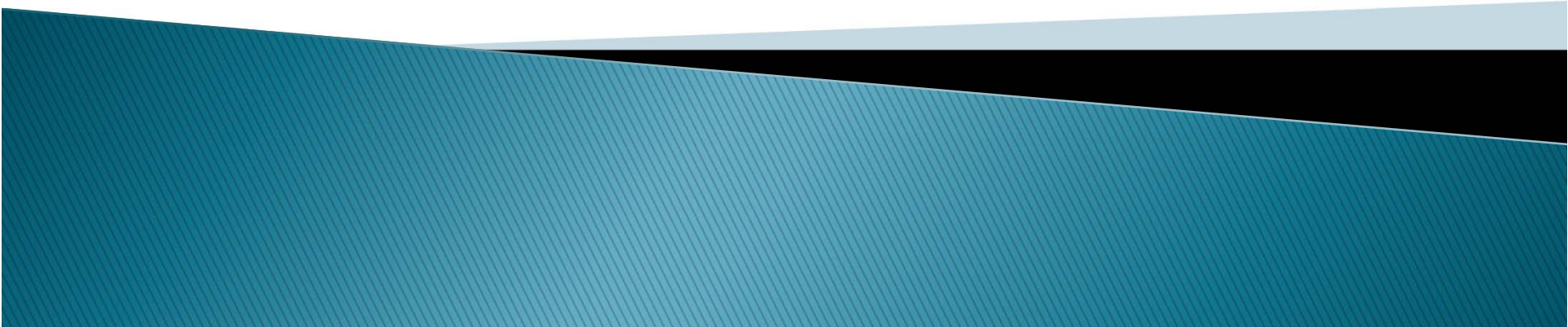


Income Taxation of Trusts: Grantor Trusts and Simple Trusts

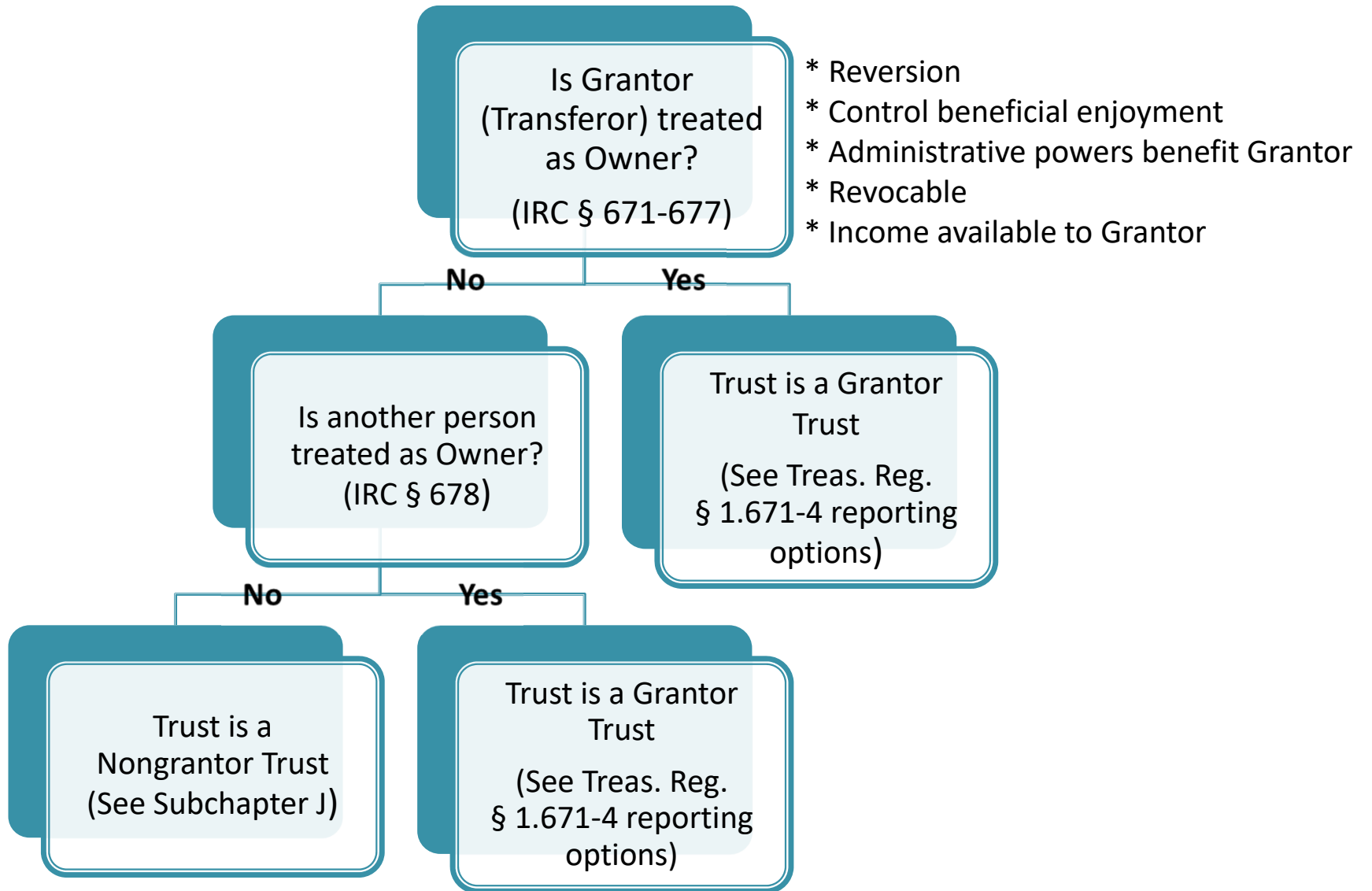
Montgomery County Estate Planning Council
Megan E. Wernke
November 1, 2017



