Evaluating Trust Documents for Tax Consequences: Trust Types, Distribution and Termination Clauses, Beneficiary Powers

WEDNESDAY, JUNE 16, 2021, 1:00-2:50 pm Eastern

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June 16, 2021

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WEALTH MANAGEMENT

June, 2021

Tax Provisions in Trust Documents

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Estate Planning – The Basics

Agenda

- Estate tax marital deduction
- Typical estate plan
- Irrevocable life insurance trusts (ILIT)
- Generation skipping trusts (GST)
- Tax clauses
- Disclaimer provisions
- Rev. Rul. 69-486 – non-pro-rata distributions
- Pecuniary v. fractional bequests
- Charitable deduction – Section 642(c)
- Depreciation – Section 642(e)
- Types of trusts
- Complex trusts
    - General distribution rules
    - Tier system
    - Separate share rule
    - Specific bequests
- Gains in DNI
- Tax reimbursement clause for grantor trusts
- Subchapter S stock
- Qualified domestic trusts (QDOT)

Estate Tax Marital Deduction

How to Qualify

- Outright to spouse
- Life estate/general power of appointment. §2056(b)(5).
- Qualified terminable property trust (QTIP). §2056(b)(7).
- Estate trust. Reg. 20.2056(c)-2(b)(1)(iii)
- Life estate to spouse, remainder to charity. §2056(b)(8)
- Qualified domestic trust (QDOT) – modified version of the marital deduction for property left to a non-U.S. citizen spouse.

Estate Tax Marital Deduction

QTIP Trust

- Income to surviving spouse for life
- No person, including the surviving spouse, can have any power to appoint the property to any third person during the surviving spouse's lifetime.
- Election needed

Typical Estate Plan –Estate Tax Results

Estate

Living Trust

Marital Trust

Exemption Trust

1st Death – non-taxable (marital deduction)

2nd Death - taxable

1st Death – Non-taxable (Exemption)

2nd Death – Non-taxable (Limited Control)

Typical Estate Plan –Rights to Distributions

Estate

Living Trust

Marital Trust

Exemption Trust

Income: **Mandatory or Discretionary**

Principal:

- **No Rights**
- **Discretionary**
- **Ascertainable Standard**
- **5 x 5 Power**
- **Special Power of Appointment**

Typical Estate Plan –Rights to Distributions

Estate

Living Trust

Outright Bequest

Exemption Trust

Income: Mandatory or Discretionary

Principal:
- No Rights
- Discretionary
- Ascertainable Standard
- 5 x 5 Power
- Special Power of Appointment

Typical Estate Plan –Rights to Distributions

Estate

Living Trust

LE/GPOA Trust

Exemption Trust

Income: **Net Income**

Principal:
- **Discretionary during life**
- **Lifetime or Testamentary General Power of Appointment**

Income: Mandatory or Discretionary

Principal:
- No Rights
- Discretionary
- Ascertainable Standard
- 5 x 5 Power
- Special Power of Appointment

Typical Estate Plan –Rights to Distributions

Estate

Living Trust

QTIP Trust

Exemption Trust

Income: **Net Income**

Principal:
- **No Rights, or**
- **Discretionary**
- **Ascertainable Standard**
- **5 x 5 power**
- **Special Power of Appointment**

Income: Mandatory or Discretionary

Principal:
- No Rights
- Discretionary
- Ascertainable Standard
- 5 x 5 Power
- Special Power of Appointment

