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Minimizing federal income tax on trusts under the TCJA

The tax rate on trusts compared to individuals has gotten even higher after the new tax law. Here are some possible workarounds.

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Having recently closed out another individual and trust tax return season (extensions excepted, of course), CPAs, attorneys, trustees, and financial advisers are noticing that the disparate tax treatment between trusts and individuals, which has existed for 33 years, has grown even more pronounced than it was before the tax law known as the Tax Cuts and Jobs Act, (TCJA), P.L. 115-97, was enacted. This article, which is intended as a supplement to my article that appeared in the May 2014 issue of *Trusts & Estates*, "The Minimum Income Tax Trust," and my 2017 book, *Optimum Estate Planning*, will first examine the problems we are all currently facing and will then propose solutions to these problems.

The current predicament

With the advent of the TCJA, structuring trusts for spouses, descendants, and other beneficiaries, so as to minimize the aggregate federal income tax liability for the trust and its beneficiaries, has become more important than ever. Discussed below are some of the reasons.

In 2019, individuals can effectively exclude the first $12,200 ($24,400, if married) of income (i.e., the standard deduction for individual taxpayers, which is adjusted for inflation), whereas trusts can effectively exclude only the first $100 ($300, if a simple trust), which is the deductible exemption amount for a trust. Individuals at the same level of taxable income are also taxed at significantly lower ordinary income tax rates than trusts. This gap in income tax treatment has widened considerably under the TCJA.

For example, a single individual with $172,925 of interest income, and no deductions, will pay $32,748.50 of federal income tax in 2019, while married couples with the same level of interest income will pay only $24,392.50. Complex trusts with the same amount of interest income, and no deductions (including the distribution deduction), on the other hand, will pay $68,389.90 of federal income tax in 2019 ($62,303.25 regular tax + $6,086.65 net investment income tax). These differences under the TCJA are obviously staggering. A trust pays well over twice as much federal income tax as a single individual with the same amount of interest income, and almost three times as much as a married couple.

In 2017, pre-TCJA, an individual with the same amount of interest income would have paid $38,488.75, and a married couple would have paid $29,508.75. Thus, using the above example, the "disadvantage" of taxing income to trusts versus individuals under the new tax law has grown by 17.5% for individuals and 21% for married couples. If the same trust income were instead spread between or among two or more children who were beneficiaries of the trust, the disparity between the trust and individual income tax brackets would become even greater.

Individuals also enjoy a substantial benefit over trusts when it comes to the income taxation of capital gains and qualified dividends. A trust may only have up to $2,650 (in 2019) of taxable income and still be taxed at 0% on its capital gains and qualified dividends. The comparable level for single individuals is almost 15 times higher, at $39,375 (in 2019), which, when combined with the single beneficiary's $12,200 standard deduction, means that a single individual (including a minor child) could have up to $51,575 in qualified dividends annually without paying any federal income tax. A trust with a like amount of qualified dividend income, on the other hand, would pay approximately $10,750 in income tax (applying 2018 rates), including approximately $1,500 in net investment income tax. The same amount each year invested and compounded at 4%, over 20 years would equal approximately $320,000, which can certainly help pay for college.

A similar but more dramatic result would occur if there were two or more beneficiaries of the trust. As long as each beneficiary's taxable income was less than $51,575, they would each pay no federal income tax on the capital gains and qualified dividends. Thus, there could be over $150,000 of qualified dividends and capital gains inside of a trust, which if taxed equally to three single individual beneficiaries, with no independent income of their own, would result in $0 federal income tax. The annual federal income tax to the trust, on the other hand, including the net investment income tax, would be approximately $34,000. Compounded annually at 4% over 20 years again, this annual income tax difference would equal over $1 million! Similar larger tax gaps between trusts and individuals occur at the 15% and 20% capital gain rates, as well as at ordinary income tax rates.

As already mentioned, trusts also pay the 3.8% net investment income tax on the lesser of undistributed net investment income or adjusted gross income in excess of $12,750; a single individual, on the other hand, needs to have net investment income or modified adjusted gross income in excess of $200,000 ($250,000 for married couples) before he or she will pay the 3.8% tax.

The singular tax benefit trusts now maintain over individuals is the deduction for trustee fees, trust tax return preparation fees, and other expenses uniquely related to trusts. Trusts are entitled to these deductions whereas individuals are not.

Given that most income generated by trusts is passive income, it is extremely important for CPAs, estate planning attorneys, trustees, and their financial advisers to be aware of the significant disparity in the federal income taxation of the various types of passive income taxable to trusts versus individuals, whether in tax planning, document preparation, encroachment decisions, or investment decisions. The client's professional team also needs to be ever cognizant of the nontax advantages of retaining income and capital gains inside trusts when it comes to estate tax protection, divorce protection, creditor protection, and the various protections that are normally required for underage and otherwise financially immature beneficiaries. These significant advantages of trusts would all be negated to the extent the trustee chooses to distribute the income (including qualified plan and IRA receipts) and capital gains to the beneficiary in an effort to plan around the severely compressed trust income and capital gains tax brackets.