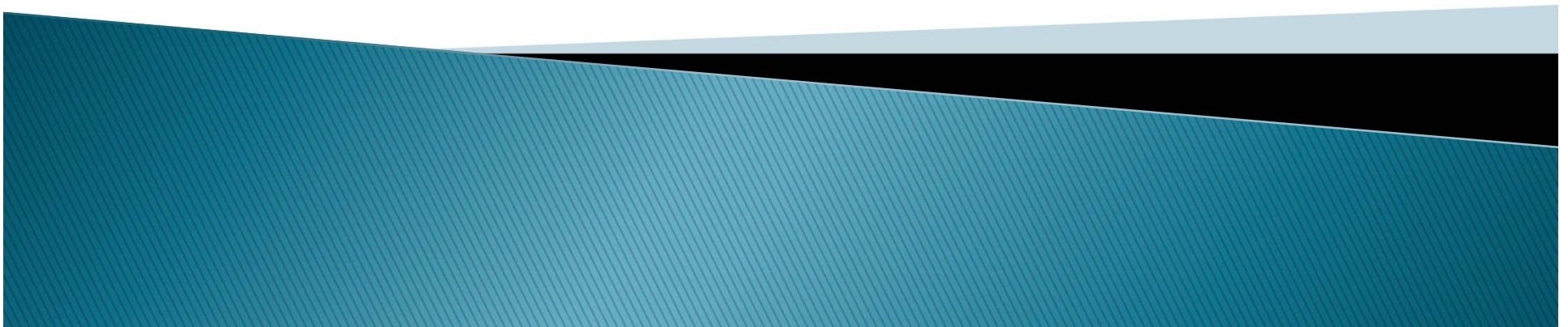
Three Types of Trusts

- ▶ Grantor Trusts (IRC § 671 et seq.)
 - Not separate taxable entities
- ▶ Simple Trusts (IRC §§ 640 et seq., 651-52)
 - Trusts that distribute current income only
- ▶ Complex Trusts (IRC §§ 640 et seq., 661-62)
 - Trusts that may accumulate income or distribute corpus

- ▶ Calendar year taxpayers (IRC § 644(a))
- ▶ Type of trust determined year-by-year
- ▶ NOT discussing foreign trusts



Grantor Trusts



What is a Grantor Trust?