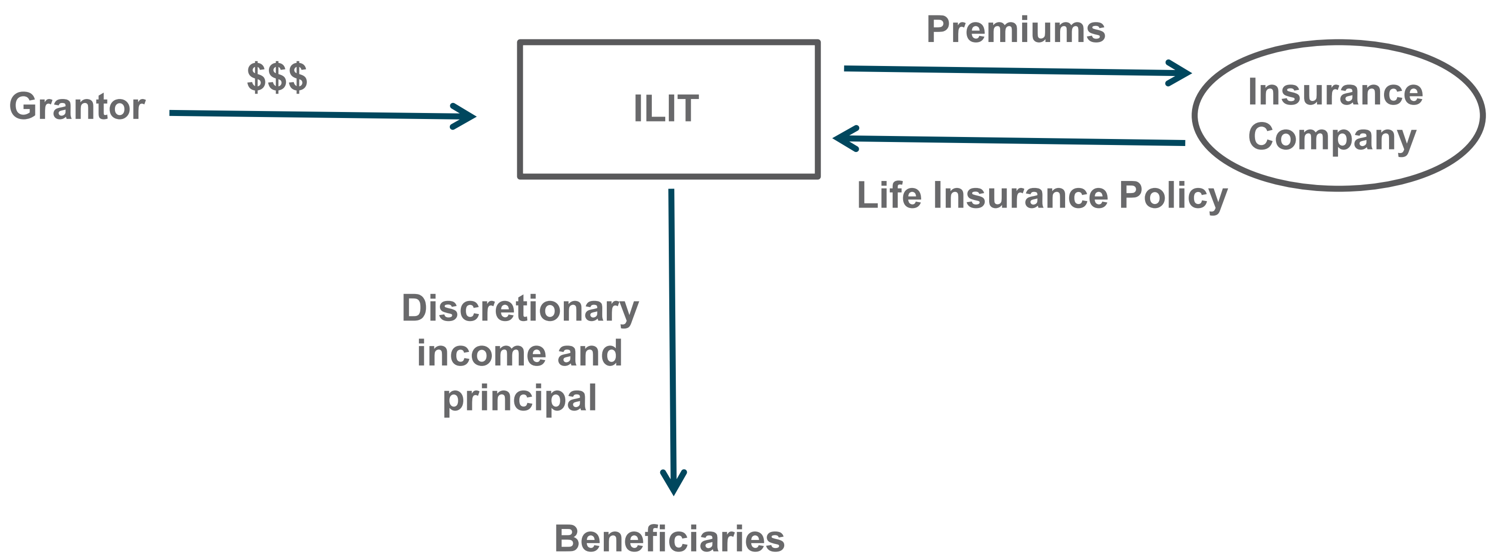
Irrevocable Life Insurance Trust (ILIT)

How It Works

- Grantor establishes irrevocable life insurance trust
- Grantor funds trust with cash
- Trust uses cash to pay premiums on life insurance policy on life of grantor or second to die policy on grantor and spouse
- Insurance company issues policy to the trustee of the irrevocable life insurance trust which then owns the policy
- Result: life insurance policy removed from inclusion in grantor's gross estate from time of issuance of the policy.

Irrevocable Life Insurance Trust (ILIT)

Objective: Remove Proceeds of Life Insurance from Grantor’s Gross Estate



Result: Life Insurance Proceeds Not Included in Grantor’s Gross Estate

Irrevocable Life Insurance Trust (ILIT)

Crummey Withdrawal Provisions

- Trusts, especially ILITs, will allow beneficiaries to withdraw assets from the trust.
- For ILITs, the right to withdraw is drafted into the trust document to allow the grantor's contribution to qualify for the gift tax annual exclusion.
- The annual exclusion is only available for gifts of a "present interest."
- The Crummey withdrawal provision is designed to convert a potential gift of a future interest into a present interest, thereby allowing the gift to the trust to qualify for the gift tax annual exclusion.
- Such provisions can take up a page or two in the trust document and be quite involved.

Generation Skipping Tax

Objective

- Allow assets to appreciate outside the transfer tax system for future generations

