The
Estate Analyst®

November 2013

Explaining Trust Income Strategies

An End-Of-Year Q&A

By Robert L. Moshman, Esq.

The waning moments of the year sometimes provide an opportunity for several gratifying tax-saving adjustments. On the other hand, dramatic year-end revisions of estate plans in anticipation of cataclysmic tax law changes have become an ill-advised pattern.

"This is the end, beautiful friend,
This is the end, my only friend.
The end of our elaborate plans,
The end of everything that stands,
The end, no safety no surprise,
The end, I'll never look
into your eyes again."

—Jim Morrison

This year, there are no cliff-hangers per se, but high trust income tax rates, the Medicare surtax, the arrival of the Affordable Health Care Act, and the recognition of same-sex marriages by the IRS have prompted a number of considerations.

Presented With Our Compliments

Here, we address the questions that clients are asking their professional advisors, with special emphasis on explaining trust income taxation to clients.

Bad Traditions

It is the time of year when professionals and their clients maximize stress for each other and then arrive in the New Year with a hangover.

Professionals—bombarded by the annual pageant of year-end planning strategies in professional literature and lectures, and pressured by the hard deadline of December 31 that terminates most effective tax moves for the year—feel obligated to inform their clients of the potential tax-saving moves that can be made.

For their part, some clients become aware of the savvy tax-saving maneuvers of others and clearly want in on that action—being decisive, avoiding taxes, outsmarting the IRS, and being able to able to brag about it to in-laws, golf buddies, colleagues, and the collective universe of people who will be irritated and jealous of the cool, smart moves that they missed out on.

Other clients who haven't had a concern about their estate plan for years can encounter one piece of information and contact their financial advisor about it with three weeks left in the year. "Do I need a trust?" "Should I make a gift?" "Should I revise my entire estate plan before the end of the year?"

Last year's exercise (the end of 2012), with the potential expiration of the $5.12-million gift tax exemption, prompted great concern at the end of the year. Transfers of a number of rushed gifts were subsequently regretted (which in turn led to a pronounced interest in the topic of decanting trust funds during the past year).

The end of 2010 also created a dramatic year-end planning concern when the estate tax repeal faced automatic termination. The tax code faced the same potential end to the "Bush tax cuts" and an automatic return to 2001 rules. Chaotic predictions and speculative planning resulted.

If we have learned anything from these exercises, it is that 1) Congressional brinkmanship, wrangling, drama, hyperbole, and last-minute (or retroactive) fixes are standard operating procedure; 2) the estate tax system has resisted revisions, such as repeals or shifts to a carryover basis for assets owned at death, and we gravitate back to the unified estate and gift tax exemption each time, perhaps, because it has organically evolved over a century; and 3) year-end tweaking of income and deductions is useful for some people, but the emergency year-end revision of entire estate plans has been the unfortunate collateral damage from our nation's political dysfunction. "Let's never do that again," some of us have vowed.

Q&A

Here are some questions that people are asking their financial advisors, as well as some responses that might be offered.

Q: Aren't you the same planner who suggested that I put $5 million in an irrevocable trust last year?

A: I'm sure you have me confused with someone equally handsome.

Q: What is the income tax rate for trust income?

A: The top rate for trust income is 39.6%; for 2013, that rate applies to trust income exceeding $11,950. Under the Patient Protection and Affordable Health Care Act of 2010 (PPACA), there is also a 3.8% Medicare surtax on undistributed net investment income or the adjusted gross income exceeding the trust's top income tax bracket.

Q: In English, please?

A: For 2013, trust income over $11,950 is likely to be taxed at a rate of 43.4%.

Example: A trust fund has stocks and bonds worth $2 million; in 2013, it generates, after expenses, $100,000. The graduated taxes on the first $11,950 amount to $3,090. The tax rate of 39.6% on the remaining $88,050 of trust income amounts to an additional $34,867.80 of tax. The surtax of 3.8% would apply to the amount of income in the 39.6% bracket, which adds another $3,345.90. The total tax on the trust income would be $41,303.70. By comparison, an individual with $100,000 of income would pay income tax rates graduating from 10% to 28% and would have a tax of $21,293.25 (not allowing for any deductions or adjustments). So the effective tax rate on the same income in a trust would be 41.3% compared with an individual's effective rate of 21.3%. The trust would pay $20,010.45 more in tax.

Q: What capital gains tax rate applies to trusts?

