Income Tax Considerations for Trusts: Hot Topics

November 2016

Justin T. Miller, J.D., LL.M., TEP, AEP®, CFP®
National Wealth Strategist

BNY MELLON
WEALTH MANAGEMENT

Agenda

The 3.8% Net Investment Income Tax (NIIT)

Minimizing the Impact of Higher Tax Rates

Charitable Remainder Trusts (CRTs)

Charitable Deductions

The 2% Floor on Miscellaneous Itemized Deductions

State Taxation of Trusts – DINGs, NINGs and WINGs

BNY MELLON
WEALTH MANAGEMENT

Why Use Trusts?

Purposes of a Trust

- Minimize gift, estate and generation skipping transfer (GST) taxes
- Provide asset protection (e.g., creditors and divorce)
- Ensure professional investment management
- Protect beneficiaries from poor financial decisions
- Preserve assets for multiple generations
- Privacy and confidentiality
- Encourage or discourage certain behaviors ("control from the grave")

3

Fiduciary Income Tax Rates

2016 HIGHEST TAX RATE COMPARISON

	Joint Filers	Individuals	Trusts and Estates
39.6%: Ordinary Income ***(based on Taxable Income)***	**>466,950**	**>415,050**	**>12,400**
20%: Qualified Dividends and Long-Term Capital Gains ***(based on Taxable Income)***	**>466,950**	**>415,050**	**>12,400**
3.8%: Surtax on Net Investment Income ("NII") ***(based on Modified Adjusted Gross Income)***	**>250,000**	**>200,000**	**>12,400**

The 2016 rates reflect Rev. Proc. 2015-53, the American Taxpayer Relief Act of 2012 and the 3.8% surtax on net investment income under the Patient Protection and Affordable Care Act of 2010, as amended by the Health Care and Education Reconciliation Act of 2010.

4

Net Investment Income Tax (NIIT)

Applies to:	Does Not Apply to:
• Non-Grantor Trusts	• Grantor Trusts[1]
• Non-Grantor Charitable Lead Trusts	• Charitable Remainder Trusts[2]
• Domestic Estates	• Fully Charitable Trusts
• Electing Small Business Trusts	• Other Trusts Exempt From Tax
• Pooled Income Funds	• Common Trust Funds
• Qualified Funeral Trusts	• Real Estate Investment Trusts
	• Designated Settlement Funds
	• Foreign Trusts[3]
	• Foreign Estates[3]
	• Alaska Native Settlement Trusts
	• Cemetery Perpetual Care Funds

[1] Applies to grantor. Treas. Reg. § 1.1411-3(b)(1)(v).
[2] Applies to annuity/unitrust recipient to extent CRT distribution includes NII (realized post 12/31/2012).
[3] Applies to distributions to U.S. beneficiaries. Treas. Reg. § 1.1411-3(e)(3)(ii).

5

Net Investment Income Tax (NIIT)

IRC § 1411 imposes a tax of 3.8% on lesser of:

- Undistributed net investment income (UNII)
- Adjusted gross income (AGI) under IRC § 67(e) in excess of threshold

6

Net Investment Income Tax (NIIT)

IRC § 1411 imposes a tax of 3.8% on lesser of:

- Undistributed net investment income (UNII) under Treas. Reg. § 1.1411-3(e)(2), which is NII reduced by:
  - Distributions of NII to beneficiaries
  - NII attributable to the charitable deduction under IRC § 642(c)
- Adjusted gross income (AGI) under IRC § 67(e) in excess of dollar amount at which the highest income tax bracket begins ($12,300 in 2015), except deductions are allowed for:
  - Personal exemption ($100, $300, $600)
  - Distributions to beneficiaries
  - Administration expenses which would not have been incurred if the property were not held in the estate or trust (i.e., not “commonly or customarily” incurred by an individual)

7

Hypothetical

TREAS. REG. § 1.1411-3(e)(5), Ex. 1

In 2015, Trust Has:

- $15K of qualified dividends
- $10K of taxable interest income
- $5K of long-term capital gains (allocated to principal)
- $75K IRA distribution

During 2015, Trustee Distributes:

- $10K to a beneficiary

What is subject to the 3.8% NIIT?

