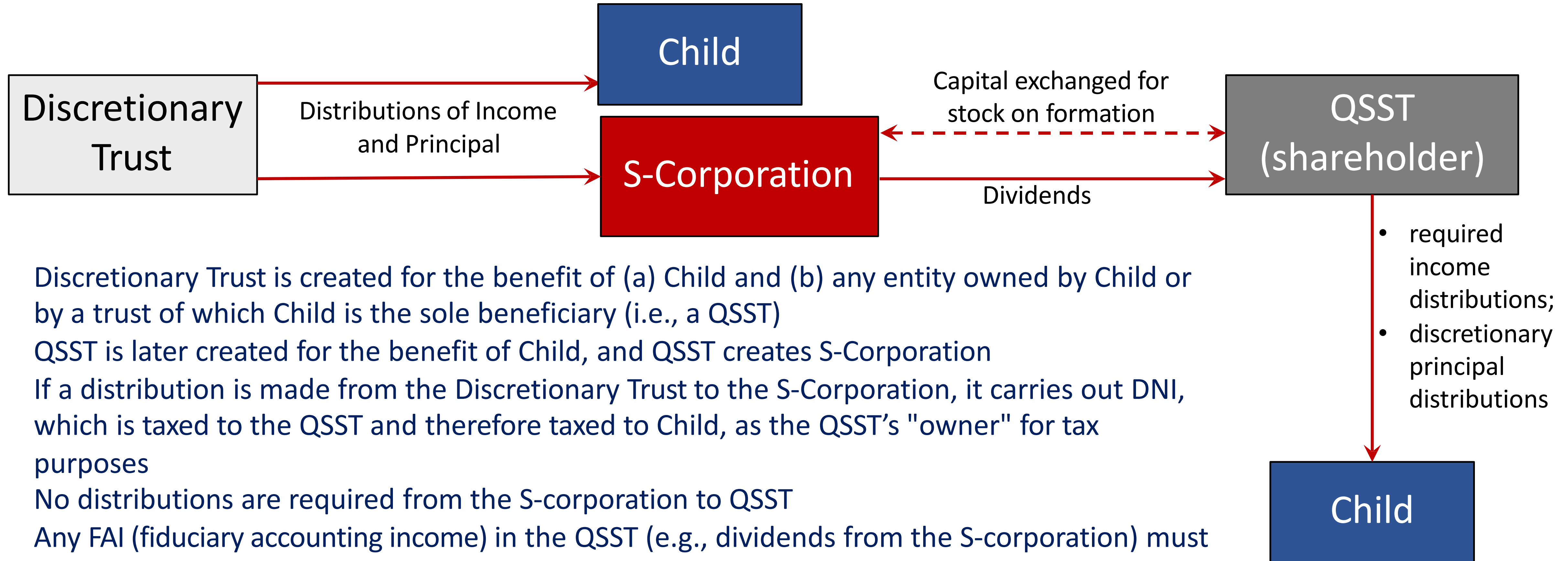
More on Making Distributions to CRTs

- A distribution by an estate or non-grantor trust to a CRT should produce a Section 642(c) charitable deduction to the extent of gross income so distributed if pursuant to the terms of the governing instrument and a distribution deduction under Section 661 for the distribution of DNI to the CRT. But not it will not produce any deduction under Section 170, 2055, 2106 or 2522 and it would, therefore, seem to fail to be a CRT as described in Reg 1.664-1(a)(1)(iii)(*a*) ("a trust with respect to which a deduction is allowable under section 170, 2055, 2106, or 2522"). However, a contribution to a pre-existing CRUT seems completely viable.
- Although additional contributions cannot be made to a CRAT, they may be made to a CRUT, if the CRUT so authorizes. So distributing DNI to a pre-existing CRUT, which holds some property for which a charitable deduction was allowed under 170, 2055, 2106 or 2522 should mean that the DNI is not taxed at all. (Any UBTI taint in the distributing trust seems to be washed away when distributed.)
- And if the distribution is made to a pre-existing NIMCRUT, it may be possible to avoid having the DNI income taxed for a long time. See "Using a Charitable Remainder Trust as the Recipient of Qualified Plans and IRAs," 47 Estate Planning 3 (May 2020). Note that making a distribution of DNI from the "main" trust to an entity (e.g., an LLC) of which a NIMCRUT is the sole member (or major partner), means the income will be attributed to the NIMCRUT but no FAI (which would otherwise have to be distributed) would be generated until the entity makes a distribution (which could be treated as FAI). So the DNI will not be currently taxed.
- Hence, someone should create the NIMCRUT and a disregarded entity (e.g., single member LLC) "owned" by the NIMCRUT for those descendants who may not need current distributions and to which the trustee of the "main" trust may distribute DNI. The person controlling the LLC should be other than the trustee or beneficiary, the grantor or someone related or subordinate—see Rev Proc. 97-23) These need not have been in existence when the main trust was created. In fact, it may be appropriate to create a new NIMCRUT for each distribution of DNI from the main trust.

