Price & Farrington's Estate and Tax Planning *Fast*Facts September, 2009

Estate, Tax and Family Wealth Planning for Advisors and Clients

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How Trusts Are Taxed:
A Brief, Untaxing Overview

The roles ***trusts*** play in estate planning are versatile and invaluable. Trusts can be used to achieve planning goals for: asset protection; taxes; minors; a surviving spouse; business; charitable giving; special needs; and, in general, wealth protection, growth and transfer. Over the years, we have addressed many aspects of trust planning in our Estate and Tax Planning *Fast*Facts. All of these articles are archived chronologically by title on our website at www.pricefarrington.com.

Trusts as taxpayers. ***The general rule is that all trusts are separate taxpayers,*** each with its own tax year and accounting method. The exception to this rule is trusts that are *ignored for income tax purposes* under the ***grantor trust*** rules discussed here.

Just like their human counterparts, trusts are taxed on ***income*** and receive ***deductions*** for certain authorized expenses. Unlike human taxpayers, however, trusts are taxed under a ***compressed rate schedule*** which results in a significantly higher tax at any given level of income. As shown in the trust tax rate schedule for 2009, ***the highest trust tax bracket is reached at just $11,150 of taxable income, whereas an individual taxpayer would need an income of $372,950 in 2009 to reach the same tax bracket.*** Bear in mind that these compressed rates only apply to ***ordinary income.*** *Capital gains* and *dividend income* are taxed the same for individuals and trusts.

INCOME TAX RATES ON ESTATES AND TRUSTS

Taxable Income		Tax on Col. 1	Rate on Excess
From (Col. 1)	To		
$0	$2,300	$0	15%
$2,300	$5,350	$345	25%
$5,350	$8,200	$1,107.50	28%
$8,200	$11,150	$1,905.50	33%
$11,150	Infinity	$2,879	35%

Because of this substantial disparity between individual income tax rates and those for trusts, it is important to understand how trusts are taxed. For our purposes, trusts are divided into three categories: ***grantor trusts; simple trusts;*** and ***complex trusts***.

Grantor trusts. A grantor trust is the exception to the rule that all trusts are taxpayers. ***Grantor trusts are ignored for income tax purposes.*** Under the Internal Revenue Code (IRC), a trust is a "grantor trust" if the grantor (i.e., the person who established the trust) retains one or more of the powers listed in IRC Sections 673-677. It is also possible for a third party who is not the grantor to be deemed the owner of a trust if that person has control over the principal or income of the trust as defined in IRC Section 678.

This means, in essence, that ***if the grantor (or a third party) has the kind of control over the trust property that would ordinarily be consistent with ownership of the property, the trust will be ignored for income tax purposes and the deemed owner will be taxed on all income to the trust as if it were his or her own income.***

The most common type of "grantor trust" is the popular ***revocable living trust (RLT).*** Because it is virtually impossible for a person to create an RLT without retaining one of the grantor trust powers (e.g., the power to designate beneficiaries), anyone creating an RLT doesn't need to worry about filing a separate income tax return for the trust. It is always a good idea to state the following in the RLT:

Charles P. Farrington and Glenn D. Price

"By reserving the broad rights and powers set forth in this Article, I intend to qualify my trust as a "Grantor Trust" under IRC Sections 671-677 so that for federal income tax purposes, I will be treated as the owner during my lifetime of all the assets held in the trust as though I held them in my individual capacity. During any period that my trust is a Grantor Trust, the taxpayer i.d. number of my trust shall be my social security number…"

Intentionally Defective" Grantor Trusts. One of the most misunderstood terms in the estate planning field is the ***Intentionally Defective Grantor Trust*" or IDGT**. The term only means that *the trust was intentionally created so that the grantor retains one of the powers listed in the IRC grantor trust rules.*

This powerful technique takes advantage of a quirk in the tax code that classifies the owner of a trust differently for *estate tax* purposes than for *income tax* purposes. This means that a gift in trust can be complete (i.e., removed from the grantor's estate) for *estate tax* purposes but not complete for *income tax* purposes. A gift is only complete for income tax purposes if you give away all of the powers in the grantor trust rules. If you *retain* any of the listed powers, the gift is "defective", which means the trust will be considered a grantor trust, and *you will pay income tax on all of the trust's income at your individual income tax rate.*

Opportunities. This creates two planning opportunities. First, you can't sell something to yourself for tax purposes. That is, a sale transaction where you are both the *seller* and the *buyer* is not considered a "transfer" for income tax purposes. This means ***you can create and fund (transfer assets into) an IDGT where the IDGT is outside your estate for estate tax purposes, and then sell an asset to that trust without incurring any capital gains tax on the sale.*** This technique also avoids other penalties and consequences that might apply to certain transfers, such as transfers of life insurance.