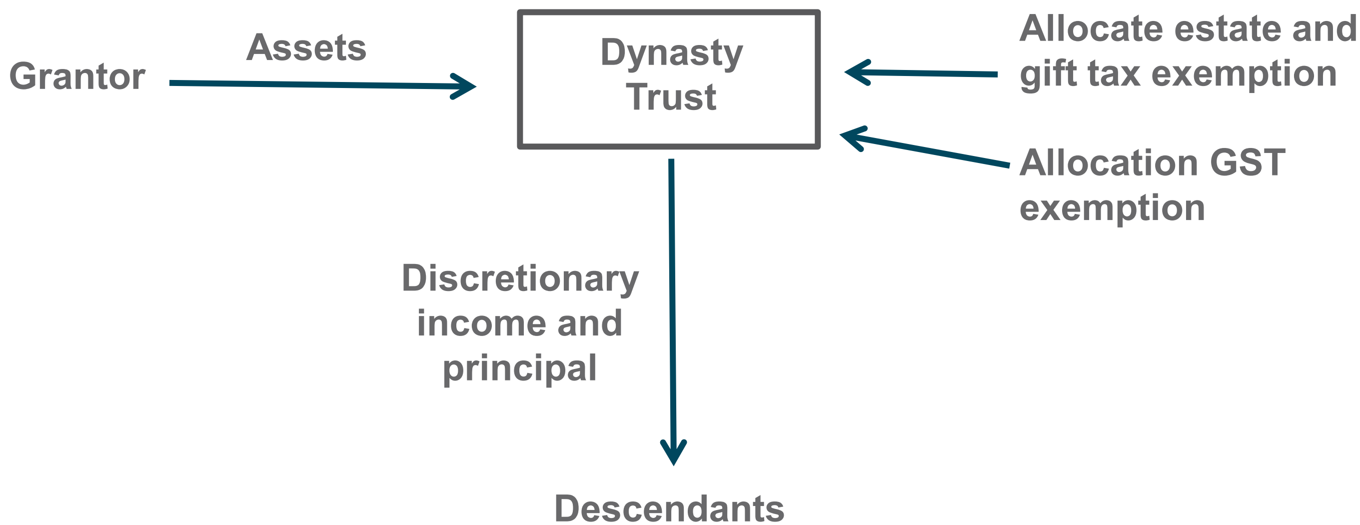
Generation Skipping Tax

How It Works

- Grantor transfers assets to irrevocable trust
- Allocates estate and gift tax exemption to trust reducing or eliminating estate or gift tax
- Allocates GST exemption to trust to shelter trust from GST tax on future distributions or termination
- Pay income and principal in trustee's discretion
- Ideally, governed by state which allows perpetual trusts
- Assets not subject to transfer tax at death of each generation

Generation Skipping Tax

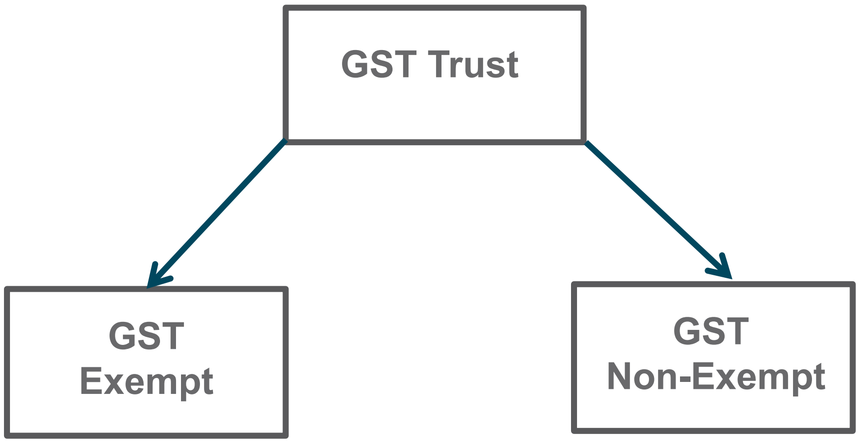
Objective: Establish a Long-Term Trust to Benefit Descendants for Generations While Escaping Transfer Tax At Each Generation Dies



Result: Trust assets grow without being subject to transfer tax at the death of each generation

Generation Skipping Tax

Look to language to divide trust into a GST exempt trust and GST non-exempt trust



Tax Clause

- Look for a tax clause in the trust to determine how the taxes are to be allocated to the various beneficiaries.

- If there is no tax clause, refer to state law. All states have a statute that describes how taxes are to be allocated to the various beneficiaries in default of language in the trust.

Disclaimer Provisions

- Look for language in the trust document to determine how assets pass in the event a beneficiary disclaims his interest in the trust.

- Language in the trust may permit the surviving spouse to disclaim her interest with the trust indicating that the spouse's interest is to pass, upon disclaimer, to a trust for her benefit. Such a disclaimer is permissible as long as the surviving spouse does not have a power of appointment over the trust into which the disclaimed assets will be transferred. Reg. 25.2518-2(e)(5), Examples 4-6.

