National Business Institute™

Wills and Trusts 101

San Diego, California

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Day 2: Section XI: Trust Taxation

A. ESTATE TAX UPDATE

1. Federal - Background:

At the Federal tax level, "transfer tax" is comprised of three different types of tax which are interrelated. These are known as: "Estate Tax", "Gift Tax", and "Generation-Skipping Transfer Tax" (or "GST Tax").

The modern Estate Tax was enacted by the Revenue Act of 1916 with tax rates starting at 1% for estates valued at $50,000 (today's equivalent is in excess of $11 million) increasing to a maximum rate of 10% for estates valued over $5 million (in excess of $1 billion today).

When Estate Tax was first enacted, there was no tax on lifetime gifts, only on property transferred due to death (i.e. inheritance). Naturally, this allowed for avoidance of Estate Tax by making gifts before death.

In 1924, Congress enacted Gift Tax in an attempt to close this loophole. The Estate Tax and Gift Tax, however, had separate exemptions which allowed a taxpayer to reduce the combined tax by gift and estate planning. In 1976, Congress overhauled Estate and Gift Tax by enacting the Tax Reform Act of 1976. The biggest change made by the Tax Reform Act of 1976 was making a single, unified Estate and Gift Tax credit. Thus, if a lifetime gift used Gift Tax credit, the Estate Tax credit was simultaneously consumed. This is essentially the system we have for Estate and Gift Tax today.

The Tax Reform Act of 1976 also introduced the Generation-Skipping Transfer Tax or GST Tax. Prior to this law, some taxpayers with wealthy children avoided Estate Tax for certain generations by transferring assets to grandchildren or subsequent generations ("Skip Generations"). Because the property transferred to Skip Generations was not included in the children's estate, it was not subject to Estate Tax when the children passed away. The GST Tax is intended to close this loophole by assessing a

separate tax from Estate Tax and Gift Tax when transfers are made to Skip Generations in excess of the available credit for GST Tax.

2. Federal - 2017 Law:

In December 2017, Congress enacted The Tax Cuts and Jobs Act of 2017 (the "2017 Law"). Under the 2017 Law, the credits for Estate Tax, Gift Tax, and GST Tax *temporarily* doubled. As of 2019, the exemption amount is $11.4 million per person (or $22.8 million combined for spouses). Without Congress enacting new laws, however, *in 2026 the exemption amount will revert back to the amount prior to the 2017 Law*. This means the exemption amount will be cut in half in 2026.

With the current credits, most taxpayers are not subject to Federal Estate Tax, Gift Tax, or GST Tax. Old trust and estate planning documents, however, may have undesirable and unintended consequences. For example, not too long ago without certain planning, the Estate Tax credit of the first spouse to die could be lost.[1] To avoid losing the Estate Tax credit, it was common for estate planners to recommend spouses create an A-B Trust even when the desire was to give the surviving spouse as much control over the property as possible. The B Trust (i.e. sometimes known as the Bypass Trust, Credit Shelter Trust, Exempt Trust, Exemption Trust or similar name), however, was structured to be an irrevocable, unamendable, non-grantor Trust to utilize the deceased spouse's Estate Tax credit. The B Trust provided certain restrictions to the surviving spouse and required separate accounting, separate fiduciary income tax returns (IRS Form 1041) and generally more complexity and inflexibility than desired by the spouses. The tradeoff of less tax was determined to be acceptable for many spouses. But due to portability, which enables the estate of a surviving spouse to utilize the unused credit of the deceased spouse, this structure is no longer required to utilize the deceased spouse's Estate Tax credit. *Old trusts and estate plans should be reviewed to determine the necessity and desirability of such terms considering new laws.*

[1] With the advent of portability first enacted in 2010 and made "permanent" in 2012, the unused estate tax credit from the first spouse to die can be transferred to the surviving spouse by timely filing an Estate Tax Return (IRS Form 706).

Estate tax is due nine (9) months after the date of death. An Estate Tax Return (IRS Form 706) with valuations supported (generally) by qualified appraisals is due at the same time but may automatically be extended for another six (6) months. The Estate Tax rate is graduated up to the first $1 million. For estates involving U.S. citizens or residents eligible for the basic exclusion amount (i.e. $11.4 million for 2019), the amount in excess of the exclusion amount is taxed at the top marginal rate of 40%. Gift Tax and GST Tax are assessed in a similar manner when credits are exhausted.