8

Hypothetical

TREAS. REG. § 1.1411-3(e)(5), Ex. 1

	Total Income	DNI	B's Share of DNI (10%)	Trust's Total NII	B's Share of NII (10%)	Trust's UNII
Dividends	15,000	15,000	1,500	15,000	1,500	13,500
Interest	10,000	10,000	1,000	10,000	1,000	9,000
Capital Gain	5,000	-	-	5,000	-	5,000
IRA	75,000	75,000	7,500	-	-	-
TOTAL	**105,000**	**100,000**	**10,000**	**30,000**	**2,500**	**27,500**

Lesser of:	
UNII	**27,500**
AGI over Threshold	
Total Income	105,000
Less: Dist. Ded.	(10,000)
Less: Exemption	(100)
Trust AGI:	94,900
Less: Threshold	(12,300)
	$82,600

3.8% NIIT x $27,500 UNII = $1,045

9

Minimizing the Impact of Higher Income Tax Rates

Tax Efficient Investment Management

- Tax loss harvesting
- Tax-preferred investments and long-term growth

Use Grantor Trusts

- Rethink outright gifts of shares of S Corp. stock or LLC interests

Discretionary Distributions to Beneficiaries

- Balance the interests of all beneficiaries
- Capital gains generally not included in DNI

Allocate Indirect Expenses

- Offset highest taxed income, depending on beneficiaries

65-Day Rule – Election Under IRC § 663(b)

In-Kind Distributions Under IRC § 643(e)

Utilize Trustee Who Materially Participates

10

Key Findings from Risk Assessments

1. Missing Asset Classes...89%
2. Lack of an Overall Portfolio Plan......................................89%
3. Following, or Fleeing, a Trend Too Late..............................86%
4. Sector Bets Happening Without Investor's Knowledge.......83%
5. Not Enough – or Too Many – Holdings...............................78%
6. Unnecessary or Unknown Portfolio Risk..............................78%
7. Little to No Tax Management..75%
8. Hidden Costs..68%

Source: BNY Mellon Wealth Management

11

Minimizing the Impact of Higher Income Tax Rates

Tax Efficient Investment Management

- Tax loss harvesting
- Tax-preferred investments and long-term growth

Use Grantor Trusts

- Rethink outright gifts of shares of S Corp. stock or LLC interests

Discretionary Distributions to Beneficiaries

- Balance the interests of all beneficiaries
- Capital gains generally not included in DNI

Allocate Indirect Expenses

- Offset highest taxed income, depending on beneficiaries

65-Day Rule – Election Under IRC § 663(b)

In-Kind Distributions Under IRC § 643(e)

Utilize Trustee Who Materially Participates

12

Grantor Trusts (IRC §§ 671-679)

Intentionally "Defective" Grantor Trusts

- Not included in Grantor's estate for estate tax purposes
- Grantor's tax payments not subject to gift taxes
- Trust effectively grows "tax-free"

* *See* Rev. Rul. 85-13 and Rev. Rul. 2004-64.

13

Minimizing the Impact of Higher Income Tax Rates

Tax Efficient Investment Management

- Tax loss harvesting
- Tax-preferred investments and long-term growth

Use Grantor Trusts

- Rethink outright gifts of shares of S Corp. stock or LLC interests

Discretionary Distributions to Beneficiaries

- Balance the interests of all beneficiaries
- Capital gains generally not included in DNI

Allocate Indirect Expenses

- Offset highest taxed income, depending on beneficiaries

65-Day Rule – Election Under IRC § 663(b)

In-Kind Distributions Under IRC § 643(e)