It would be a simple matter to distribute all of the trust's current income to the trust beneficiaries to avoid the trust income tax rates. In limited circumstances, it might also be possible to distribute the trust's capital gains to the beneficiaries to avoid the higher capital gains rates typically applicable to trusts, as well as the 3.8% net investment income tax. The problem, again, is that few clients want these automatic trust distributions to their children or other heirs to occur.

For the parents of minors and other young children and adult children, the issue is obvious. Parents of young and adult children do not want significant automatic annual distributions to the children, or to the guardian or conservator for the children, to be made. Parents of older children are more concerned with issues of divorce protection, creditor protection, and estate tax minimization (including state death taxes) for their children. The automatic distribution of trust income and capital gains to the children ignores this concern. Parents of special needs children obviously do not want the trust income to be paid to the children.

Proposed solutions

Here are some planning ideas that trustees and advisers may wish to consider to assist their clients in responding to their current tax predicament, the challenge of achieving significant income tax savings while also preserving all of the nontax purposes of the trust.

Use of Sec. 678 withdrawal power over trust income

For new trusts, drafting a Sec. 678(a)(1) withdrawal power over taxable income into the trust (other than a simple trust) to tax the trust beneficiary on all trust taxable income is not only permissible in the tax law, but, for all the income-tax-saving reasons outlined above, is usually advisable. (See Regs. Secs. 1.678(a)-1, 1.671-3(c), 1.677(a)-1(g), Ex. 2.) This power should be coupled with a direction in the trust instrument to allocate all capital gains to income, which is also specifically permitted in Regs. Sec. 1.643(b)-1, as well as with a power in the trustee to fully or partially suspend the beneficiary's withdrawal power in appropriate situations, e.g., immature or unwise use of withdrawn funds by the beneficiary, lawsuits, divorce, college financial aid qualification reasons, or, as discussed below, to minimize overall income taxes to the trust and its beneficiary. Because the withdrawal right is designed to lapse at the end of each year, it will normally also need to be limited to avoid annual taxable gifts under Sec. 2514(e), concerning the lapse of a power of appointment, which may cause a taxable transfer of property.

It may even be possible and make sense in some circumstances to add a Sec. 678 withdrawal power to a "special" or "supplemental" needs trust, e.g., by giving the withdrawal power to a sibling or siblings whose other taxable income is in a modest income tax bracket. If so, the sibling's withdrawal power should be coupled with an ability in the trustee to suspend the same sibling's withdrawal power, if he or she is not acting in the special needs child's best interests. (See the discussion on trustee suspension powers, below.)

Note that if the withdrawal power holder needs funds to pay the income tax that results from the withdrawal right, the holder merely exercises the withdrawal power to the extent necessary to obtain money to pay the taxes. Another alternative would be to allow an independent trustee to distribute the needed funds to the withdrawal power holder.

Especially with the current and future uncertainty in the tax law, as well as with the uncertainty in the trust's and beneficiary's respective tax situations, the Sec. 678 power needs to be drafted in a flexible fashion, so that it can adapt to various and changing circumstances. One way of accomplishing this is to allow an "independent trustee" (meaning one with no beneficial interest in the trust) the opportunity to either (1) annually suspend (and restore), broaden, and/or alter the Sec. 678 power, in whole or in part, before Jan. 1 of the next tax year, or (2) amend the trust's terms to achieve the lowest combined current income tax liability for the trust and its beneficiaries. (See Blattmachr, *Income Taxation of Estates and Trusts,* §5.5.1 (17th ed. 2018).)

Some may argue that a minor's legal guardian has a fiduciary duty to exercise the Sec. 678 withdrawal power on behalf of the ward/beneficiary, and that therefore employment of the power of withdrawal in the case of minor beneficiaries could turn out to defeat the parents' desire that their children not receive substantial sums at age 18. But is this really true?

Would a legal guardian, knowing that any amounts not withdrawn on the beneficiary's behalf will remain in a creditor-protected trust held exclusively for the ward's benefit, and that the ward will eventually control this trust at a designated age, be acting in the ward's best interest if he or she chose to exercise the withdrawal power and deposit the withdrawn funds in an unprotected guardianship or conservatorship account for the ward? Assume the ward is later involved in a major automobile accident, and the estate's assets are exhausted to satisfy a claim against the ward. Could the guardian then be surcharged for foolishly and needlessly withdrawing the funds from the protected trust? The point is self-evident.

