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Flex Your Beneficiaries:

Reducing the Income Tax Burden on Non-Grantor Trusts

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Today's Speakers:

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Types of Trusts and Their Taxation

- Trusts are either grantor trusts or non-grantor trusts (or a combination of both)
- Grantor trusts are “deemed owner” trusts – their income, deductions, and credits are attributed directly to the deemed owner under Section 671, who either is the grantor of the trust or (under Section 678) a beneficiary of the trust
- At one time, grantor trusts were considered to be so adverse that they were called “defective”
- Trusts and individuals used to have the same income tax brackets, but that changed in the Tax Reform Act of 1986. Trusts reached the top income tax bracket at only $7,500 of income at that time, and in 2022, with inflation adjustments, now reach the top bracket with income of $13,450.
- So now dividing income with one or more trusts (especially with the Section 643(f) multiple trust rule) likely doesn’t save any federal income tax (although using trusts may save state income tax)

How Grantor Trusts Help with Estate Tax Planning

- Swapping or selling assets to a grantor trust so lower basis assets are in the gross estate to secure the step up in basis under Section 1014
- No gain recognition on completing a swap
- Have assets producing greater returns held by the trust to maximize appreciation
- Because assets may be sold to the trust for an AFR note (which has a lower return on average than market returns) the sale to a grantor trust for an AFR note may be beneficial is shifting wealth out of the client's estate
- Because the income received by a grantor trust is included in the gross income of the grantor, without causing the grantor to be treated as making a gift (although in essence the grantor pays what would otherwise be the trust's tax bill), it permits the trust to grow on a tax-free compounded basis, one of the most powerful forces in building wealth. This "burning" of the grantor's gross estate (and all of it excluded from the grantor's gross estate) is one of the most important estate tax planning opportunities. This is commonly called "Tax Burn."

When Grantor Trust Status Will End and Why You May Want It to End

- Grantor trust status may only exist while the deemed owner is alive
- The deemed owner may not wish to be responsible for the income tax
- The deemed owner may be subject to state income tax (while a non-grantor trust would not be). See *North Carolina v. Kaestner* (USSC 2019)
- Adverse consequences may arise by "toggling" grantor trust status off or on during the grantor's lifetime as with a "negative basis" asset. Cf. Rev. Rul. 77-402. Arguably, this may not apply to indebtedness owed by the trust to the grantor as no debt is deemed to exist. See Rev. Rul. 85-13.
- A transfer of the right to IRD to a grantor trust by the grantor should not be an income recognition event but ending grantor trust status during the grantor's lifetime may cause the gain to be recognized (although arguably not if returned to the grantor)

When Non-Grantor Trusts May Be Beneficial

- When the trust can avoid state income tax and the person who would be the deemed owner could not
- When the trust is entitled to additional deductions or other tax benefits that the person who would be the deemed owner could not take advantage of—e.g., an additional $10,000 SALT deduction
- When the person who would be the deemed owner could not get the benefit of contributions to charity because of the AGI limitations individual donors face

Additional Income Taxes a Trust May Face

- Individuals generally do not reach the top (37%) federal income tax bracket until income exceeds $500,000 but a trust reaches the top bracket (in 2022) at $13,450
  - Tax due on $25,000 of income by Single Individual ($1,342), Married Couple ($60), or Trust ($7,551)
  - Tax due on $100,000 of income by Single Individual ($15,247), Married Couple ($8,684), or Trust ($35,301)
  - Tax due on $200,000 of income by Single Individual ($41,413). Married Couple ($30,493), or Trust ($72,301)
- Individuals pay the 3.8% tax on the lesser of NIT or the amount of above the excess of modified adjusted gross income over the following threshold amounts:
  - $250,000 for married filing jointly or qualifying widow(er)
  - $125,000 for married filing separately
  - $200,000 in all other cases
- Trusts pay the 3.8% tax on undistributed NIT or the excess of modified AGI above (for 2022) $13,450
- Proposed surcharges: for individuals, 5% on amounts above $10 million and 8% on amounts above $25 million. But for trusts and decedents' estates, the thresholds are $200,000 and $500,000.

Reduce Income Tax on Trust Income by Distributing Gross Income to Charity

- Section 642(c) allows an unlimited income tax deduction for gross income paid, pursuant to the terms of the governing instrument, for a charitable purpose.