Utilize Trustee Who Materially Participates

14

Planning for Capital Gains

Capital Gains

- As a general rule, accumulated and taxed at the estate or trust level
- Exception if capital gains can be included in distributable net income (DNI) and distributed to the beneficiaries:
  - In year of termination
  - Three methods under Treas. Reg. § 1.643(a)-3
  - If paid, permanently set aside or used for charitable purposes for which a fiduciary income tax charitable deduction is allowed under IRC § 642(c) for those gains under Treas. Reg. § 1.643(a)-3(c)

15

Hypothetical

In 2015, Trust Has:

- $50K of qualified dividends
- $50K of rental income
- $50K of long-term capital gains

During 2015, Trustee Distributes:

- $150K to Betty

What is distributed to Betty for tax purposes?

16

Hypothetical

TRUST → $150K → BETTY

2015:
$50K Dividends
$50K Rents
$50K Cap. Gains

Distribution?
- **$150K Principal**
- **$50K Dividends, $50K Rents, $50K Principal**
- **$50K Dividends, $50K Rents, $50K Cap. Gains**

17

Hypothetical

TRUST → $1.1M → BETTY

2015:
$50K Dividends
$50K Rents
$1M Cap. Gains

Distribution
$50K Dividends
$50K Rents
$1M Cap. Gains

What happens if capital gains are allocated to FAI and included in DNI?

What happens if Betty's step-children are the remainder beneficiaries?

18

Fiduciary Accounting Income (FAI)

Trustee Allocates Receipts/Disbursements between Accounting Income and Principal

- Determined by governing instrument or, if instrument is silent, by state law
- Potential strategies under state law
  - Power to adjust
  - Unitrust

Minimizing the Impact of Higher Income Tax Rates

Tax Efficient Investment Management

- Tax loss harvesting
- Tax-preferred investments and long-term growth

Use Grantor Trusts

- Rethink outright gifts of shares of S Corp. stock or LLC interests

Discretionary Distributions to Beneficiaries

- Balance the interests of all beneficiaries
- Capital gains generally not included in DNI

Allocate Indirect Expenses

- Offset highest taxed income, depending on beneficiaries

65-Day Rule – Election Under IRC § 663(b)

In-Kind Distributions Under IRC § 643(e)

Utilize Trustee Who Materially Participates

Hypothetical

In 2015, Trust Has the Following Income:
- $150K of rental income
- $50K of qualified dividends
- $100K of tax-exempt interest

In 2015, Trust Has the Following Expenses:
- $50K of rental expense
- $60K of trustee fees

How should the expenses be allocated?

Non-Deductible Expenses
IRC § 265

Disallows Any Deduction Attributable to Tax-Exempt Income
- Generally applies to deductions for production of income
- Typically, trustee/executor fees
- If tax-exempt income, portion of fees is non-deductible

Typically, a Ratio of:

$$\frac{\textbf{Tax-Exempt Income}}{\textbf{All Items of Income Included in DNI}}$$

Indirect Expenses

	43.4%	23.8%	0.0%	
	Rental Income	Dividends	Tax-Exempt Interest	TOTAL
Gross FAI	150,000	50,000	100,000	**300,000**
Less:				
$50K Rental Expenses	(50,000)			**(50,000)**
$60K Trustee Fees	(20,000)	(20,000)	(20,000)	**(60,000)**
TOTAL DNI	80,000	30,000	80,000	190,000

Proportional allocation of indirect expenses.

23

Indirect Expenses

	43.4%	23.8%	0.0%	
	Rental Income	Dividends	Tax-Exempt Interest	TOTAL
Gross FAI	150,000	50,000	100,000	**300,000**
Less:				
$50K Rental Expenses	(50,000)			**(50,000)**
$60K Trustee Fees	(40,000)	0	(20,000)	**(60,000)**
TOTAL DNI	60,000	50,000	80,000	190,000

The trustee fees (other than portion attributable to tax-exempt income) can be allocated against any class of income. Treas. Reg. § 1.652(b)-3

