Year-End Tax Planning for Trusts
December 2014

Trust Tax Rates Remain High
In 2014, most types of income earned by non-grantor trusts in excess of $12,150 ($12,300 in 2015) are subject to the top marginal tax rate of 39.6%. In contrast, for single, individual taxpayers, only taxable income in excess of $406,715 will be subject to the 39.6% top rate ($413,201 in 2015). The net long-term capital gains and qualified dividends of trusts are subjected to a similar and somewhat punitive tax treatment relative to individual taxpayers: long-term capital gains and qualified dividends are taxed at a top rate of 20% at the same $12,150 ($12,300 in 2015) threshold. Thus, understanding how trusts will be taxed and the details of how fiduciary and individual taxation differ continue to prove important this year and into next.

<table>
<thead>
<tr>
<th>Trust taxation 2014</th>
<th>Trust taxation 2015</th>
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<tbody>
<tr>
<td>Taxable income:</td>
<td>Taxable income:</td>
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<tr>
<td>Over $12,150</td>
<td>39.6%</td>
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<tr>
<td>Over $8,900 to $12,150</td>
<td>33%</td>
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<tr>
<td>Over $5,800 to $8,900</td>
<td>28%</td>
</tr>
<tr>
<td>Over $2,500 to $5,800</td>
<td>25%</td>
</tr>
<tr>
<td>Not over $2,500</td>
<td>15%</td>
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<tr>
<td>Long-term capital gains and qualifying dividends*</td>
<td>0%/15%/20%</td>
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</tbody>
</table>

* Taxed at 0% if the trust is in the 15% tax bracket, 15% if in the 25%, 28%, or 33% brackets, and 20% for those in the 39.6% bracket

Alternative minimum tax | 26%/28% | Alternative minimum tax | 26%/28%
Net investment income tax** | 3.8% | Net investment income tax** | 3.8%

** 3.8% on the lesser of annual “undistributed net investment income”, or the excess of annual adjusted gross income (“AGI”) over $12,150 ($12,300 in 2015)

Net investment income tax (“NIIT”)
If the increased regular and capital gains tax rates are not, by themselves, a disincentive to the accumulation of trust income, the 3.8% NIIT on certain income of individuals, trusts, and estates further contributes to the punitive nature of using trusts to shift income taxes. The NIIT, effective for years beginning after December 31, 2012, was put in place through the collaboration of the Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act. Specifically, for estates and trusts, the tax is imposed equal to 3.8% of the lesser of:
(a) Annual "undistributed net investment income" or

(b) The excess of annual adjusted gross income ("AGI") over the dollar amount at which the highest tax bracket begins for the respective tax year.

Thus, in 2014, non-grantor trusts with certain taxable, undistributed income in excess of $12,150 ($12,300 in 2015) potentially will be subject to three separate tax systems (e.g., the regular income tax, the alternative minimum tax and the 3.8% NIIT on net investment income). For purposes of the NIIT, net investment income includes interest, dividends, annuities, royalties, rents, capital gains, and passive activity income, reduced only by certain deductions which are allocable to such income. Income derived in the ordinary course of a trade or business which is not a passive activity is excluded from the NIIT. Furthermore, tax-exempt interest income (e.g., municipal bond interest), annual inside build-up of certain life insurance value, distributions from qualified retirement plans, and certain annuities are also excluded from the definition.

**Year-end Planning Opportunities for Trusts**

Given the above tax burden imposed upon trusts, tax planning is critical. We have outlined below three strategies to consider with regard to managing the tax liabilities of trusts: distribution planning, capital gains planning and planning aimed at qualifying the income of a trust as non-passive.

**Distribution planning**

Trust distributions to beneficiaries can serve to reduce both a trust’s AGI and “undistributed net investment income.” Trusts receive an income distribution deduction to avoid the double taxation of any distributed income. For “complex” trusts, this deduction is limited to the lesser of distributions or distributable net income (“DNI”); for “simple” trusts, the limitation is the lesser of trust accounting income (“TAI”) or DNI.

The key to making efficient use of trust distributions is to identify situations where the distributions will carry out the proper types and amounts of income to individual beneficiaries in beneficial tax situations. Individual beneficiaries in marginal tax rate brackets lower than applicable to the respective trust are able to apply the higher individual Medicare surtax thresholds as well as the higher regular tax and AMT thresholds. Distributions can be required by the trust instrument or made pursuant to specific, discretionary powers of trustees as prescribed by the trust instrument. Care must be taken to adhere fully to the provisions of the respective trust document, and distribution decisions should not be driven purely by tax considerations. Quarterly estimated tax payment calculations will need to take into account the types and amounts of trust income, whether distributions are expected, and other pertinent information.

It is helpful to keep in mind that distributions made from complex trusts within the first 65 days after year-end can, pursuant to a special election, be treated as distributions made during the prior taxable year. The election allows a trustee to review the complete picture of annual trust income and make appropriate distributions shortly after year-end to take advantage of any variance between individual and fiduciary income tax brackets.
Capital gains planning

In recent years, trusts enjoyed a maximum federal long-term capital gains rate of 15%. Subsequent to the passage of the American Taxpayer Relief Act of 2012 (“ATRA”), the maximum rate rose to 23.8% (20% top rate plus the 3.8% Medicare surtax). In general, under the Uniform Principal and Income Act and local state law, gains realized upon the sale of capital assets are attributed to a trust's principal. Therefore, as a general rule, the net capital gains of trusts will not be includible in DNI, and will be subject to taxation at the trust level. As many trusts will have material capital gains each year, understanding the taxation of such income and planning techniques to minimize related tax liabilities becomes a highly relevant topic.

In general, if capital gains are not income under the governing instrument or local law, they cannot be distributed to the beneficiary. However, if the trust document gives the trustee the power to allocate trust receipts between income and principal, or provides that capital gains are to be allocated to income, then, unless local law provides otherwise, it should be possible to include such gains in DNI and distribute the appropriate amount to the beneficiary. It may be possible for a trustee to include capital gains in DNI when:

1. Capital gains are allocated to income by the governing instrument and/or local law;
2. The trustee has discretion to allocate capital gains to income under the governing instrument and/or local law;
3. The trustee consistently distributes capital gains to a beneficiary; and/or
4. The trustee actually distributes the capital gains to a beneficiary or utilizes the capital gains to determine an amount distributed (or required to be distributed) to a beneficiary.

It is advisable to consult with a qualified tax professional to determine whether the trust instrument was designed (or can be reformed under local law) to permit capital gains to be allocated to trust income and whether local law permits such an allocation. Assuming such an allocation is permissible and makes sense from other perspectives, distributing capital gains to beneficiaries may provide a substantial tax advantage for the trust and its beneficiaries.

Passive vs. non-passive activity considerations

An additional strategy for managing the 3.8% Medicare surtax for trusts involves the classification of certain types of income as being from passive or non-passive activities (remember that non-passive income is not included in the definition of net investment income). Passive activities are business activities in which the owner does not materially participate (i.e., is not involved in the operations of the business on a regular, continuous, and substantial basis). Trusts and estates, in general, may be treated as materially participating in an activity if an executor or fiduciary satisfies the relevant criteria for such standard. Therefore, now may be the perfect time to consider whether a trustee’s actions may permit a trust to treat certain income as from a non-passive activity, and thus realize the related tax benefits of avoiding NIIT on that income.
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