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Top Ten Tactical and Strategic Issues for Fiduciary Income Tax Planning and Returns

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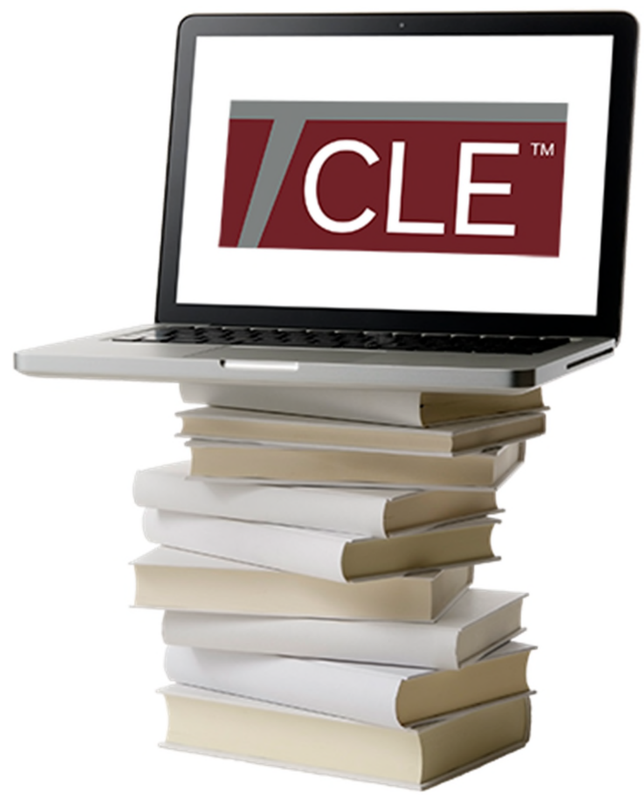

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Overview

- 2017 Tax Law Changes
- Strategic Income Tax Planning
- Ten Tips for Fiduciary Income Tax Preparers

2017 Tax Law Changes

- Code § 199A – Deduction for Qualified Business Income (QBI), etc.
- Itemized Deductions
- ESBTs

Code § 199A Deduction and Taxable Income Thresholds (II.E.1.c.v.)

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- For details on Code § 199A, free January 30 1-hour webinar, is available on Gorin blog at Strategic Planning for Business Entities after 2017 Tax Reform.
- $157,500-$207,500 for all other taxpayers, including trusts
- Below threshold, most ineligible service businesses become eligible and the wage limitations do not apply
- Benefits phase out over that range
- Phase-outs apply cumulatively

Trusts and QBI (II.E.1.f.)

- Grantor trusts are disregarded and their items attributed to their deemed owners.
- The trust and beneficiaries are allocated the various items in proportion to their respective portions of distributable net income (“DNI”), determined after applying the separate share rules, if relevant.

Trusts and QBI (II.E.1.f.)

- The Code § 199A deduction is not included in calculating DNI. Considering that both deductions are artificial deductions rather than deductions of actual expenditures, there is some logic to this.
- Taxable income thresholds are applied separately at the trust and beneficiary levels.

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Trusts and 2017 Law (II.J.3.d.)

- Trust administrative expenses – Code § 67(e) makes deductions not be itemized
- State tax deduction under Code § 164(b)(6) – separate $10,000 limitations; consider that property taxes but not income taxes are unlimited for trade or business or rental real estate

Trusts and 2017 Law (II.J.3.d.)

- ESBT may now have nonresident alien as permissible current beneficiary (II.A.2.g.)
- ESBT deduction for charitable contributions on K-1 from S corporation now applies Code § 170 instead of Code § 642(c) (III.A.3.e.ii.(b).)

Strategic Income Tax Planning

- Who Is Best Taxed on Gross Income
- Effect of Kiddie Tax on Rates
- Who Benefits Most from Deductions
- State and Local Income Tax
- Consider Trust Purposes
- Effect on Future Years
- Flexibility in Trust Income Taxation
- Planning for Excess Losses

Who Is Best Taxed on Gross Income (II.J.3.a.)