3. Federal – Future Laws:

No one knows what future laws may be enacted. Certain candidates for President are proposing changes to the Estate Tax laws. For example, Presidential candidate Senator Bernie Sanders says he will pass the "For the 99.8 Percent Act" ("Bernie's Tax Act")[2] and Presidential candidate Senator Cory Booker says he will roll back the changes made to Estate Tax by the 2017 Law.[3]

Bernie's Tax Act would reduce the Federal Estate Tax exemption amount to $3.5 million. In addition, the Estate Tax rate would be increased with graduated rates beginning at 45% up to the highest rate of 77% for estates valued in excess of $1 billion. Bernie's Tax Act would also limit the use of certain planning tools available today including Dynasty Trusts (50 year limit); Grantor Retained Annuity Trusts (minimum 10 year term); and valuation discounts (e.g. Family Limited Partnerships; no minority or control discounts for family transfers).

In June 2019, Senator Cory Booker of New Jersey announced a plan to provide a tax credit for renters who spend more than 30 percent of their income on rent. Senator Booker did not specifically propose how to pay for the plan beyond saying he would roll back changes to Estate Tax and restore various tax cuts made in the 2017 Law. It appears

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[2] See http://Bernie Sanders.com/issues and https://Sanders.senate.gov/download/Estate-Tax-one-pager?inline=file (Both viewed by author on May 15, 2019)

[3] See New York Times article by Shane Goldmacher and Conor Dougherty dated June 5, 2019; https//www.nytimes.com/2019/06/05/us/politics/booker-renters-credit.html (Viewed by author on June 6, 2019)

this means cutting the Estate Tax exemption back to pre-2017 Law levels which for 2019 amounts to $5.7 million.

4. California - Background & Law:

In 1982, California voters approved Proposition 6 which prohibits the legislature or a political subdivision of the State of California from imposing any tax on or by reason of any transfer occurring due to death (i.e. Estate Tax). Existing law imposes a California estate tax, commonly referred to as the "pick up tax," equal to a certain portion of the maximum allowable amount of credit for state death taxes allowable under applicable Federal Estate Tax law. The "pick up tax" was a clever way for the California legislature to circumvent Proposition 6. As of 2005, however, with changes in Federal law the tax associated with the "pick up tax" was effectively eliminated in California. What does this mean? *California currently does not have Estate Tax.*

5. California - Future Laws:

As noted above, no one knows what future laws may be enacted. California State Senator Scott Wiener,[4] however, introduced Senate Bill number 378 on February 20, 2019 ("California Estate Tax Bill"). The California Estate Tax Bill would repeal Proposition 6 and impose an Estate Tax on California residents. The exclusion amount under the California Estate Tax Bill is $3.5 million, without future adjustment for inflation. Similar to Federal Estate Tax laws, under the California Estate Tax Bill the tax is due nine (9) months after the date of death of the decedent. The tax rate follows the federal tax rates which currently have a top marginal rate of 40%. When the value of the estate reaches a value where Federal Estate Tax is assessed, the California estate tax is eliminated. In other words, *California residents will pay approximately 40% of the value of a decedent's estate in excess of $3.5 million.* So, under the California Estate Tax Bill, California residents will pay Estate Tax (California Estate Tax) of approximately 40% on the portion of their estate between $3.5 million and the Federal Exemption amount

[4] Representative for California Senate District 11 located in San Francisco.

(currently $11.4 million)[5]. For estates above the Federal exemption amount, this would mean up to $3,160,000 in additional tax.[6]

[5] Assuming no life time gifts requiring the use of the unified gift and estate tax credit. To the extent unified credits are used during life, estate tax will be assessed for estates valued at $3.5 million less the amount of gift and estate tax exclusion used.
[6] $11.4 million less $3.5 million equals $7.9 million. Multiplied by 40%, the additional tax equals $3.16 million.