24

Minimizing the Impact of Higher Income Tax Rates

Tax Efficient Investment Management
- Tax loss harvesting
- Tax-preferred investments and long-term growth

Use Grantor Trusts
- Rethink outright gifts of shares of S Corp. stock or LLC interests

Discretionary Distributions to Beneficiaries
- Balance the interests of all beneficiaries
- Capital gains generally not included in DNI

Allocate Indirect Expenses
- Offset highest taxed income, depending on beneficiaries

65-Day Rule – Election Under IRC § 663(b)

In-Kind Distributions Under IRC § 643(e)

Utilize Trustee Who Materially Participates

25

65-Day Rule: Election Under IRC § 663(b)

Planning After the End of the Year

- Fiduciary may elect to treat distributions made within the first 65 days of a tax year as having been made in the preceding tax year
- Distributable net income (DNI) for the prior year will be carried out and reported by the beneficiaries as if they actually received the distributions in the preceding year

26

Minimizing the Impact of Higher Income Tax Rates

Tax Efficient Investment Management
- Tax loss harvesting
- Tax-preferred investments and long-term growth

Use Grantor Trusts
- Rethink outright gifts of shares of S Corp. stock or LLC interests

Discretionary Distributions to Beneficiaries
- Balance the interests of all beneficiaries
- Capital gains generally not included in DNI

Allocate Indirect Expenses
- Offset highest taxed income, depending on beneficiaries

65-Day Rule – Election Under IRC § 663(b)

In-Kind Distributions Under IRC § 643(e)

Utilize Trustee Who Materially Participates

27

In-Kind Distributions
TRAP FOR THE UNWARY

Funding a Pecuniary Bequest with Appreciated Property
- Gain recognition to estate or trust
- Gain is NII, potentially subject to 3.8% NIIT

* *See Kenan v. Commissioner*, 114 F. 2d 217 (2nd Cir. 1940).

28

Minimizing the Impact of Higher Income Tax Rates

Tax Efficient Investment Management
- Tax loss harvesting
- Tax-preferred investments and long-term growth

Use Grantor Trusts
- Rethink outright gifts of shares of S Corp. stock or LLC interests

Discretionary Distributions to Beneficiaries
- Balance the interests of all beneficiaries
- Capital gains generally not included in DNI

Allocate Indirect Expenses
- Offset highest taxed income, depending on beneficiaries

65-Day Rule – Election Under IRC § 663(b)

In-Kind Distributions Under IRC § 643(e)

Utilize Trustee Who Materially Participates

29

Passive vs. Active

Material Participation by Individuals
- "Regular, continuous and substantial" under I.R.C. § 469(h)(1)
- Seven safe harbor tests in Temp. Treas. Reg. § 1.469-5T(a)(1)-(7), T.D. 8175 (Feb. 19, 1988)
  - Limited partners may only use three of the seven tests
  - LLC members are considered general rather than limited partners, and may rely on any one of the seven tests*

* *See Hegarty v. Commissioner*, T.C. Summ. Op. 2009-153 (Oct. 6, 2009); *Thompson v. United States*, 87 Fed. Cl. 728 (Jul. 20, 2009); and *Garnett v. Commissioner*, T.C. No. 19 (Jun. 30, 2009).

30

Passive vs. Active

Material Participation by Estates and Trusts

- Trustee must materially participate under IRC § 469(h)(1)
- Treasury Regulation § 1.469-8 – Application of section 469 to trust, estates, and their beneficiaries
- U.S. District Court in *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003)
- IRS in TAM 201317010, PLR 201029014 and TAM 200733023
- U.S. Tax Court in *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (March 27, 2014)

31

Charitable Remainder Trusts and NIIT

Charitable Remainder Trusts (CRTs)