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Increasing a beneficiary's AGI can cause the following tax issues:

- Reduction in Particular Itemized Deductions
- Phase Out of AMT Exemption
- Phase Out of Personal Exemption (2026+)
- Net Investment Income (NII) Tax

Who Is Best Taxed on Gross Income (II.J.3.a.)

- Consider Beneficiary Loss Carryovers to offset income

Effect of Kiddie Tax on Rates (II.J.3.b.)

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- Trust Rates for Unearned Income 2018-2025
- No Rule Coordinating Net Investment Income Tax

Who Benefits Most from Deductions

- Administrative Expenses Above-the-Line for Trusts But Temporarily Disallowed for Beneficiaries
- State Tax Deduction
- Charitable Deduction Limitations (discussed further below)
- Code § 1244 Stock
- Special Rule for Depreciation Deductions

State and Local Income Tax

- Trust's vs. Beneficiary's Rates
- Nonresident Trust Escaping Taxation
- Effect of Grantor Trust Status on a Trust's Residence (including grantor later moving)

Consider Trust Purposes

- Protecting Beneficiary from Third Parties
- Protecting Beneficiary from Self
- Avoiding Estate Tax at Beneficiary's Death (increased exemption might change this need)

Effect on Future Years

- Capital Gain Distribution Election (discussed later)
- Turning On/Off Grantor Trust Powers (discussed later)

Flexibility in Trust Income Taxation

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- Support – Check for Considering or Ignoring Other Resources
- See Whether Distributions for Welfare are Permissible – Check Living Client's Estate Plan for Welfare and 5% Withdrawal Right (described further below)

Planning for Excess Losses (II.J.3.i.)

- Cannot Pass Through Losses Other Than Depreciation (II.J.11.a.ii.(b)); Level at Which the Passive Loss Rules Apply Is Uncertain When Trust Has Net Income (II.K.2.b.iv.)
- Lose Excess Losses Except for Final Year or Net Operating Loss
- Passive Loss Rules Might Simplify Due to Suspended Losses

Tips for Fiduciary Income Tax Return Preparers (II.J.4.)

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- Distributions after Yearend to Carry Out Income to Beneficiaries
- Capital Gain Elections
- Charitable Distributions
- Possible Change in Beneficiary's Residence
- Material Participation for Business or Rental Activities

Tips for Fiduciary Income Tax Return Preparers (II.J.4.)

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- Making Trust a Partial Grantor Trust as to a Beneficiary
- Making the Trust a Complete Grantor Trust as to the Beneficiary
- Trapping Income in Trust Notwithstanding Distributions
- Modifying Trust to Make More Income Tax Efficient

Tips for Fiduciary Income Tax Return Preparers (II.J.4.)

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- Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure
  - Need to Provide Notices
  - Sample Notice

Distributions after Yearend to Carry Out Income to Beneficiaries (II.J.4.a)

- Rough Draft of Return in February
- Compare to Beneficiaries' Tax Rates
- Distributions by March 6, 2018 (II.J.2.)
- Distributions Can Carry Out Capital Gains (see below)

Capital Gain Elections (II.J.4.b)

- Tax Preparation Software Traps Unless Take Special Steps
- Next Slides Discuss Strategic Issues, Law, and Practical Issues (II.J.8.)

Additional 5% Capital Gain Tax

	2018	2017
Single	$ 500,000	$ 418,401
Married filing jointly	$ 600,000	$ 470,701
Trust	$ 12,500	$ 12,500

3.8% Tax on Net Investment Income

Single	$200,000
Married	$250,000
Trust	$12,500

Indexed for Trusts But Not Individuals

Capital Gain is DNI Unless Excluded (II.J.8.a.)

Capital Gain Excluded Only If:

- From Sale of Capital Asset
- Allocated to Corpus
- Not Paid, Credited, or Required to Be Distributed to a Beneficiary
- Paid, Permanently Set Aside, or to Be Used for Charitable Purposes

Capital Asset (II.J.8.a.i.)

