WealthManagement.com

Creatas/Thinkstock

WEALTH PLANNING > **HIGH NET WORTH**

Trust Income Tax Basics

See the following for an overview of the steps needed to handle this issue for a client.

Christine G. Pronek , Martin M. Shenkman | Mar 21, 2019

Trusts are ubiquitous in asset protection and estate planning. Regardless of a client's wealth level, he should be using trusts to avoid problems such as a minor child inheriting money outright; giving an adult child an outright inheritance, which is risky due to the possibility of divorce; or subjecting a gift or inheritance to the reach of a donee's creditors. But whenever trusts are involved, the wealth planning professional (whether a CPA, attorney or wealth manager) must understand how the trust is taxed. Here's an overview for those not familiar with trust income taxation. We'll define some of the jargon that makes this area of the tax law difficult for many.

Characterizing a Trust for Income Tax Purposes

When using trusts for income tax purposes, there are two broad categories:

- **Grantor trusts,** in which the income is taxed back to the grantor; or
- **Non-grantor trusts,** which can be either simple or complex. In a **simple trust,** all fiduciary income is distributed to the beneficiary at least annually. In a **complex trust,** the trustee has the discretion to decide if/when income will be distributed or accumulated.

Review of Trust Document

When you're planning for trust income taxes, or working on a trust income tax return, the first step to take is to review the trust document, which provides a blueprint of the trust. All of the finer-point details are in that document and bear critical importance when one is seeking to understand how to handle the income tax reporting of the trust. It's vital to gain a grasp of the terminology, provisions, language, trigger dates, directives and where the fiduciary accounting income may need to be distributed. You want to be aware of dates when something is supposed to occur, such as mandatory distributions at certain ages, and monitor closely so as not to miss these key events for both practical and tax reasons. The document itself presents the overview of the trust.

Create a Trust Summary

Some financial advisors and accountants don't feel fully comfortable reviewing a trust document because some trusts can be very complicated and sophisticated legal documents. The financial planner or accountant may opt to meet with the attorney that drafted the trust and go through the instrument. There's no reason not to, and it's a very worthwhile investment for the trustee to have the attorney who drafted the trust meet with the accountant who's preparing the fiduciary income tax returns to have the drafting attorney walk the accountant through that instrument and ensure that everyone is on the same page. Similarly, for a wealth manager investing trust money, an understanding of the terms of the trust, anticipated distributions, restrictions on investments, swap power, etc. is essential. In both cases, the accountant and investment advisor can create a summary of the trust provisions relevant to their roles with the guidance of the drafting attorney.

Distributable Net Income

A basic of trust income tax planning that both CPAs preparing returns and investment advisors planning for income tax implications must understand is **distributable net income (DNI).** What does DNI have to do with trust income taxation? DNI is the amount of income that can be deducted as a distribution on the fiduciary income tax return and is the amount of income that the beneficiary reports on her individual income tax return. **Schedule K-1** is the tax reporting statement that's prepared with the fiduciary income tax return when distributions have been made during the tax year, and it reports to the beneficiary the amounts of income that she must report on her individual income tax return. The deduction of DNI at the trust level avoids taxing the same income twice—once to the trust and again to the beneficiary.

As a planning thought, if you're working on a trust that has four beneficiaries and one is living in a no-tax state like Florida, and one resides in a high-tax state like California, you can, if the trust permits, opt to shift income as part out of the trust to the beneficiary in the lower-tax state. This example, however, assumes that there aren't other non-tax reasons for not making a distribution to that beneficiary.

Fiduciary Accounting Income

Separate and distinct from DNI, there's **fiduciary accounting income (FAI)**. FAI is the "income" being referred to in the trust document when it says, for example, in a simple trust, "income must be distributed at least annually." You need to be aware of what's contained in the trust document as a starting point to correctly compute the trust's FAI. The trust document may give the trustee discretion to allocate receipts and disbursements between income and principal. It's very important to be aware of any such provisions in the document so that FAI is correctly determined. If the document is silent as to the determination of FAI, then you'll have to look to the state law where the trust is governed. Many states follow the **Uniform Principal and Income Act**, but be careful as many states adopting this (and other) uniform laws add their own twists and modifications. It's important to correctly compute FAI because that's what's actually being distributed to your client's beneficiaries. DNI then comes into play to act as the ceiling in figuring out how much of a deduction the trust can get. The trust could distribute FAI in excess of DNI, but DNI represents the amount of income on which the beneficiaries would be subject to income tax and the deduction the trust can take for distributions made.