The second key benefit is this: when the grantor pays the income tax on the trust's income, it is effectively the same as ***making a tax-free gift to the beneficiaries equal to the amount of the income tax the beneficiaries would have had to pay if the trust were a non-grantor trust***.

Non-Grantor Trusts: Simple or Complex? Trusts that are not considered grantor trusts are divided into two categories. A non-grantor trust will either be a ***simple*** trust or a ***complex*** trust.

A ***simple trust*** must pass three tests: it *must distribute all income* to the beneficiaries; it *cannot distribute principal;* and it cannot make distributions to charities. A ***complex trust***, by comparison, does one or more of the things that a simple trust cannot do: accumulate income; distribute principal; and/or make distributions to charity. A trust must qualify as a simple trust or else it will be considered a complex trust. *The difference between the two is in the way that the trust deducts distributions to beneficiaries.*

In a simple trust, all income is treated as distributed to the beneficiaries. The trust reports all income annually, but is entitled to a deduction for the entire amount distributed to beneficiaries. The result is that the trust only pays tax on capital gains. (Note: *in some states, including Washington, capital gains are permitted to be treated as income*. In those instances, a simple trust would distribute all income *and* capital gains.)

With a complex trust, distributions can include ordinary income, dividends, capital gains and, perhaps, principal. It is also possible that the trust earns income that is not distributed, and there might be a deduction for distribution to charities. The result is that the allocation of the tax and any deductions between the trust and its beneficiaries – and among beneficiaries—can be quite complex. Hence, the name.

A complex trust may not distribute principal unless all income has first been distributed. It is even more complex than this. The rules require that: all ***ordinary income*** be distributed before dividends; all ***dividends*** be distributed before capital gains; and all ***capital gains*** be distributed before ***principal***. The result is what tax lawyers call *"worst in, first out"* -- the worst character of income must be exhausted before moving to the next tier.

When these distributions are made, the trust is entitled to a deduction for any income distributed to beneficiaries. However, because the income (and certain deductions) must be *allocated equitably* among the trust and the beneficiaries, it becomes necessary to calculate what the tax code refers to as ***"Distributable Net Income" or DNI.*** How DNI is determined is beyond the scope of this article. It is enough to know that ***DNI represents the amount that must be either distributed to beneficiaries or taxed to the trust.*** It represents the upper limit on the trust's deduction for distributions and the upper limit on the amount of income taxable to the beneficiaries.

Because of the nature of tax rules for complex trusts, careful planning and coordination between your investment, legal and tax professionals is critical. ***GDP*** ◘

Irregular Verbs

(How we approach *ourselves, present company* and *those beyond earshot.)*

▪ ***I*** **am firm*; You* are obstinate; *He* is a pig-headed fool.**

▪ ***I*** **have reconsidered*; You* have changed your mind*; He* has gone back on his word.**

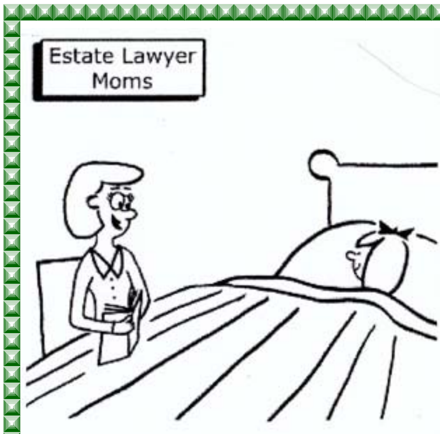
▪ ***I*** **am righteously indignant; *You* are annoyed; *He* is making a fuss about nothing.**

▪ ***I*** **am a behavioral researcher; *You* are curious about people; *He* is a Peeping Tom.**

▪ ***I*** **am nostalgic; *You* are old-fashioned; *He* is living in the past.**

▪ ***I*** **dream; *You* escape; *He* needs help.**

From "The Official Rules and Explanations" compiled by Paul Dickson



Then, the dragon ate the prince, but his trust lived happily ever after."