- However, Section 681 imposes the same percentage limits tied to an individual's contribution base (essentially, AGI) to the extent the distribution to charity from the trust constitutes essentially of unrelated business [taxable] income (under Section 512). But the taint of UBTI seems to be washed away when distributed from a trust to charity. See Schmolka, "Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism," 40 Tax Law Rev. 1, 294, n. 653.

- The Section 642(c) deduction is allowed not only if the governing instrument directs payments for a charitable purpose but also if it merely authorizes them.

- In addition, if a trust is a partner is a partnership that makes a donation to charity from its gross income, the trust, as a partner, may deduct its proportionate share of the charitable donation. Rev. Rul. 2004-5.

Reduce Income Tax on Trust Income by Distributing DNI to Beneficiaries

- Although, in general, a non-grantor trust is taxed as an individual is, in addition to a different deduction for charitable contributions, a trust is entitled to a deduction for distributions of its distributable net income (DNI) to its non-charitable beneficiaries, subject to exceptions and special rules
- DNI is defined in Section 643(a) and is the trust's taxable income for the year with special rules and exceptions. For example, except for the year of termination of the trust, capital gain is not included in DNI unless it is actually distributed (or deemed distributed). The regulations explain ways for that to happen, such as allocating capital gain to fiduciary accounting income or by "deeming" a distribution of corpus as consisting of capital gain
- In any event, distributing DNI to a beneficiary shifts the income to the beneficiary and away from the trust. And to that extent, the trust's tax brackets and other income tax attributes will not apply.
- Also, the trust may be able to avoid state income tax that a beneficiary who receives DNI cannot. See *North Carolina v. Kaestner* (USSC 2019)

Distributing DNI Among a Class of Beneficiaries that May Include the Spouses of Descendants

- Subject to exceptions and special rules, DNI can be distributed to any discretionary beneficiary (that is, a beneficiary who is eligible in the discretion of a non-beneficiary trustee to receive trust distributions; if the trustee may distribute to himself or herself, it may be a deemed owner trust under Section 678)
- A beneficiary may be any beneficiary other than charity (for which a shift of income out of the trust to the beneficiary is allowed only under Section 642(c)) and may include other trusts or any other non-charitable "person," including a corporation
- Hence, distributions may be authorized to be made to the spouses of the primary beneficiaries (such as the spouses of descendants of the person whose wealth funded the trust)
- It may make sense to include such spouses as discretionary beneficiaries for at least two reasons:
    - First, the descendant may be under the threat of a creditor claim
    - Second, the descendant may have an addiction or spendthrift problem or be incompetent
- Distributions to the descendant's spouse can be conditioned on the spouse being married to and living as a married couple with the descendant and/or obtaining the descendant's consent (only minimal risk of any real risk tax exposure to the consenting descendants as the gift would likely be de minimus and/or qualifying for the gift tax marital deduction, or the expanded annual exclusion if the spouse is not a US citizen).

Distributing DNI Among a Class of Beneficiaries that Includes Other Trusts, Such as CRTs for Descendants

- Subject to exceptions and special rules, DNI can be distributed to any discretionary beneficiary (that is, a beneficiary who is eligible in the discretion of a non-beneficiary trustee to receive trust distributions)
- A beneficiary, who may receive DNI, may include any other non-charitable "person" including other trusts
- Before making the distribution to another trust, consideration should be given to the tax attributes of the "receiving" trust, such as whether the receiving trust is GST exempt or subject to a particular rule against perpetuities or subject to state income tax
- A distribution to a charitable remainder trust (CRT) described in Section 664 might be considered, as CRTs are income tax exempt (but are subject to a 100% excise tax on their unrelated [taxable] business income, essentially as defined under Section 512)
- However, a trust is a CRT described in Section 664 only if it meets the definition of a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT) including an income only unitrust such as a NIMCRUT (a CRUT with make-up provisions) and has property for which an income tax charitable deduction was allowable under Section 170, 2055, 2106 or 2522. Reg. 1.664-1(a)(1)(iii)(*a*)
- Note several points: the charitable deduction under Section 642(c) is not mentioned; a distribution of DNI falls under Sections 651/652 or 661/662; there is no requirement that all of the property in the CRT qualified for the charitable deduction under Section 170, 2055, 2106 or 2522 (indeed, it never could).