- CRTs are exempt from tax. IRC § 664(c)
- CRT income beneficiaries are subject to tax under a four tier system on the income earned by the CRT. IRC § 664(b)
- CRTs are <u>not</u> subject to the 3.8% NIIT (Treas. Reg. § 1.1411-3(b)(1)(iii)), however
  - Annuity/unitrust distributions may be NII to non-charitable beneficiary
  - CRT income beneficiaries are subject to the 3.8% NIIT to the extent their distributions are considered NII. Treas. Reg. § 1.1411-3(d)
  - NII only applies to income realized by CRT after 12/31/2012

32

Charitable Remainder Trusts (CRTs)

TREAS. REG. § 1.1411-3(d)(2)(iii), Ex. 1

Category	Class	Excluded/NII	2012 Income	2013 Income	Tax Rate	2013 $50,000 Dist.	NII in 2013 Dist.	Amt C/O to 2014
Ordinary Income	Interest	NII		7,000	43.4%	7,000	7,000	
	Interest	Excluded	4,000		39.6%	4,000		
	Net Rental Income	Excluded	8,000		39.6%	8,000		
	Non-Qualified Dividends	Excluded	2,000		39.6%	2,000		
	Qualified Dividends	NII		9,000	23.8%	9,000	9,000	
	Qualified Dividends	Excluded	10,000		20.0%	10,000		
Capital Gains	STCG	NII		4,000	43.4%	4,000	4,000	
	STCG	Excluded	39,000		39.6%	6,000		33,000
	Sec. 1250 Gain	Excluded	1,000		25.0%			1,000
	LTCG	NII		11,000	23.8%			11,000
	LTCG	Excluded	560,000		20.0%			560,000
Total Excluded Income 1/1/2013			624,000					
Total Distribution						50,000	20,000	

33

Charitable Deduction

IRC § 642(c)

Requirements

- Paid from gross income
- Paid pursuant to governing document

Unlimited in Amount

No Distribution Deduction

Generally, Must Be Actually Paid in Current Year or Following Year

- Estates and pre-1969 trusts get charitable deduction if “permanently set aside”

34

Hypothetical

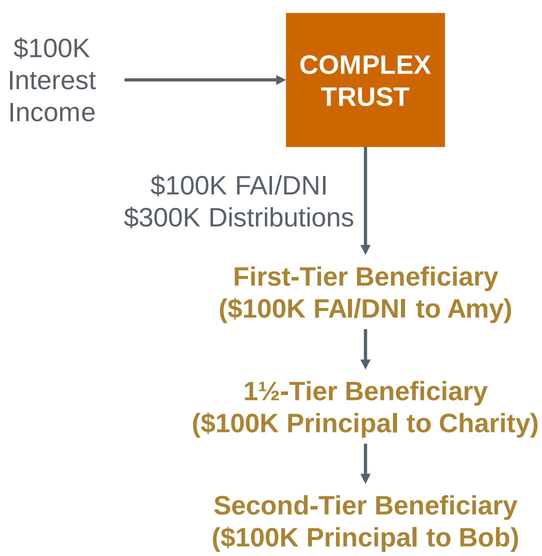
In 2015, Trust Has:
- $100K of taxable interest income

During 2015, Trustee Distributes:
- $100K to Amy (mandatory income distribution)
- $100K to Bob
- $100K to a charity

What was distributed to the beneficiaries for tax purposes?

35

Complex Trusts and Estates



4. Trust receives distribution deduction of $100K of DNI
1. $100K DNI is taxed first to Amy
2. No remaining DNI is distributed to charity
3. No remaining DNI is distributed to Bob

36

Charitable Deduction

IRC § 642(c)

Another Option:

- Distribute additional $100K to Amy instead of charity (not taxable since the DNI already came out)
- Amy can make a $100K contribution to charity
- Amy will get an income tax deduction, subject to the AGI rules and other limitations

37

Administration Expenses

Consist of Attorney Fees, Accountant Fees, Executor Commissions, Filing Fees, Surety Bond Premiums, Appraisal Fees, Etc.