B. INCOME TAX RAMIFICATIONS:

The 2017 Law also impacts trust income tax. First, the maximum federal marginal rate was reduced from 39.6% to 37%. This applies to both individual tax returns (IRS Form 1040) and fiduciary income tax returns (IRS Form 1041). Also, the incremental marginal tax rates for each tax bracket are generally less than in 2017.[7] For individual tax returns, the new 24% bracket (2017 bracket for 28%) and 35% bracket have been significantly expanded. Fiduciary income tax brackets have also been adjusted but the adjustment is relatively deminimus. What is the take away? Income tax rates are less than they were under the 2017 Law.

The fundamental methodology of trust taxation, however, is unchanged under the 2017 Law. In other words, grantor trust taxable income passes through to the grantor and fiduciaries (i.e. trustees) for non-grantor trusts file tax returns (IRS Form 1041) and pay tax from trust property. See Trust Taxation Basics below.

[7] For individual tax returns the marginal rate is up to 4% less than 2017 depending on the bracket with some tax brackets at the same rate. For fiduciary tax returns, the first tax bracket has a 5% lower rate, the next bracket has a 1% lower rate, and the next two brackets from 2017 have been combined into one bracket which is 2% to 7% higher depending on which of the prior brackets you compare.

C. TRUST TAXATION BASICS:

1. Grantor Trust v. Non-Grantor Trust:

For income tax purposes, a trust is either a grantor trust or a non-grantor trust (or a portion of each).[8] The rules to determine whether a trust is a grantor trust or non-grantor trust can be technical and complex. These rules are found under Internal Revenue Code ("IRC") Sections 671 through 679 and the Treasury Regulations promulgated thereunder.

The taxable income, deductions, and credits against tax of a grantor trust flow through to the grantor.[9] This means taxable income of a grantor trust is not reported by the trust as a separate taxpayer but rather by its grantor on the grantor's individual income tax returns (IRS Form 1040) as if the grantor had received the items of income or incurred the expenses directly.[10] For example, a trust created by a person who retains a power to revoke the trust (i.e. a revocable living trust) is a grantor trust[11] during the life of the grantor and the taxable income from that trust must be reported and tax paid by the grantor (i.e. trust creator).

Unlike a grantor trust, a non-grantor trust is a separate taxpayer with its own taxpayer identification number separate from the grantor's social security number (SSN) or individual taxpayer identification number (ITIN). The trustee (i.e. fiduciary) of a non-grantor trust files fiduciary income tax returns (IRS Form 1041) on behalf of the trust and pays tax from the trust's property.[12]

The tax brackets for a non-grantor trust are significantly compressed as compared to the tax rate for an individual taxpayer. For example, in 2019, a non-grantor trust pays at the Federal maximum rate of 37% for taxable income in excess of $12,750. For a married couple filing jointly, the Federal maximum rate of 37% is assessed for taxable

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[8] Note, exceptions exist for certain types of trusts (e.g., a Charitable Remainder Trust) which do not follow the basic rules discussed herein and are beyond the scope of this presentation.
[9] Typically, the trust creator but in rare instances can be another person contributing property to the trust.
[10] See Bloomberg BNA Tax & Accounting Portfolio 819-2nd, Grantor Trusts (Sections 671 - 678), Section III.C.
[11] See IRC Section 676.
[12] See discussion concerning Fiduciary Taxes below.

income in excess of $612,350.[13] So, essentially all taxable income of a non-grantor trust is taxed at the top marginal rate.

2. Tax Basis:

Tax basis in property represents the property owner's investment in the property for income tax purposes.[14] Tax basis is a complex concept and often misunderstood. Tax basis is important to understand, at least at a conceptual level, because it is a key element in determining income tax liability. From a taxpayer's perspective, a higher tax basis is better than a lower tax basis because it will result in a lower gain (i.e. lower tax) or higher loss (which can be applied against other gains for an overall lower tax).

For property acquired from or through a decedent (i.e. inheritance), the tax basis for the recipient of such property (i.e. heir on beneficiary) is its fair market value at the date of the decedent's death.[15] This is commonly known as a "step up" in basis. Receiving a "step up" in basis on low basis property due to the death of the decedent from which the property is received is a tremendous tax benefit and must be considered in tax, trust, and estate planning. Whether the transfer of property to a trust will affect the ability to receive a "step up" in basis needs to be considered and understood during the planning of such potential transfer.