Some may also argue that, under Sec. 678(a)(2) and IRS letter rulings, when the beneficiary's withdrawal power lapses each year, the beneficiary continues to be taxed on an ever-increasing portion of the trust's income, including capital gains. The problem with this argument (aside from the fact that it is really just an argument in favor of lower income taxes, in most instances) is that it flies in the face of the Code itself, as the *withdrawal power holder* has not "partially released or otherwise modified" the power. The power lapses by the terms of the trust, not by any affirmative "release" or "modification" *on the part of the beneficiary withdrawal power holder*, which is what Sec. 678(a)(2) requires.

Use of trustee suspension power

One reason for the needed flexibility is the above-noted manner in which certain trust expenses are treated for trust versus individual income tax purposes. The unbundled portion of trustee fees not attributable to investment advisory services, for example, may be deductible for trust income tax purposes, under the current tax law, but not deductible for individual income tax purposes. Under the regulations, an allocable portion of these types of fees would be applied to the beneficiary of the Sec. 678 withdrawal power, and as a consequence would no longer be deductible. (See Regs. Secs. 1.678(a)-1, 1.671-3(c), 1.677(a)-1(g), Ex. 2.) The trustee may thus find himself or herself in a situation where the federal marginal income tax rate applicable to the individual beneficiary is much lower than the trust marginal income tax rate, but making use of the former would eliminate a potentially significant annual income tax deduction.

Take, for example, a $2 million trust with a 1% annual trustee fee on the first $1 million of assets and a 0.75% fee on the next million. The total annual trustee fee would be $17,500. Assume also that no portion of this fee is allocable to tax-exempt income and no portion is allocable to investment advisory services. If the deduction for this fee is lost by allocating it to the individual beneficiary under a Sec. 678 power, the negative annual income tax effect could be as much as $6,475. If the individual beneficiary is at least that much ahead by having the trust income and capital gains taxed to him or her, versus the trust, this may be fine; but if the overall savings is less than this, suspension of the beneficiary's Sec. 678 withdrawal power by an independent trustee may be in order.

In most cases this will be easy enough to do, because the trust would likely already have an independent trustee in place. Note also that, after the suspension, the independent trustee will still retain the power to make Sec. 661/662 distributions to the individual beneficiary with the "after tax deduction income," the negative, of course, being the loss of the nontax advantages for retaining assets in trust.

Under current law, suspension or alteration of the individual beneficiary's withdrawal power may likewise be advantageous when the trust would otherwise be entitled to a significant tax deduction for state taxes paid (e.g., if the trust pays state capital gains taxes as a result of a large capital gain inside the trust that pushed the beneficiary's withdrawal right beyond the Sec. 2514(e) 5% limitation), at a time when the individual beneficiary is already benefiting from a similar state tax deduction (including as a result of the Sec. 678 withdrawal power). Suspending the individual beneficiary's Sec. 678 withdrawal power may make it possible to, in effect, "double up" on the current $10,000 annual ceiling on the state income tax deduction and achieve an aggregate deduction of as much as $20,000. As in the case of the trustee fee deduction, this technique could then be coupled with a Sec. 661/662 distribution to the individual beneficiary of the "after tax deduction income." Again, the aggregate tax savings of using the suspension power in this situation should be balanced against the nontax reasons for retaining the income in the trust.

Suspension of the individual beneficiary's Sec. 678 withdrawal power may also make sense if the individual beneficiary is already in a high tax bracket, or if the individual beneficiary is subject to the "kiddie tax" in a particular year. However, before making this decision, the independent trustee should bear in mind that this type of individual beneficiary might also be benefiting on the estate tax side by personally paying the income taxes attributable to an estate or generation-skipping transfer tax exempt trust's income. If the decision to suspend is made here, remember that the independent trustee can always restore the beneficiary's withdrawal power in the future, in full or in part, if and when circumstances dictate.

In certain situations it may make sense for an independent trustee to only partially suspend a beneficiary's Sec. 678 withdrawal power. For example, if the trust does not have any significant tax deductions that would be lost, it might be beneficial to suspend the beneficiary's withdrawal power only over an amount equal to the level at which the trust reaches the maximum income tax bracket (e.g., $12,750 in 2019), or to some other lower tax bracket level. In doing so, the trustee may also elect to limit the suspension to income items other than qualified dividends and capital gains first, so that the beneficiary may avail himself or herself of the significantly larger 0% tax bracket amount for these items, while also avoiding the 3.8% tax on net investment income.