Mistakes are frequently made in computing FAI when the trust owns an interest in a pass-through entity, such as a partnership. The Schedule K-1 received by the trust reflects the trust's share of taxable income from the partnership. These numbers don't factor into the computation of FAI. The distribution, if any, that the trust received from the partnership is the FAI (assuming it was a distribution made in the ordinary course of business and not a liquidating distribution or property distribution). The preparer of the trust income tax return needs to be aware that the amounts reported on the Schedule K-1 from the partnership aren't amounts of income that will be going out to the beneficiaries. If there were no distributions received by the trust from the partnership, then the FAI with respect to the partnership interest is zero, and the taxable income amounts on the partnership K-1 can't be pushed out to the beneficiaries. That income is trapped in the trust. This is a very important FAI concept to understand so you can correctly prepare the fiduciary income tax return.

Net Investment Income Tax

Net investment income tax (NIIT) as it applies to trusts is another area of trust income taxation that's important to understand. The trust could be subject to NIIT if there's undistributed net investment income in the trust and the trust's taxable income is over $12,700 (for 2018). In addition to the highest capital gains tax rate of 20 percent being applicable at this level of taxable income in a trust, the trust will also be subject to the 3.8 percent NIIT.

We talked earlier about distributing income from the trust to beneficiaries who are in lower-tax states to save on state income tax. Similar to that logic is making allowable distributions from the trust to avoid the NIIT. Knowing the trust beneficiaries' individual income tax situations is key to doing the proper tax planning for a trust. One thing to consider when dealing with the NIIT is whether the trustee is an active participant in the business that's generating the income. As an example, if your client isn't actively involved in a family business, the income he receives would be subject to NIIT. If his interest is transferred to a non-grantor trust and the trustee is active in the business (it's not fully clear how the determination is made that a trustee participates enough to be considered "active"), then the NIIT should no longer apply.

State Taxation of Trusts

State income taxation of trusts is also a minefield when preparing trust income tax returns. It's important to be aware of what each state considers to be a strong enough connection to subject a trust to its state income tax. California, for example, will require the filing of a California fiduciary income tax return and impose tax for a trust that has a beneficiary who resides in California and/or a trust with a California trustee. Being aware of current addresses of all of the trustees, not just the one whose address is reflected on the trust income tax return, as well as the current addresses of all of the beneficiaries, is key to not missing a required state return filing. The tax return preparer also needs to be aware of which states the trust may have to file an income tax return in without having income tax nexus. In New Jersey, as an example, a trust could start off with income tax nexus in New Jersey, but if the trustees have moved out of New Jersey, the trust doesn't have real or tangible assets in New Jersey, or it doesn't have any New Jersey source income, then the trust will still have to file a New Jersey fiduciary income tax return, but it won't have to pay tax. Practitioners should be aware that state income taxation is an evolving area and that the U.S. Supreme Court recently agreed to hear a landmark state income tax case, so important guidance and even changes may occur to this area of the tax laws.

Pulling It All Together

The starting point is combing through the trust instrument to see what that provides for and striking a balance, which is often difficult, if not impossible, between the state income tax issues, the NIIT issues and grappling with the new Internal Revenue Code Section 199A deduction, which we haven't covered. Even if you grasp all of these points, that's still not the end answer. Consider this: What if you can decant the trust and merge it into a new trust with slightly different provisions, or a trust protector makes changes to the trust, or the resignation of a trustee brings on a successor trustee who resides in a different state? The point is, you can influence some of these factors. It's an incredibly complex array of issues that are sometimes very interrelated, and the planning has to balance all of that.

Source URL: https://www.wealthmanagement.com/high-net-worth/trust-income-tax-basics