- ▶ “Where ... the grantor [i.e., transferors] or another person shall be treated as the owner
- ▶ “Of any portion of a trust
- ▶ “There shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deduction, and credits against tax of the trust which are attributable to that portion of the trust”

IRC § 671

General Categories of Retained Interests

As to Grantor:

- ▶ Reversionary interest (IRC § 673)
- ▶ Control beneficial enjoyment (IRC § 674)
 - Many exceptions
- ▶ Certain administrative powers benefit the grantor (IRC § 675)
- ▶ Power to revoke or revest (IRC § 676)
- ▶ Use of trust income for the benefit of the grantor or the grantor's spouse (IRC § 677)

As to Other Person:

- ▶ Sole power to vest assets in self (IRC § 678)

Key Grantor Trust Concepts

- ▶ Nonadverse party
 - Authority often attributable to grantor
 - Someone who is not a substantial beneficiary
 - Adverse party: “any person having a **substantial beneficial interest** in the trust which would be **adversely affected** by the exercise or nonexercise of the power,” including GPOA holder (IRC § 672(a))
 - Versus so-called “Independent Trustees”

- ▶ Spouse
 - Authority attributable to grantor

IRC § 672

Common Grantor Trusts

- ▶ Revocable Trusts (IRC § 676)
- ▶ Self-Settled Special Needs Trusts (IRC § 677(a)(1)-(2))
- ▶ Insurance Trusts (IRC § 677(a)(3))
 - **Income** payable for premiums on grantor or spouse's life insurance
- ▶ “Intentionally Defective Grantor Trusts” (IDGT)
 - Look for separate Article called “Grantor Trust Powers”
 - Estate planning advantages
 - Eligible S corp. shareholder (IRC § 1361(c)(2)(A)(i))

IDGT common powers

- ▶ Power to substitute (Rev. Rul. 2008-22; Rev. Proc. 2008-46)
 - Exercisable by **grantor or nonadverse nonfiduciary** without the approval or consent of a fiduciary to “**reacquire** the trust corpus by substituting other property of an equivalent value” (IRC § 675(4)(C); Treas. Reg. § 1.675-1(b)(4))
- ▶ Power to borrow without adequate interest or adequate security
 - Exercisable by **grantor or nonadverse party** to lend to grantor “without adequate interest **or** without adequate security” (IRC § 675(2))
 - Not a general lending power
- ▶ Power to add beneficiary
 - Exercisable by **a nonadverse party** to add beneficiaries other than “after-born or after-adopted children.” (IRC §§ 674(b)-(d))
 - Charities are popular
 - Not grantor or trustee (or beneficiary)

“Accidental” Grantor Trusts

- ▶ Outstanding loan to Grantor on Jan 1 (IRC § 675(3))
 - Personal piggy bank situation
 - Exception if adequate interest/security and non-“related and subordinate” trustee
- ▶ Insurance premiums (IRC § 677(a)(3))
- ▶ Distributions that discharge the grantor’s **legal obligation** to support a dependent (IRC § 674(b)(1))
- ▶ Related or subordinate trustees with broad distribution authority

A Tour Through IRC § 674

Grantor Trust

674(a): Grantor or nonadverse party controls beneficial enjoyment

Generally:

Any person has power to add beneficiary other than after-born or after-adopted children

Not a Grantor Trust

Key Exceptions:

674(c): Sprinkling power of non-“related or subordinate” trustees

674(b)(5)(A) & 674(d): Distributions limited to “reasonably definite standard” in instrument

674(b)(6)-(7): Mere accumulation of income

674(b)(4): Allocate among charitable beneficiaries

* Related or subordinate: Nonadverse spouse, parent, issue, sibling, employee (IRC § 672(c))

* Reasonably definite: sufficiently precise to create legal accountability; HEMS, “reasonable support and comfort,” maintain standard of living; NOT “pleasure, desire, or happiness” (Treas. Reg. § 1.674(b)-1(b)(5)(i))

Beneficiaries as Owners

- ▶ DOES NOT APPLY if grantor is treated as the owner. (IRC § 678(b))
- ▶ “A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
 - Such person has a power exercisable **solely by himself** to vest the corpus or income therefrom in himself, or
 - Such person has **previously partially released or otherwise modified** such a power and [still] retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.” (IRC § 678(a))

Beneficiaries as Owners

- ▶ Age-triggered withdrawal powers
 - Even if released, presumably remains a discretionary beneficiary (IRC §§ 677(a)(1), 678(a)(2))
- ▶ Lifetime **general** power of appointment
- ▶ Beneficiary as Trustee
 - Understood to be okay if authority limited to ascertainable standard
- ▶ *Crummey* Powers (for annual exclusion giving)
 - IRS position is that **lapse** = partial release
 - Plain language of statute and regulation arguably distinguish between lapse and release, but beware **hanging powers**