Bear in mind, however, that the tax benefits of this "partial" suspension will be limited because the general effective tax rate on the compressed lower brackets of the trust is over 24%, a rate that does not kick in for single individuals until income levels of over $96,400 in 2019, including the $12,200 standard deduction. (The numbers for married couples filing jointly are twice these figures.) The next tax bracket of 32% is not reached until the single individual has over $172,925 in income, including the $12,200 standard deduction. (Again, the numbers for married couples filing jointly are twice these figures.) Thus, unless the beneficiary has significant taxable income, using this partial suspension technique will normally be tax neutral at best. In fact, if the beneficiary has little or no separate income, using the suspension technique may effectively cause a loss of the 0% tax rate on qualified dividends and capital gains to a single beneficiary with income (including the $12,200 standard deduction) of $51,575 or less in 2019.

As alluded to above, perhaps the most important reason for including a trustee suspension power in the trust is that it allows the trustee to maintain some control over the beneficiary's "nontax situation." This is what most concerns the majority of our parent clients. As just some of the potential examples, the trustee might suspend the beneficiary's withdrawal power (1) because of the immature or unwise use of funds the beneficiary is withdrawing from the trust, (2) to motivate the beneficiary to take a particular action (e.g., go to college or get a job), (3) because the beneficiary is getting a divorce, (4) because the beneficiary is involved in a lawsuit, or (5) because the beneficiary is attempting to qualify for college financial aid and a withdrawal right would hinder these efforts.

Due to the multitude and potential complexity of the issues involved, the trust document should exonerate the independent trustee for any decision or nondecision relative to the trustee's suspension power. The trustee should also be reminded that, to clearly comply with the Sec. 678(a)(1) requirements, the suspension power may only be exercised effective Jan. 1 of the following tax year. This will typically require some level of annual dialogue between or among the trust's CPA, attorney, trustee, and/or investment adviser.

Sec. 678 withdrawal powers that exceed the Sec. 2514(e) limitation

Assume that a significant portion of the trust accounting income (including capital gains allocated to trust accounting income) cannot be withdrawn under Sec. 678 in a particular year, because of the Sec. 2514(e) 5% limitation (which may occur when the trust incurs a substantial capital gain, for example). Which category or categories of income should be deemed withdrawable first by the beneficiary under the trust document? Recognizing that the reason the Sec. 678 withdrawable amount exceeds the 5% ceiling is likely due to a large capital gain in the trust, would it be better to have this capital gain (and qualified dividends) taxed to the trust, or to the beneficiary, when compared, for example, to a like amount of taxable interest taxed to the trust or to the beneficiary?

Both forms of income are subject to the tax on net investment income, but the tax rate on the capital gain and qualified dividends to the beneficiary will likely be no more than 15% (or 18.8%, if the single beneficiary's income exceeds $200,000), and could be as low as 0%. When taxed to the trust, the likely tax rate will be 20% plus the 3.8% tax on net investment income, or 23.8%, for a differential of between 5% and 23.8%. Interest income, on the other hand, would likely be taxed to the trust at 40.8%. The same form of income taxed to the beneficiary will likely be taxed at a much lower rate, perhaps as low as 22% or 24%, a differential of between 16.8% and 18.8%.

It thus appears that it is impossible to determine upfront which form of income should be withdrawable first by the beneficiary if the trust runs into the Sec. 2514(e) limitation. A pro rata solution would therefore appear to be the recommended drafting approach, with an independent trustee always possessing the ability to alter this plan in the future.

Finally, remember that if the independent trustee determines that income taxes could be further reduced by placing more income (including capital gains allocated to income under the trust document) in the hands of the beneficiary, and that taking this action will not create significant nontax issues for the beneficiary, the trustee can also always make a Sec. 661/662 distribution of income over and above the 5% limitation to the beneficiary.

Planning with existing trusts

When CPAs, attorneys, trustees, and their financial advisers are faced with existing (i.e., irrevocable) trusts, consideration should be given to employing the state's decanting legislation to move the trust assets to a new Sec. 678 trust, which will receive much more favorable income tax treatment for the current beneficiary and remaindermen of the trust. While it can be argued that it would be unfair to the trust remaindermen to add a Sec. 678 withdrawal power over income (including capital gains) to the trust in favor of the current beneficiary, the trustee should bear in mind that saving income taxes for the trust will usually benefit the remaindermen of the trust at least as much as it will benefit the current income beneficiaries, and also that the trustee possesses the power to suspend the current beneficiary's withdrawal power if it is being abused.

If a state does not have a decanting statute, it may still be possible for the trustee to distribute trust assets under a typical maintenance, support, health care, and education standard to the trustees of a new trust, which includes a Sec. 678 withdrawal power over trust income, the theory being that such a distribution is warranted because it will maximize the funds *ultimately* available to the beneficiary for his or her maintenance, support, health care, and education, as well as maximize the funds ultimately available to the trust remaindermen.

Sample form

The author's website contains a sample form (http://www.blaselaw.com/sample_form) that implements the above drafting recommendations.

DISCLAIMER: The contents of this article and the linked sample form are provided for informational purposes only, and are not intended as legal or tax advice. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship.

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