Rev. Rul. 69-486 – Non-Pro Rata Distributions

- Look for boilerplate language that allows for non-pro-rata distributions
- If trust (or local law) does not allow non-pro-rata distributions, distributions of property between two or more beneficiaries will be deemed an exchange of property between the beneficiaries potentially resulting in gain recognition.

Pecuniary v. Fractional Formula Bequests

- Pecuniary formula bequest – “an amount equal to [wording of formula].

  - Gain recognized if a pecuniary formula bequest is funded with appreciated property.

- Fractional formula bequest – “an amount equal to that fractional amount [formula defining the numerator and denominator of the fraction and the amount against which the fraction is to be applied].

  – Gain not required to be recognized if fractional formula bequest is funded with appreciated property.

Charitable Deduction - Sec. 642(c)

- Requirements:
  - Paid from gross income
  - Paid pursuant to the governing document
- Unlimited in amount
- Paid for a "purpose" stated in §170(c)
- No distribution deduction
- Generally, must be actually paid in current year or preceding year
  - Estates and pre-1969 trusts get charitable deduction if "permanently set aside"

Depreciation - Sec. 642(e)

- General Rule: Depreciation allocated based in TAI allocated to trust/estate and beneficiary

- 2 exceptions - both apply to trusts:
  - Trust inst or local law indicates who get depreciation deduction
  - Trustee maintains depreciation reserve, trust gets deduction to extent trustee transfers income to reserve for depreciation

Types of Trusts

- Simple
- Complex
- Grantor

Simple Trust

- REQUIRED to distribute trust accounting income annually
- Makes no principal distributions, and
- Makes no distributions to charity

Complex Trust

- Makes discretionary distributions of trust accounting income
- Makes mandatory or discretionary distributions of principal, or
- Makes distributions to charity

Grantor Trust

- Grantor retains a power under §§673-677 which causes the grantor to be taxed on the income of the trust to the extent of his retained power.
  - The most frequently encountered grantor trust power is a power to substitute assets (“swap power”) under §675(4)(C).
  - Sample “swap power” language: “The grantor shall have the power, exercisable in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.”
- Beneficiary has right to withdraw trust assets under §678. Beneficiary is taxed on the income of the trust to the extent of his withdrawal power.

Inclusion of Amounts in Gross Income of Beneficiaries of Complex Trusts - §662

The key to understanding the distribution rules for complex trusts and estates and the allocation of DNI among multiple beneficiaries consists of understanding six important concepts. They are:

(1) General Rule: DNI is allocated to the beneficiaries on a pro-rata basis i.e. amount of the distribution to the beneficiary/total distributions to all the beneficiaries x DNI = beneficiaries share of DNI

(2) the “tier system” of distributions,

(3) the separate share rule,

(4) the 65 day rule under §663(b)

(5) specific bequests under §663(a)(1)

(6) Distributions in Kind - §643(e

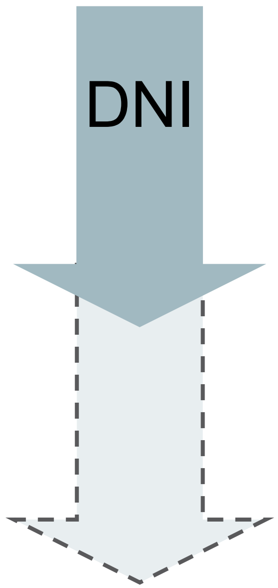
Complex Trust and Estates - Tier System

- The tier system of allocating DNI is applicable if:
  - (1) **Distributions exceed DNI;**
  - (2) There are **multiple beneficiaries;**
  - (3) Some beneficiaries are **required to get trust accounting income (first tier beneficiaries);**
  - (4) and others who **receive distributions in the trustee's discretion (second tier beneficiaries)**

Complex Trust and Estates - Tier System

- Two tiers:
  - First Tier - Distribution of trust accounting income *required* to be distributed currently
  - Second Tier - Distribution of *all other amounts* paid, credited or required to be distributed

Complex Trust and Estates - Tier System



First Tier Beneficiary

Second Tier Beneficiary

DNI is taxed first to FTB and any balance of DNI is taxed to STB

Complex Trust and Estates
Tier System - Example

Facts: $40,000 DNI and TAI
Trust requires A receive 50% of income
Trustee makes discretionary distributions of $20,000 to each B and C

A is FTB (Gets 50% of $40,000 TAI)