A: For 2013, the top capital gains rate rose from 15% to 20% for individuals in the 39.6% tax bracket, i.e., individuals earning more than $400,000 and married people filing jointly with income exceeding $450,000. But for trusts, the top bracket of 39.6% applies at $11,950 of income and so does the top capital gains tax rate of 20%. Note: For 2014, it is projected that the 39.6% bracket will rise to $406,750 for individuals and $457,600 for married people filing jointly.

Q: Does the 3.8% Medicare surtax apply to capital gains income of trusts?

A: Yes. So if the trust has income between $2,450 and $5,700, that income would be subject to a top rate of 25% and would therefore have a standard capital gains tax rate of 15%. The additional 3.8% Medicare surtax would be added to that amount for a total tax rate of 18.8% on the capital gains realized by that trust. However, if the trust has income exceeding $11,950, then it would be in a top tax bracket of 39.6% and would have a capital gains tax rate of 20%. For that estate, the additional Medicare surtax of 3.8% would result in a total capital gains tax rate of 23.8%.

Q: How does the Medicare surtax on capital gains apply to individuals?

A: The 3.8% surtax applies to individuals with income exceeding $200,000 or married couples filing jointly with income exceeding $250,000. These individuals will pay capital gains tax at a 15% rate, and the 3.8% surtax will bring that amount to 18.8%. But if those individuals have more than $400,000 of income for single taxpayers or $450,000 for married taxpayers filing jointly, their capital gains tax rate would be 20%, and the surtax would bring their total to 23.8%.

Note: Trusts with relatively small capital gains and small amounts of income can end up in the top capital gains bracket of 23.8% that would only apply to individuals earning more than $400,000.

Q: Will I have to pay a 3.8% "sales tax" on the sale of my real estate because of the new health care law?

A: This is a misconception. The 3.8% Medicare surtax applies to net investment income, i.e., the gain from the sale, not the entire sale. Actually, the surtax applies to the lesser of net investment income or the amount that adjusted gross income exceeds $200,000 for single taxpayers, $250,000 for married taxpayers filing jointly.

Q: What about selling a primary residence? If I utilize the $250,000 exemption for capital gains as an individual owner or the $500,000 exemption for joint owners, will the 3.8% surtax apply to the amount covered by the exemption?

A: No, the surtax does not apply to amounts excluded under the Internal Revenue Code.

Q: What else does the 3.8% tax apply to?

A: Along with net capital gains for the disposition of property, the 3.8% Medicare surtax on net investment income applies to many types of income: interest, dividends, capital gains, rents, royalties, and nonqualified annuities. It also applies to income from passive activities and income from the trading of financial instruments or commodities.

Q: Does the 3.8% tax apply to mandatory minimum distributions from a retirement account?

A: No. The surtax also doesn't apply to income from tax-exempt municipal bonds, items included in the calculation of self employment tax, gains on the sale of an active interest in a partnership, or income from an active trade or business.

Q: Does the Medicare surtax apply to regular earned income?

A: There is another Medicare surtax of 0.9% that applies to earned income. Employers are to withhold this surtax for wages of single employees earning in excess of $200,000 or $250,000 for married employees filing jointly. Note: This Medicare surtax is in addition to the normal 2.9% Medicare tax on wages and the Social Security tax that employers withhold, which returned to 12.4% in 2013 after spending 2011 and 2012 at 10.4% due to a "payroll tax holiday."

Q: So there are two different Medicare surtaxes?

A: Incredibly, yes. There is a 3.8% Medicare surtax on net investment income (NII) and a 0.9% Medicare surtax on earned income; in both cases, the starting point is at $200,000 of income for single taxpayers and $250,000 for married taxpayers filing jointly. At least one tax publisher is referring to the 3.8% the "NII surtax," which helps distinguish the two.

Trust Income

In the minds of Grantors, trusts take on a magical quality. People with few assets and no need for estate tax techniques nevertheless sit down with their lawyers and want to know if they need a trust. Even highly astute Grantors, who already have a trust that is designed for estate tax savings and asset protection against creditor claims, will nonetheless express shock to be reminded that trust income is subject to taxation.

The taxation of trust income at a steeply graduated rate is not new. There has been a noteworthy downside to the taxation of trust income for many years. But the severity and unfairness of taxation on personal trusts has become especially pronounced during 2013. Let us therefore consider how professionals can explain the taxation of trusts to clients, along with the alternatives.