Not a Capital Asset:

•Code § 1231 Property

•Amortized Goodwill (self-created goodwill not amortizable is a capital asset)

Mechanism for Distributing Capital Gain: Reg. § 1.643(a)-3(b) (II.J.8.c.)

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1. Allocated to income
2. Allocated to corpus but distributed consistently
3. 65-day rule distribution

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Allocated to Income (II.J.8.c.i.)

- "Power to adjust" principal
- Uniform Principal & Income Act reflects Prudent Investor Rule; UPIA becoming UFIPA (Uniform Fiduciary Principal & Income Act) (Uniform Law Commission may adopt in 2019)
- No duty of consistency from year to year except unitrust

Allocated to Income

- Trust agreement can allocate capital gain to income
- Cannot “depart fundamentally from traditional principles of income and principal” per Reg. § 1.643(b)-1
- 3%-5% should be OK

Allocated to Corpus But Distributed Consistently (II.J.8.c.ii.)

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- Existing trusts – probably did NOT allocate capital gain to DNI
- Solution discussed later
- New trusts – generally allocate capital gain to DNI unless beneficiary in higher federal & state combined bracket (including phase-outs)

Actual or Deemed Distribution (II.J.8.c.iii.)

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- Tracing Actual Distribution Often Not Practical Unless Terminate Trust
- Referring to Capital Gain Suffices – 65-Day Rule Distribution When Trustee Refers to Capital Gain
- Can Be Inconsistent from Year to Year

Fairness Issues (II.J.8.c.v)

- Fair for cash distribution to carry out taxable income
- If not, “gross up” distribution for taxes paid by distributee
- “Gross up” payment costs remaindermen less than if the trust paid the tax

Are distributions advisable?

- Are Distributions Available?
- Protective Nature of Trust

Are distributions available?

- Support vs. Welfare
- Consider or Not Consider Other Resources

Additional Tax Issues

- Estate Tax on Beneficiary's Estate
- Distribution in Kind to Include in Beneficiary's Estate for Basis Step-Up (II.J.8.d.)

Protective Nature of Trust

- Very Real Creditor or Spousal Issues
- Burning a Hole in the Beneficiary's Pocket
- Beneficiary Saves But Might One Day Have Creditors

Consider Forming Partnership (II.J.8.e.)

- Trust is General Partner
- Beneficiary is Limited Partner

Partnership

- Converts Capital Gain To Trust Accounting Income
- Beneficiary Can't Spend the Partnership Interest If Distributed to Carry Out Capital Gain
- Need to Gross Up Beneficiary for Capital Gain If Use Distribution of Partnership Interest to Carry Out Capital Gain

Ideal Trust Distribution Provisions

- Distributions of income and principal for support
- Distributions of income and principal for welfare by independent trustee
- Consider 5% withdrawal right exercisable that trustee can turn off before the taxable year begins

Using Distributions for Welfare

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- If appropriate, beneficiary can appoint person who is not a related or subordinate party (Code § 672(c))
- Distributions can carry out capital gain
- Can decant into more suitable trust or facilitate estate inclusion to get basis step-up at death

Charitable Distributions (II.J.4.c.)

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- Reduce Adjusted Gross Income
- Exclusive Way For Charitable Deductions to Reduce NII
- More Liberal than 65-Day Rule - Contribution Made on or before December 31, 2018 Can Count as a 2017 contribution
- From Gross Income (II.Q.7.c.i.(a))

Look for Change in Beneficiary's Residence (II.J.4.d.)

- Beneficiary Changing Residence Might Change Trust's Residence
- Generally, States Do Not Tax Nonbusiness Income Earned by a Nonresident Trust. (II.J.3.e.i.)

Material Participation for Business or Rental Activities (II.J.4.e.)