Crummey Power Example

- ▶ Nongrantor trust as to grantor
- ▶ Trust provides withdrawal power to children Anne, Ben, and Caroline equal to greater of annual exclusion amount or contribution
- ▶ Noncumulative and lapses after 30 days except to the extent it exceeds the greater of \$5,000 or 5% of corpus
- ▶ Children also may receive distributions of income in trustee's discretion
- ▶ Grantor contributes \$45,000 to trust in 2018
- ▶ Assets double in value, realized within 30 days (\$45,000 gains; \$90,000 corpus)
- ▶ Assets double in value again in 2019 (\$90,000 gains; \$180,000 corpus)

Crummey Power Example

IRS position: lapse treated as partial release

2018: Each beneficiary owns 1/3, includes \$15,000 gain; trust includes no gain

2019: Each beneficiary still owns 1/3 due to § 677 interest, includes \$30,000 gain; trust includes no gain

“Plain language” position: lapse is not partial release

2018: Each beneficiary owns 1/3, recognizes \$15,000 gain; trust includes no gain

2019: Each beneficiary has “hanging” withdrawal right of \$10,000, includes \$5,000 gain (1/18 of \$90,000); trust includes \$75,000 (15/18 of \$90,000) of gain

Toggling

- ▶ Methods:
 - Release of power (sometimes reinstatement by separate party)
 - Substitution of adverse versus non-adverse trustee
 - Taking out /paying off loan
 - Trust modification
- ▶ Consider consequences of any recognition event
- ▶ Is toggling abusive? (Notice 2007-73)
 - Structured transactions with built-in toggling are “transactions of interest” (Notice 2007-73)
 - Conservatively, do not “turn back on”
- ▶ Alternative: tax reimbursement provisions
 - Likely **discretionary**; should use rarely (Rev. Rul. 2004-64)

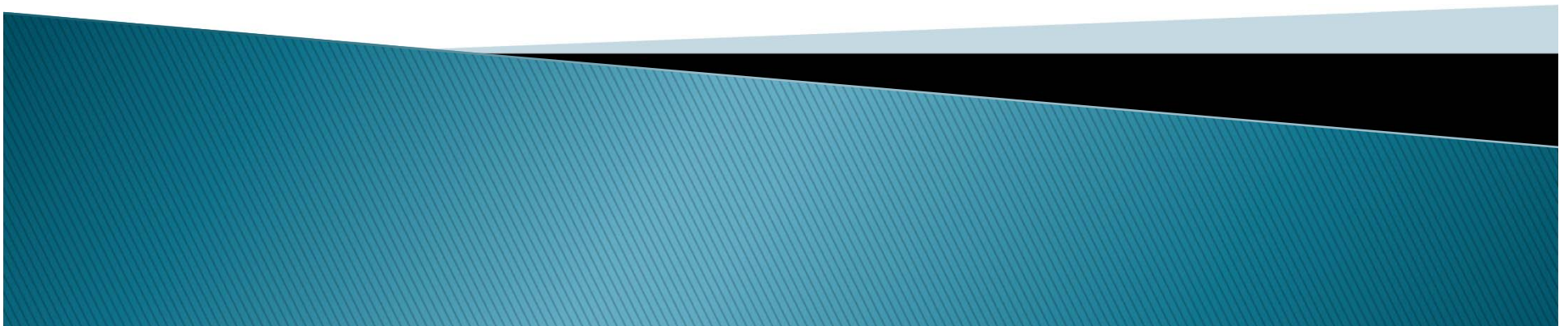
Mechanics of Tax Reporting: Grantor Trusts

- ▶ Direct Payor Reporting Method (Treas. Reg. § 1.671-4(b)(2)(ii))
 - Only available if wholly owned grantor trust with one owner (or husband and wife filing jointly)
 - Obtain W-9 from owner
 - Provide payors with owner’s name and TIN but trust’s address
 - Consider “John Doe, as grantor of Grantor Trust” to create record
 - Send grantor tax information letter to owner (unless owner is trustee)
- ▶ Grantor tax information statement
 - All items of income, deduction, and credit
 - Identify payor of each item of income
 - Provide information necessary to take information into account when preparing personal return
 - Inform owner of requirement to include on their return