Deductible on Federal Estate Tax Return (Form 706) or Fiduciary Income Tax Return (Form 1041)

- The "Section 642(g) election"
  - Fiduciary can elect where to take expenses
  - Form 706 or Form 1041, but not both
  - Generally, claim on return with highest tax rate

38

Administration Expenses

2% FLOOR

Generally, Not Subject to the 2% Floor

Test

- Would expenses be "commonly or customarily incurred" by an individual?*

Bundled Trustee/Investment Management Fees?

- Final Regulations under IRC § 67(e) require "reasonable" allocation

Why Do We Care?

- Alternative minimum tax (AMT) and Circular 230

39 * *See Knight v. Commissioner*, 552 U.S. 181 (2008).

California Tax Rates—2015

HIGHER RATES FOR HIGH INCOME TAXPAYERS, TRUSTS AND ESTATES

	2015
Joint Filers: $103,060 - $526,444 Individuals, Trusts and Estates: $51,530 - $263,222	9.3%
Joint Filers: $526,444 - $631,732 Individuals, Trusts and Estates: $263,222 - $315,866	10.3%
Joint Filers: $631,732 - $1,052,886 Individuals, Trusts and Estates: $315,866 - $526,443	11.3%
Joint Filers: > $1,052,886 Individuals, Trusts and Estates: > $526,443	12.3%
All Filers: > $1,000,000	+1.0%

13.3% top tax rate in California

40

California State Income Taxation

Residence of Grantor Does Not Matter

- For non-grantor trusts

California Source Income

- E.g., business or real estate in CA

"Fiduciary" in California

- Broader definition than trustee
- Could include a trust protector
- Corporate fiduciary—if major portion of administration in CA

"Non-Contingent Beneficiary" in California

- "Throwback" rules

41

THANK YOU!

BNY MELLON
WEALTH MANAGEMENT

Biography

Justin T. Miller, J.D., LL.M., TEP, AEP®, CFP®
National Wealth Strategist

As a national wealth strategist at BNY Mellon, Justin Miller works collaboratively with other advisors to provide comprehensive wealth planning advice to clients and their families. He also is an adjunct professor at Golden Gate University School of Law and a sought-after speaker on tax, estate planning and family governance topics for conferences throughout the country, including events hosted by the ABA, ACTEC, CalCPA, Golden Gate University, Santa Clara University, Silicon Valley Community Foundation, Stanford University, the State Bar of California, the State Bar of Georgia, the State Bar of Texas, STEP, UCLA, the Washington State Bar Association, Vistage International and YPO. In addition, he has published numerous articles in publications such as the *American Journal of Family Law*, the *California Tax Lawyer*, *State Tax Notes*, *Tax Notes* and *Trusts & Estates*, and he is frequently quoted as an industry expert in a variety of publications.

Mr. Miller has served as an executive committee member of the State Bar of California Taxation Section, an executive committee member of the Los Angeles County Bar Association Taxation Section, the chair of the Century City Bar Association Taxation Section, and the editor-in-chief of the *California Tax Lawyer*. Prior to joining BNY Mellon, he was an attorney at a major law firm, where he advised wealthy families, senior corporate executives and closely-held business owners regarding tax-efficient estate and business succession planning, trust law and management and asset preservation.

Mr. Miller received a master of laws in taxation and a juris doctor from New York University School of Law and a bachelor's degree, with honors, from the University of California at Berkeley.

43

BNY MELLON
WEALTH MANAGEMENT

Disclosure

This material is provided for illustrative/educational purposes only. This material is not intended to constitute legal, tax, investment or financial advice. Effort has been made to ensure that the material presented herein is accurate at the time of publication. However, this material is not intended to be a full and exhaustive explanation of the law in any area or of all of the tax, investment or financial options available. The information discussed herein may not be applicable to or appropriate for every investor and should be used only after consultation with professionals who have reviewed your specific situation.

Pursuant to IRS Circular 230 we inform you that any tax information contained in this communication is not intended as tax advice and is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

BNY Mellon Wealth Management conducts business through various operating subsidiaries of The Bank of New York Mellon Corporation.

44