B and C are STB (Discretionary Benes)

Complex Trust and Estates
Tier System - Example

$40,000   DNI

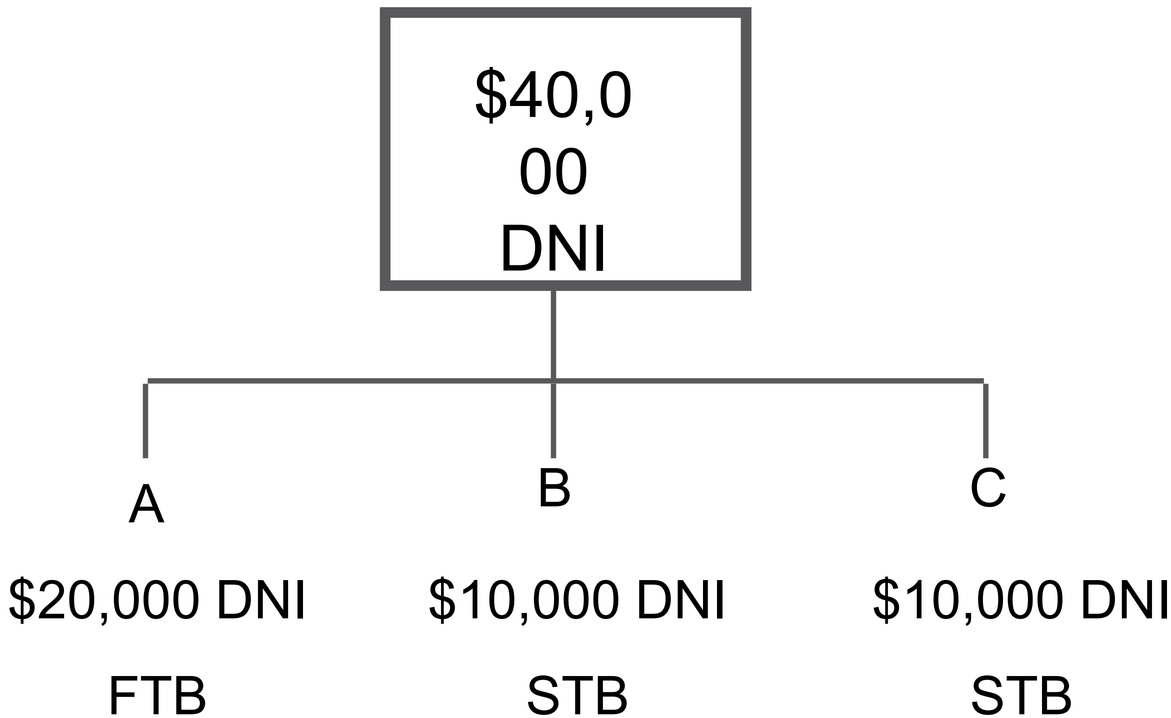
(<u>$20,000</u>) DNI for FTB

$20,000 DNI for STB

Divided by 2 STB

$10,000 DNI for Each STB

Complex Trust and Estates
Tier System - Example



Complex Trusts – Separate Share Rule

- What if one beneficiary has a portion or share of a trust in which no other beneficiary has right to receive a distribution from that share i.e., the beneficiary has a share that is separate from the interests of the other beneficiaries?

- This is where the separate share comes into play.

- The beneficiary is only taxed up to the DNI from his separate share.

- Thus, the DNI must be calculated separately for each share that constitutes a “separate share” and the beneficiary can only be taxed up to the amount of DNI earned in his separate share.

- The distribution deduction for each separate share are added together to determine the distribution deduction for the entire trust.

Complex Trusts - Separate Share Rule

- Applies to estates (for decedents dying after August 5, 1997) and trusts
- DNI computed separately for each share
- Mandatory, not elective. Reg. 1.663(c)-1(d).
- Only affects share of DNI
  - Doesn’t allow filing multiple returns
  - Doesn’t allow separate calculation of tax
  - Doesn’t allow multiple exemptions
  - Doesn’t required separate accounts for each share. Reg. 1.663(c)-1(c).
- Want to avoid separate share rule?
  - Draft as a “spray” trust
  - Provide in trust document that the shares subdivide into separate trusts

Complex Trusts - Separate Share Rule

- The separate share rule has a special rule that applies to funding a separate share with income in respect of a decedent (IRD). Reg. 1.663(c)-2(b)(3).