Distributing DNI to an S Corporation Which Has Descendants or a QSSTs for Descendants as its Shareholders

- Subject to exceptions and special rules, DNI can be distributed to any discretionary beneficiary (that is, a beneficiary who is eligible in the discretion of a non-beneficiary trustee to receive trust distributions), including an S corporation
- The income of an S corporation is not taxed to the corporation, but to its shareholders
- The class of permissible S corporation shareholders is limited but includes US individual taxpayers and qualified subchapter S trusts (QSSTs) described in Section 1361(d)(3). A QSST is a trust that has a US individual taxpayer as its sole beneficiary and must currently distribute all of its *fiduciary accounting income* to that beneficiary.
- DNI distributed to an S corporation will be included (directly) in the gross income of its shareholders. Hence, if a descendant is the shareholder, the DNI will be included in that descendant's gross income, without necessitating any distribution to the descendant other than for fiduciary accounting income which can be minimized—see discussion in "Using a Charitable Remainder Trust as the Recipient of Qualified Plans and IRAs," 47 Estate Planning 3 (May 2020). Although that might directly protect the income from attachment by a creditor of the descendant shareholder, the stock owned by the descendant will not be protected.
- Hence, instead of having the stock in the S corporation owned by a descendant, it might be preferable to have the stock owned by a QSST for the descendant. The income of the S corporation (including any DNI distributed to it) will be taxed to the descendant as the beneficiary of the QSST without making either the income (if not distributed or distributable from the S corporation) or the stock subject to the claims of the descendant's creditors, and should not cause the descendant to exceed thresholds for government entitlements such as Medicaid. Obviously, the descendant should not be able to control distributions from the S corporation.

Non-grantor trust with beneficiary as taxpayer using QSST/S-Corp



- Discretionary Trust is created for the benefit of (a) Child and (b) any entity owned by Child or by a trust of which Child is the sole beneficiary (i.e., a QSST)
- QSST is later created for the benefit of Child, and QSST creates S-Corporation
- If a distribution is made from the Discretionary Trust to the S-Corporation, it carries out DNI, which is taxed to the QSST and therefore taxed to Child, as the QSST's "owner" for tax purposes
- No distributions are required from the S-corporation to QSST
- Any FAI (fiduciary accounting income) in the QSST (e.g., dividends from the S-corporation) must be distributed to Child
- Accordingly, assets can be accumulated at the S-corporation level, and only pass to Child when a dividend is declared, but income is taxed to Child (at individual rates, instead of trust rates)

Summary & Conclusions

- Under current law, grantor trusts are often an effective tool for estate planning. However, a trust cannot be governed by the grantor trust rules once its "deemed owner" dies.
- Non-grantor trusts may be beneficial for certain purposes, such as avoiding state income tax or providing certain additional tax benefits (such as an additional SALT deduction or Section 199A deduction).
- Unfortunately, non-grantor trusts face extremely high federal income taxes compared to individuals, but distributions of trust income can, in a flexibly drafted trust, be distributed to charity and/or non-charitable beneficiaries that may include descendants, their spouses, CLTs, CRTs for them and S corporations of which descendants or QSSTs for them are the shareholders. These flexible options need not be used so consider adding them to all trusts.
- And remember the flexibility of the Section 663(b) sixty-five (65) day rule that applies to distributions of DNI (and for Section 642(c) the trust has the entire next year to make the distribution).
- But in all events, the family's tax advisors (e.g., CPAs) need to be fully looped in on trust administration and projections