3. Completed Gifts:

Similar to the rules to determine whether a trust is a grantor trust or non-grantor trust, the Internal Revenue Code provides rules to determine whether transfer of property to a trust is a "completed gift" from the transferor (i.e. donor) to the beneficiaries of the trust (i.e. donee). These rules are generally found under Internal Revenue Code Sections 2501 through 2505.

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[13] Please note fiduciary income tax returns (IRS Form 1041) receive an additional deduction not available on individual tax returns (IRS Form 1040) for distributions of taxable income to beneficiaries. See discussion concerning Fiduciary Taxes below.

[14] Bloomberg BNA Tax & Accounting Portfolio 560-3rd, Income Tax Basis: Overview and Conceptual Aspects, Section I.A.1.

[15] See IRC Section 1014(a)(1); Reg. Section 1.014-1(a).

If there is a "completed gift" the property is no longer included in the estate of the transferor for Estate Tax purposes and is subject to Gift Tax at the time of transfer.[16] The donee receives the tax basis of the donor in the property. For example, if the donor contributed real property worth $5 million with a tax basis of $1 million to a trust for the benefit of donor's children and the contribution is determined to be a "completed gift," the tax basis in the property is unchanged (still $1 million). If the trustee of the trust sells the property for $5 million, the trust will recognize a taxable gain of $4 million ($5 million sale price less $1 million tax basis equals $4 million gain).

If there is a "completed gift," because the property is no longer in the estate of the donor of the property, the death of the donor does not affect the tax basis in the property (i.e. no "step up" in basis due to donor's death). So, consideration must be made before making a "completed gift" of the loss for the opportunity of a "step up" in tax basis of the property due to the death of the contemplated donor. Electing to cause a "completed gift" and lose the opportunity for a "step up" in tax basis should be weighed against the benefits of having future appreciation of the "completed gift" outside of the estate of the donor and therefore avoiding Estate or Gift Tax on the future appreciation.

[16] Using unified Estate and Gift Tax credits and if the credits are exhausted the transferor pays Gift Tax.

D. FIDUCIARY TAXES:

As discussed above, grantor trusts are not assessed fiduciary income tax but rather taxable income of the trust flows through to the grantor who reports and pays the tax. Fiduciary income tax, however, is assessed to non-grantor trusts.

Generally, the taxable income of an estate or trust requiring a fiduciary income tax return (IRS Form 1041) is computed in the same manner as taxable income of an individual.[17] A significant difference, however, is fiduciary income tax returns are entitled to a distribution deduction.[18] The amount of the deduction is the amount of income required to be distributed and other amounts of income paid, credited, or permanently set aside for beneficiaries. The distribution deduction is limited to the lesser of distributions or Distributable Net Income ("DNI").[19] DNI is the maximum amount of taxable income of the trust taxed to a beneficiary of a trust as the result of a distribution to the beneficiary.[20] The taxable income of the trust[21] is determined under: 1.) the governing instrument (i.e. Declaration of Trust or Trust Agreement); and 2.) applicable local law (i.e. a state's Principal and Income Act).[22]

Each beneficiary receiving distributions of taxable income of the trust for which the trust was entitled to a distribution deduction must report such income on his/her individual tax return (IRS Form 1040) and pay the tax attributable to such income.

Big Take Away: Taxable income retained by a trust required to file fiduciary income tax returns (IRS Form 1041) is generally taxed at the highest marginal tax rate while taxable income distributed to beneficiaries is taxed at the income tax bracket of each beneficiary. So, it may be more tax efficient for a trust required to file fiduciary income tax returns to distribute taxable income to its beneficiaries rather than retain the income.

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[17] See IRC Section 641(b).
[18] See IRC Sections 651 and 661.
[19] See IRC Section 651 and 661.
[20] See IRC Section 643(a).
[21] Commonly known as trust accounting income.
[22] See IRC Section 643(b).

Special thanks to my colleagues Anna Lisa Vega, Marisa Wadsworth, and James Daneri, Esq. for assistance in preparation of these materials!