Mechanics of Tax Reporting: Grantor Trusts

- ▶ Blank 1041 Method (Treas. Reg. § 1.671-4(a))
 - Must be used if only partially a grantor trust
 - Payors report as if trust was taxable owner
 - File blank 1041 (only trust's name, address, and TIN)
 - Attach a grantor trust information letter and send to owner (unless owner is trustee)
- ▶ Form 1099 Method (Treas. Reg. § 1.671-4(b)(2)(iii))
 - Can be used for one or multiple owners
 - Payors report as if trust was taxable owner
 - File 1099s with trust as payor and owner as payee; can be time-consuming
 - Send grantor tax information letter to owner (unless owner is trustee)
- ▶ Rules for switching methods (Treas. Reg. § 1.671-4(g))

Simple trusts



Nongrantor Trusts: General Principles

- ▶ Conduit principle

- ▶ Form 1041
 1. Generally, compute tax as if individual (IRC § 641(a)-(b))
 2. Look for special rules for credits and deductions (IRC § 642 *etc.*)
 3. Take additional distribution deductions
 - A. Simple Trust (IRC § 651) v. Complex Trust (IRC § 661)
 - B. Calculate DNI (IRC § 643(a))
 4. Issue K-1s to beneficiaries

Subchapter J (IRC §§ 641 *et seq.*)

Step 2: Special Deductions and Credits

- ▶ Special personal exemption (IRC § 642(b))
- ▶ Broad charitable deduction (IRC § 642(c))
- ▶ Deduction for administration expenses (IRC § 212; Treas. Reg. § 1.652(b)-3)
 - Direct Expenses
 - Indirect expenses
- ▶ Special AGI definition and rules (IRC § 67(e); Treas. Reg. § 1.67-4)
 - Distribution deductions and “administration”-specific expenses are above the line
 - Circular calculation
- ▶ Distribution in kind in satisfaction of pecuniary/**income** bequest (Rev. Rul. 86-105; Treas. Reg. § 1.651(a)-2(d); Treas. Reg. § 1.661(a)-2(f)(1))
- ▶ Rules for allocation of foreign tax credits, NOLs, depreciation, depletion, amortization, partially tax-exempt interest

Nongrantor Trusts: General Principles

1. Generally, compute tax as if individual (Code § 641(a)-(b))
2. Look for special rules for credits and deductions (Code § 642 *etc.*)
3. Take additional distribution deductions
 - A. Simple Trust (IRC § 651)
 - B. Complex Trust (IRC § 661)
4. Issue K-1s to beneficiaries

Step 3A: Simple Versus Complex Trusts

Year-by-year determination

Simple Trust

- ▶ **Requires** distribution of all FAI currently
- ▶ Does not provide for any charitable payments
- ▶ Does not **actually distribute** any corpus

(IRC § 651(a))

Simple Trust Examples

Husband's Will creates a QTIP trust for surviving spouse

- ▶ *Example 1:*
 - Makes all required FAI distributions
 - Discretionary principal distributions: none paid
- ▶ *Example 2:*
 - Trustee forgets to make FAI distributions
- ▶ *Example 3:*
 - Must distribute greater of FAI or \$50,000
 - FAI was only \$40,000
 - Trustee accidentally distributes only FAI

Nongrantor Trusts: General Principles

1. Generally, compute tax as if individual (Code § 641(a)-(b))
2. Look for special rules for credits and deductions (Code § 642 *etc.*)
3. Take additional distribution deductions
 - A. Simple Trust (IRC § 651)
 - B. Complex Trust (IRC § 661)
4. Issue K-1s to beneficiaries

Step 3B: Distribution Deduction for Simple Trusts

- ▶ Trust deducts its FAI
- ▶ Limited to DNI
- ▶ **For 651 purposes**, DNI does not include items “not included in the gross income [FAI] of the trust and the deductions allocable thereto” (e.g. tax-exempt interest)

(IRC § 651)

What is Distributable Net Income?

