

CHAPTER SIX – Income Tax – Non-grantor Trusts

What is federal income tax treatment of a “true trust”? Income allocation is to be made between: (1) trust & (2) the beneficiaries (but not grantor)? Subchap. J, Subparts A-D (not E).

Also: What allocation of trust income between the several beneficiaries?

These questions are relevant both:

- (1) during grantor’s life (for an irrevocable trust, assuming no “grantor trust” status), and,
- (2) after death, e.g., (i) “testamentary trust” & (ii) lifetime trust becoming irrevocable at death.

Remembering the Trust Distribution Options P.3

- 1) Distribute income currently
- 2) Accumulate trust income (some or all)
- 3) Ascertainable standard (HSEM)
- 4) Trustee's total discretion
- 5) Spray or sprinkle power to multiple beneficiaries (or only to one beneficiary & not the other beneficiary).

Query: What is relevance of these options for federal income tax planning purposes?

Trust Income Tax Code Statutory Rules

Subchapter J (Code §§ 641-679)

Subpart A - General rules, including the “distributable net income” or “DNI” definition

Subpart B – Simple trusts – distribute all income currently

Subpart C - Complex trusts - flexibility

Subpart D – Accumulation trusts (“throwback rules’”) (currently only for foreign trusts)

Subpart E – Grantor trust rules

Considering the Trust Income Tax Rates p.5

Maximum 37% rate reached at low level for trust - \$12,750 (as indexed) in 2019. Code §1(e).

Consider the following options:

(1) Tax incentive to distribute income.

(2) Investment policy for having “unrealized” gains (e.g., capital gain assets).

(3) Incentive for flexible structuring of the trust instrument to provide for the discretionary distribution of trust income to the tax appropriate beneficiaries.

When Does Trust's Existence Commence?

P.6

- (1) Intervivos trust – existence commences when becomes irrevocable and is funded.**
- (2) Testamentary trust – when funded from the probate estate (and other sources).**

Note (at p. 7) Code §645 (previously §646) re possible combination of (1) the estate and (2) a “qualified revocable trust” as being one taxpayer for federal income tax purposes.

Defining Distributable net Income (“DNI”) P.7

See the definition of “DNI” in Code §643(a).

What is the purpose of the DNI concept?

Note “income” definitional differences for trusts
between:

- (1) trust law accounting, and
- (2) income tax accounting.

Defining “DNI” cont.

P.7

Consider (examples, p. 11-12):

- (1) Relevance of capital gains and losses (i.e., categorized as income or corpus?); income tax liability imposed at the trust level (and not to the beneficiary)?
- (2) A “total return” investment policy (i.e., modern portfolio management).
- (3) Treatment of trust administration expenses as offsetting income or principal amounts (see Example 2, p. 12).

Simple Trust Tax p.12

Treatment - §§651-652

Example: All income is currently distributable.

Pertinent income tax rules are:

§651 - deduction to the trust for the amount required to be distributed.

§652(a) - income inclusion required of the beneficiary for the amount required to be distributed; but, even if not distributed?

§652(b) – tax character of income items is retained into the hands of the beneficiary (e.g., tax-exempt bond income).

“Complex Trust” Tax

§§661-664

p.14

§661(a) – a deduction to a trust for amounts:

- 1) required to be distributed, and
- 2) actually distributed.

§662(a) - income inclusion is required of the beneficiary for an income amount which is:

- 1) required to be distributed (even if not distributed), and/or
- 2) actually distributed.

§662(b) – character of income items is retained into the hands of the beneficiary.

Multiple Tier Distributions – Complex Trust p.14

1st tier beneficiary – receives an amount required to be distributed.

2nd tier beneficiary – receives discretionary distributions (after mandatory distributions).

Allocation of DNI first to the 1st tier beneficiary.

Planning: How direct the 1st tier distributions?

What if the financial circumstances of some beneficiaries change subsequent to the trust creation/funding?

Separate Share Rule -

§663(c)

p.15

Each trust is created under one trust agreement but is treated as a separate trust for Subchapter J income allocation rules.

What is the income tax objective of this “separate share” rule?

What if the trust has a “spray or sprinkle” power? Is the separate trust rule applicable?

See Priv. Ltr. Rul. 9321055 (p. 16) re shares in “Master Minority Trust.” However: a single trust for filing income tax return(s).

Income Distributions

Made “In Kind”

p.20

The two interrelated income tax elements are:

(1) built-in gain (loss) in the distributed property, and (2) the DNI distribution rules.

See Code §643(e) – eliminates the potential to make accrued capital gain disappear from the tax base on a property distribution from trust.

However, can make election to recognize gain.

What is the purpose of this §643(e)(3) election to recognize gain on the distribution?

Income Distributions Made “In Kind,” continued

See PLR 9246030, p. 21, re tax basis to trust.

Code §643(e)(1) re tax basis for asset distributed in kind to the beneficiary – i.e., same as the tax basis to the trust immediately prior to the distribution.

Note (p. 22) re distribution of (1) high basis asset to one beneficiary and (2) low basis asset to another beneficiary. This necessitates authorization in the “powers clauses.”

Distributions of Specific Bequests p.23

§663(a)(1) – exception from the DNI rules for the estate distribution of specific bequests.

What is a “specific bequest” for this purpose?

Why enable this exception?

Assets have a stepped-up basis for income tax.

Note Code §102 re exclusion of the bequest itself from the gross income of the recipient.

PLR 9218076 – p. 23 – will contest/dispute and compromise distributions. Not §663(a)(1).

Trust Restructurings

p.25

What are the income tax consequences of trust restructurings when shares are allocated to various beneficiaries?

Divisions of trusts are not treated as sales or exchanges of the various trust interests.

But, what is the possible impact of the Cottage Savings case?

Trust Throwback Rules

p.26

§§665-668 - accumulation trust rules.

Now domestic trusts are exempt from these rules. What is the reason for this exemption? Income tax rate bracket structure; i.e., no incentive to accumulate under the present income tax rate structure.

Throwback rules are applicable to foreign trusts. Why?

Limitation on Multiple Trusts

p.28

§§643(f) and 667(c) – objective of these rules? To limit attempts for “multiple runs up the Code §1(e) bracket ladder.”

Particularly relevant when considering the low level of the highest trust income tax bracket (i.e., \$12,750).

Tax Planning Summary

p.30

- 1) Flexibility for income and principal distributions**
- 2) Liberal investment flexibility**
- 3) Other “super-powers”, e.g., powers to split into other trusts, etc.**
- 4) Trust protector – to enable possible trust restructuring.**