For 2013, trust income exceeding $11,950 is taxed at the top income tax rate of 39.6%. Remarkably, an individual would only be taxed at that rate for income exceeding $400,000.

For many laypersons, it is difficult to distinguish one trust from another. Let's define the various trusts and demonstrate their consequences.

Revocable living trusts, or Grantor trusts, are not an issue for this discussion. Revocable trust income is taxed to the Grantor at the Grantor's tax rates.

Example #1: Gary the Grantor wants to keep several assets out of his probate estate. He sets up a revocable trust. Because he retains the authority to revoke the trust at any time, the assets will be included in his estate for estate tax purposes. The annual trust income is also part of Gary's annual income.

Irrevocable living trusts are set up during the Grantor's life (as opposed to "testamentary trusts" set up under the Grantor's will), and they are typically designed to remove assets from the Grantor's estate for estate tax purposes. However, there are rules that make it possible for the trust income to be taxed to the Grantor instead of the trust. This can reduce the income burden that would otherwise apply to the trust income. To accomplish this, the terms of the trust must provide for the Grantor to retain certain control over the disposition of the assets. Establishing Grantor trust status over an irrevocable trust is therefore desirable, and the term "intentionally defective" is applied to trusts that have been designed in this manner.

Example #2: An irrevocable trust is funded with $1 million and earns income of 5% or $50,000. The trust will pay 39.6% tax on the income exceeding $11,950. Compare this result to an individual who owns the $1 million and is taxed on the $50,000 of investment income directly. Such an individual may have a top tax rate of 25% or 28%—well below the tax rate applicable to the trust. If the income of the trust can be taxed to the Grantor instead, tax savings will result every year.

Simple Trusts and Income Distributions: If a trust distributes all of its income every year, the income can be taxed to the beneficiaries rather than at the trust's high tax rate. Making the trust such a direct conduit can defeat many of the advantages of the trust, such as the ability to accumulate wealth over time and to protect assets from the creditors of beneficiaries. On the other hand, however, trustees and executors making distributions prior to the year's end can cause a portion of income to be taxed to beneficiaries.

Tax-Free Bonds and Growth Assets: Trusts do not have to be exclusively devoted to assets generating taxable income. Trusts can hold tax-free bonds, land, and growth-oriented assets.

Example #3: William is a widower earning $125,000 annually. His top income tax bracket covers income from $72,000 to $146,400. William considered transferring income-producing assets to a trust for his grandchildren, so that he could reduce the size of his estate and provide a steady source of income inside the trust that could be used to pay life insurance premiums. But the income inside the trust would be taxed at a top rate of 39.6%. As an alternative, he can fund the trust with other assets and make annual Crummey gifts to the trust that can qualify for the annual gift tax exclusion and, when not withdrawn by his grandchildren, can be used to finance his insurance premiums.

Basic Year-End Strategies

Generally, you should defer income and, therefore, tax liabilities. A time to accelerate income is when you know you are in a lower bracket this year, have some excess capacity, and know that you'll be in a higher bracket next year.

- Offset gains with losses. But if you sell stock to realize the loss and buy it back within 30 days, you may run afoul of the wash sale rule.

- It is okay to pay for a deductible expense using a credit card during 2013, even if the actual payment follows in 2014.

- If you don't have enough deductions to itemize, then defer deductions. If you itemize every year, then accelerate deductions. But if your income is going into a higher bracket next year, consider deferring deductions.

- If you are making investment decisions, base them on sound financial reasoning and not just tax motivations.

- With so many variables, including state and local taxes and the alternate minimum tax, calculating the overall return is necessary to evaluate the consequences of any additional strategy.

Reminders

- The annual gift tax exclusion for 2013 is $14,000.

- Because of the Supreme Court's ruling about the Defense of Marriage Act (DOMA), same-sex couples who are married should be able to file joint returns.

- The $500 lifetime credit for energy efficiency improvements to a primary residence expires December 31, 2013. There are other expiring deductions, including the optional deduction of state and local sales taxes in lieu of state and local income taxes, the deduction for the discharge of personal residence debt, and the deduction of up to 50% of adjusted gross income for contributions of conservation easements, which will return to a limit of 30% of AGI next year. Some of the expiring deductions may be extended by Congress.

- Certain tuition deductions expire on December 31, 2013. Other deductions based on AGI thresholds affect whether to prepay 2014 tuition.