- ▶ Unique Subchapter J concept; not fiduciary accounting income (FAI)
- ▶ Definition: **Taxable income** with certain modifications (IRC § 643)
- ▶ Goal: Proper allocation under conduit principle
 - Ceiling on allocation of income to beneficiaries
 - Method for characterizing distributed income

What is Distributable Net Income?

- ▶ No distribution deduction
- ▶ No personal exemption
- ▶ Exclude capital gains, except
 - Reasonably allocated to FAI (Treas. Reg. § 1.643(a)-3(b)(1))
 - Allocated to principal and distributed or used to determine distribution (Treas. Reg. § 1.643(a)-3(b)(2)-(3))
 - Consider offset of capital losses
- ▶ (For simple trusts:) Exclude extraordinary dividends or taxable stock dividends allocated to corpus
- ▶ Include net tax exempt interest
- ▶ Deductions can be taken even if attributable to capital gains not included in DNI (Rev. Rul. 74-257)

IRC § 643(a)

DNI Calculation Example

- ▶ QTIP with no principal distributions; requires capital gains to be allocated to principal

Income and Expenses	FAI (IRC § 643(b) and state law)	DNI (IRC § 643(a))
<ul style="list-style-type: none"> • Dividends \$30,000 • Taxable interest \$10,000 • Tax-exempt interest \$10,000 • LT Cap Gains \$10,000 • Trustee fees and expenses allocated to principal \$5,000 	<ul style="list-style-type: none"> • Dividends \$30,000 • Taxable interest \$10,000 • Tax-exempt interest <u>\$10,000</u> • Expenses allocable to tax-exempt interest \$1000 (10,000/50,000 x 5,000) 	<ul style="list-style-type: none"> • Dividends \$30,000 • Taxable interest \$10,000 • Adj exempt interest* <u>\$9,000</u> • Less: Expenses <u>\$4,000</u>
	\$50,000	\$49,000
		\$45,000

* Income distribution deduction backs out the tax-exempt interest

Nongrantor Trusts: General Principles

1. Generally, compute tax as if individual (Code § 641(a)-(b))
2. Look for special rules for credits and deductions (Code § 642 *etc.*)
3. Take additional distribution deductions
 - A. Simple Trust (IRC § 651)
 - B. Complex Trust (IRC § 661)
4. Issue K-1s to beneficiaries

Step 4: Beneficiary Inclusion

- ▶ Beneficiaries cumulatively include FAI in income
 - Limited to DNI
 - Pro rata among beneficiaries
- ▶ Character
 - Same character in the hands of the beneficiary as in trust
 - Amounts treated as consisting of the same proportion of each class of items entering into the computation of DNI, unless the trust allocates among beneficiaries differently

IRC § 652

DNI Inclusion Example

- ▶ Simple Trust requires distribution of $\frac{1}{2}$ income to Anne, $\frac{1}{4}$ income to Ben, and $\frac{1}{4}$ income to Caroline; otherwise same as QTIP example above

DNI (IRC § 643(a))		DNI allocable to Anne:		DNI allocable to Ben and Caroline:	
• Dividends	\$30,000	• Dividends	\$15,000	• Dividends	\$7,500
• Taxable interest	\$10,000	• Taxable interest	\$ 5,000	• Taxable interest	\$ 2,500
• Adj exempt interest*	<u>\$9,000</u>	• Adj exempt interest	<u>\$ 4,500</u>	• Adj exempt interest	<u>\$ 2,250</u>
	\$49,000		\$24,500		\$12,250
• Less: Expenses	<u>\$4,000</u>	• Less: Expenses	<u>\$2,000</u>	• Less: Expenses	<u>\$1,000</u>
	\$45,000		\$22,500		\$11,250
		• Versus FAI of \$25,000		• Versus FAI of \$12,500	

* 651(b) exclusion of tax-exempt interest does not apply to inclusion

Megan E. Wernke
mwernke@capdale.com

Disclaimer

This communication does not provide legal advice, nor does it create an attorney-client relationship with you or any other reader. If you require legal guidance in any specific situation, you should engage a qualified lawyer for that purpose. Prior results do not guarantee a similar outcome.

Attorney Advertising

It is possible that under the laws, rules, or regulations of certain jurisdictions, this may be construed as an advertisement or solicitation.

© 2017 Caplin & Drysdale, Chartered
All Rights Reserved.