- Passive (II.K.) = NII (II.I.8.)
- Document Trustee's Participation
- Even If Trust Taxed to Deemed Owner under Grantor Trust Rules, Consider Having Trustee Participate (discussed below)
- Beneficiary's Participation Can Trigger Depreciation (II.J.11.a.ii.(b))

Qualified Subchapter S Trust (QSST)

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Beneficiary Taxed as Deemed Owner of S Corporation Stock ***Except*** for Gain on Sale of Stock or Business Assets

- Allows Beneficiary to Run through All the Lower Brackets before Getting to Higher Brackets
- For Sale of Business, See II.J.15, II.J.16., and II.J.17.

Material Participation for Trusts

Trust Type	Participant
QSST (normal operations)	Beneficiary
QSST (stock or asset sale)	Trustee*
ESBT	Trustee

* Per proposed regulations and IRS' litigation position on trust material participation

See II.K.2.

Making Trust a Partial Grantor Trust as to a Beneficiary (II.J.4.f.)

- Exercise Discretion to Declare a Distribution
- Credit Instead of Distribute
- Lapse Makes Beneficiary Partial Deemed Owner
- Portion Accumulates Over Time
- Cannot Turn Off

Changing the Paradigm

Gorin, "Taxing a Trust's Income: When Distributions Are Surprisingly Not the Key," BNA *Tax Management Estates, Gifts and Trusts Journal*, Vol. 46 (11/9/2017)

Making Trust a Complete Grantor Trust as to a Beneficiary (II.J.4.g.)

- Trustee Contributes Assets to S Corporation
- Convert to QSST
- Might Increase Beneficiary's Rights, Depending on How Conversion Is Done
- Can Turn Off

Qualified Subchapter S Trust (QSST)

Similar to marital deduction trust (III.A.3.e.i.(a).):

- All income must be distributed annually to sole beneficiary
- Not as protective as trust that accumulates income
- No distribution of principal during life of sole beneficiary to anyone other than sole beneficiary

Trapping Income in Trust Notwithstanding Distributions (II.J.4.h.)

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- Trustee Contributes Assets to S Corporation
- Trustee Makes ESBT Election
- Can Turn Off

Electing Small Business Trust (ESBT) (III.A.3.e.ii.)

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- Can be a sprinkle trust
- All S corporation income taxed at highest income tax bracket
  - Limited deductions
  - No income distribution deduction for S corporation items
- Flexible Trusts (III.A.3.e.iv.) Discussion Follows

Flexible Trust Design – Spouses

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- In many cases, do ***not*** use sprinkle credit shelter trust, which locks one into ESBT
- Bequeath all assets into a QTIP-able trust to toggle between QSST and ESBT as appropriate

Flexible Trust Design – Children

- At drafting stage, make flexible as described above but only one beneficiary
- Can give beneficiary inter vivos power of appointment
- Might be able to modify ESBT and split into one or more QSSTs (III.A.3.e.v.)
- See materials for strategic advantages and disadvantages and implementation steps

Flexible Trust Design
Multiple Trusts

- ESBT Portion Holds Only S Stock
- Hold Any Reinvested Distributions in Separate Investment Trust
- Distributions from S Corporation Trust Do Not Carry Out Income
- Distributions from Investment Trust Do Carry Out Income

Toggling Between QSST and ESBT

- First Time Toggling – No Time Restrictions
- Subsequent Toggling – 36 Month Wait

Modify Trust to Make More Income Tax Efficient (II.J.4.i.)

- Settlor and Beneficiaries (depends on state)
- Decanting (helpful if distributions for welfare)

Helping the Trustee Provide Annual Notices to Reduce Exposure (II.J.4.j.)

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- Trustee Liable 5 Years After Termination (Missouri or other UTC states)
- Providing Notice Cuts to 1 Year
- Litigious Beneficiaries
- Harmonious Situation
- Sample Notice – All Records on CD; Mail with Table of Contents and Receipt

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Obtaining Materials

- Over 1,500 pages on business structuring with more searching functionality available by emailing sgorin@thompsoncoburn.com
- Indicate whether want quarterly newsletter with most recent version; if so, include complete contact information, including street address