CHAPTER 19

Overview of the Taxation of Trusts

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The general rule is that all trusts are separate taxpayers, each with its own tax year and accounting method. The exception to this rule is trusts that are ignored for income tax purposes under the "grantor trust" rules discussed in more detail below.

Just like their human counterparts, trusts are taxed on income and receive deductions for certain authorized expenses.

Unlike human taxpayers, however, trusts are taxed under a compressed rate schedule which results in a significantly higher tax at any given level of income. As shown in the trust tax rate schedule below, the highest bracket is reached at just $10,050 in taxable income, whereas an individual would need an income of $357,700 in 2008 to reach that same tax bracket.

Trust Tax Rates 2008

IF TAXABLE INCOME IS...		THEN ESTIMATED TAXES ARE...		
Between	But Not Over	Base Tax	+ Rate	Of the Amount Over
$0	$2,050	$0	15%	$0
$2,050	$4,850	$307.50	25%	$2,050
$4,850	$7,400	$1,007.50	28%	$4,850
$7,400	$10,050	$1,721.50	33%	$7,400
$10,050	—	$2,596.00	35%	$10,050

Bear in mind that these compressed rates only apply to ordinary income. Capital gains and dividend income are taxed the same for individuals and trusts.

Because of the substantial disparity between individual tax rates and those for trusts, it is important to understand exactly how trusts are taxed. For our purposes, trusts will be divided into three categories: grantor trusts, simple trusts, and complex trusts. Each will be discussed in more detail below.

GRANTOR TRUSTS

A grantor trust is the exception to the general rule that all trusts are taxpayers. Therefore, grantor trusts are ignored for income tax purposes. Under the Internal Revenue Code, a trust is a "grantor trust" if the grantor retains one or more of the

powers listed in Internal Revenue Code Sections 673 through 677. It is also possible for a third party who is not the grantor to be deemed the owner of a trust if that person has control over the principal or income of the trust as described in Internal Revenue Code Section 678.

In essence, this means that if the grantor (or a third party) has the kind of control over the trust property that would ordinarily be consistent with ownership of the property, the trust will be ignored for income tax purposes and the deemed owner will be taxed on all income to the trust as if it were his or her own income.

By far, the most common type of "grantor trust" is the revocable living trust. Because it is virtually impossible to create a revocable living trust without retaining one of the grantor trust powers (e.g., power to designate beneficiaries), anyone creating a revocable living trust does not need to worry about filing a separate income tax return for the trust. Even though grantor trust status is virtually guaranteed for a revocable living trust, it is still a good idea to state in the trust that the grantor is specifically retaining one or more of the grantor trust powers.

EXAMPLE: GRANTOR TRUST STATUS LANGUAGE

By reserving the broad rights and powers set forth in this Article, I intend to qualify my trust as a "Grantor Trust" under Sections 671 to 677 of the Internal Revenue Code so that, for federal income tax purposes, I will be treated as the owner during my lifetime of all the assets held in my trust as though I held them in my individual capacity.

During any period that my trust is a Grantor Trust, the taxpayer identification number of my trust shall be my Social Security number, in accordance with Treasury Regulation Section 301.6109-1(a)(2).

INTENTIONALLY "DEFECTIVE" GRANTOR TRUSTS

Perhaps one of the most unfortunate vocabulary choices in the estate planning field lies with the "Intentionally Defective Grantor Trust," or IDGT. Many clients have blanched at the idea that their trust would be "defective." But, the term only means the trust was intentionally created so that the grantor retained one of the powers listed in the Internal Revenue Code's grantor trust rules.

This powerful technique takes advantage of a quirk in the tax code classifying the owner of the trust differently for estate tax purposes than for income tax purposes. Therefore, a gift in trust may be complete for estate tax purposes but not for income tax purposes. A gift is only complete for income tax purposes if you give away all of the powers in the grantor trust rules. If you retain any of the listed powers, then the gift is "defective," which means the trust will be considered a grantor trust, and you will pay income tax on all of the trust's income.

This schism creates two planning opportunities. First, you cannot sell something to yourself for tax purposes. That is, a sale transaction where you are both the seller and

the buyer is not considered a "transfer" for income tax purposes. That means you can create and fund an intentionally defective grantor trust, which is outside your estate for estate tax purposes, and then sell an asset to that trust without incurring any capital gains tax on the sale. This technique also avoids other penalties and consequences that may apply to certain transfers, such as transfers of life insurance.

The second key benefit is that, when the grantor pays income tax on the trust's income, it is effectively the same as making a tax-free gift to the beneficiaries equal to the amount of the income tax he or she would pay if the trust were a non-grantor trust.

NON-GRANTOR TRUSTS: SIMPLE OR COMPLEX?

Non-grantor trusts (i.e., trusts that are not considered grantor trusts) are divided into two categories. A non-grantor trust will either be a simple trust or a complex trust, depending on how it handles distributions to beneficiaries.

A simple trust must pass three tests. It must distribute all income to the beneficiaries; it cannot distribute principal; and it cannot make distributions to charities. A complex trust, by comparison, is one that does one or more of the things that a simple trust cannot do. That is, it can accumulate income, distribute principal, or make distributions to charity.

In other words, a trust must qualify as a simple trust, or else it will be considered a complex trust. The difference between the two lies in the way that the trust deducts distributions to beneficiaries.

In a simple trust, all income is treated as distributed to the beneficiaries. In such a case, the trust reports all income annually, but is entitled to a deduction for the entire amount distributed to beneficiaries. The result is that the trust only pays tax on capital gains. (Note that it is possible in some states to treat capital gains as income if permitted by the trust. In those instances, a simple trust would distribute all income and capital gains.)

With a complex trust, distributions can include ordinary income, dividends, capital gains and, perhaps, principal. It is also possible that the trust earns income that is not distributed, and there may be a deduction for distributions to charities. The result is that the allocation of the tax and any deductions between the trust and its beneficiaries — and among beneficiaries — can be quite complex. Hence, the name.

A complex trust may not distribute principal unless all income has first been distributed. However, it is actually more complex than this. The rules require that all ordinary income be distributed before dividends; all dividends be distributed before capital gains; and all capital gains be distributed before principal. The result is what tax lawyers call "worst in, first out" — that is, the worst character of income must be exhausted before moving to the next tier.

When these distributions are made, the trust is entitled to a deduction for any income distributed to beneficiaries. However, because the income (and certain

deductions) must be allocated equitably among the trust and the beneficiaries, it is necessary to calculate what the tax code refers to as the Distributable Net Income, or "DNI."

How DNI is determined is beyond the scope of this chapter. However, it should suffice to know the DNI represents the amount that must either be distributed to beneficiaries or be taxed to the trust. It represents the upper limit on the trust's deduction for distributions and the upper limit on the amount of income taxable to the beneficiaries.

Because of the nature of the tax rules for complex trusts, careful planning and coordination between your investment, legal, and tax professionals is critical.

David Hiersekorn helps affluent families and business owners protect their assets and create a lasting legacy.