- IRD is funded to shares that could "potentially" be funded with IRD.

- To change the result, the trust must state which share should be funded with the IRD.

Specific Bequests - Sec. 663(a)(1)

- Bequest of specific sum of money or specific property do not carry out DNI

- Requirements:
  - Paid all at once, or
  - Paid in not more than 3 installments
  - Not paid from income

- Amount of bequest must be ascertainable at focal date e.g. date of death

- Not deductible by trust/estate or taxable to beneficiary

Specific Bequests - Sec. 663(a)(1)

- §663(a)(1) is an exception to the §661 and §662 rules governing distributions from estates and complex trusts.

- If a distribution meets the requirements of §663(a)(1), the estate or trust is not entitled to a distribution deduction under §661 and the beneficiary is not required to include the distribution in income under §662.

Including Capital Gains in DNI - Regulation 1.643(a)-3(b)

- Two prerequisites – capital gains included n DNI only if inclusion is pursuant to:
  - Trust agreement and local law; or
  - A reasonable and impartial exercise of discretion by the trustee in accordance with a power granted to the trustee by local law or the trust agreement if not prohibited by local law.

- Three methods
  - Allocated to **income**
  - Allocated to **corpus**, but treated consistently by the fiduciary on the trust's books, records and tax returns as part of distribution to the beneficiary
  - Allocated to corpus, but actually **distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed** or required to be distributed to the beneficiary

Including Capital Gains in DNI - Regulation 1.643(a)-3(b)

- Bottom line
  - Best when appropriate discretion is expressly granted in the trust agreement
    - Attorneys should consider including such discretionary language in trust instruments going forward
  - Alternatively, local law may provide the discretionary powers
  - If not, consider:
    - Power to adjust
    - Decanting (if available)

Tax Reimbursement Clause in Grantor Trusts

- What if Grantor wants to be reimbursed for the income taxes he pays on the income in the grantor trust? See. Rev. Rul. 2004-64.

- Discretionary reimbursement is fine assuming no pre-arranged agreement to reimburse.

- Mandatory reimbursement deemed to be a retained right causing estate tax inclusion.

Is the Trust an Eligible S Corporation Shareholder?

- In addition to estates, only certain trusts are eligible S corporation shareholders. In all cases, the trust must be a domestic trust – can't be a foreign trust.
  - Grantor Trust – must have only one U.S. person as 100% grantor
  - Grantor Trust after owner's death* – 2 years beginning with D/D
  - Testamentary Trust* – 2 years after transfer of assets to trust
  - Voting Trust
  - QSST – need election by beneficiary
  - ESBT – need election by trustee
- Look for language in the document authorizing QSST or ESBT treatment.

*May continue as eligible S corporation shareholder by electing QSST or ESST status

Qualified Domestic Trusts (QDOTs)

- An federal estate tax marital deduction is only allowed for a bequest to a spouse who is a U.S. citizen.
- A modified version of the federal estate tax marital deduction is allowed for bequests to a surviving spouse who is not a U.S. citizen.
- Language in the trust document will cover the items outline on the next two slides.

Qualified Domestic Trusts (QDOTs) – Statutory Requirements

- U.S. Trustee - One trustee must be individual U.S. citizen or domestic corporation
- No distribution (other than income) made from trust unless U.S. trustee has right to withhold QDOT tax imposed on the distribution
- Trust must meet requirements prescribed by Secretary of Treasury in order to ensure payment of the estate tax imposed upon the trust
- Executor makes the QDOT election – check box on return
- Trust must be administered under laws of a U.S. state or the District of Columbia

Qualified Domestic Trusts (QDOTs) – Security Requirements

- Depends on whether the QDOT is a small or large QDOT
  - Small QDOT – total assets, not considering indebtedness against the assets, of $2 million or less
  - Large QDOT – total assets, not considering indebtedness against the assets, of more than $2 million
  - In computing the $2 million test, decedent's estate may elect to exclude up to $600,000 of the personal residence and furnishings owned directly by the QDOT. Residence means the surviving spouse's principal residence plus one other residence.

Thank you!

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