More on Distributing DNI to CRTs for Descendants

- A distribution of DNI to a CRAT will not produce any deduction under Section 170, 2055, 2106 or 2522 and it would, therefore, seem to fail to be a CRT as described in Reg 1.664-1(a)(1)(iii)(*a*) ("a trust with respect to which a deduction is allowable under section 170, 2055, 2106, or 2522")
- Although additional contributions cannot be made to a CRAT, they may be made to a CRUT. So distributing DNI to a pre-existing CRUT, which holds some property for which a charitable deduction was allowed under 170, 2055, 2106 or 2522 should mean that the DNI is not taxed at all. (Any UBTI taint in the distributing trust seems to be washed away when distributed.)
- And if the distribution is made to a pre-existing NIMCRUT, it may be possible to avoid having the DNI income taxed for a long time. See "Using a Charitable Remainder Trust as the Recipient of Qualified Plans and IRAs," 47 Estate Planning 3 (May 2020).
- Hence, someone (other than the trustee) should create the CRUT for those descendants who may not need current distributions and to which the trustee of the "main" trust may distribute DNI. These need not have been in existence when the main trust was created.

Distributing DNI to an S Corporation Which Has Descendants or a QSSTs for Descendants as its Shareholders

- Subject to exceptions and special rules, DNI can be distributed to any discretionary beneficiary (that is, a beneficiary who is eligible in the discretion of a non-beneficiary trustee to receive trust distributions), including an S corporation
- The income of an S corporation is not taxed to the corporation, but to its shareholders
- The class of permissible S corporation shareholders is limited but includes US individual taxpayers and qualified subchapter S trusts (QSSTs) described in Section 1361(d)(3). A QSST is a trust that has a US individual taxpayer as its sole beneficiary and must currently distribute all of its fiduciary accounting income to that beneficiary.
- DNI distributed to an S corporation will be included (directly) in the gross income of its shareholders. Hence, if a descendant is the shareholder, the DNI will be included in that descendant's gross income, without necessitating any distribution to the descendant other than for fiduciary accounting income which can be minimized—see discussion in "Using a Charitable Remainder Trust as the Recipient of Qualified Plans and IRAs," 47 Estate Planning 3 (May 2020). Although that might directly protect the income from attachment by a creditor of the descendant shareholder, the stock owned by the descendant will not be protected.
- Hence, instead of having the stock in the S corporation owned by a descendant, it might be preferable to have the stock owned by a QSST for the descendant. The income of the S corporation (including any DNI distributed to it) will be taxed to the descendant as the beneficiary of the QSST without making either the income (if not distributed or distributable from the S corporation) or the stock subject to the claims of the descendant's creditors, and should not cause the descendant to exceed thresholds for government entitlements such as Medicaid. Obviously, the descendant should not be able to control distributions from the S corporation.

InterActive Legal Drafting Options

- "Flexible" beneficiaries can be added to any continuing trust for descendants of the grantor (or testator) – either a single/pot trust for all descendants, or separate pro-rata trusts
- However, the flexible beneficiary options only appear if the trustee has discretion to make distributions. If income distributions to the primary beneficiary are mandatory, or if distributions are limited to only an ascertainable standard, the options for additional beneficiaries are not applicable and will not appear.

DRAFTING TIP

DRAFTING TIP: OPTIONS TO INCLUDE ADDITIONAL BENEFICIARIES

This interview offers the option to allow distributions to certain beneficiaries in addition to the primary beneficiaries of the trust, namely the spouse of the Beneficiary, a CRT, or a Subchapter S Corporation. This may be desirable for several reasons, including income tax planning and creditor protection. In order for the option to include additional beneficiaries in your document to appear, you will need to ensure that your choices related to the distribution of income and principal are compatible with a plan that includes additional beneficiaries. To that end, both of your choices related to the Distribution of Income and Distribution of Principal must include a choice that gives discretion to the Trustee to make distributions. In addition, the standard to be used for such discretionary distributions of income and of principal must include an option that allows the Trustee to distribute for any purpose. You can use either the "any purpose" standard or the standard that permits distributions both for health, education, maintenance and support and for any purpose. If the appropriate options for Distribution of Income and Distribution of Principal are selected, along with the discretionary standard described above, the option to include additional beneficiaries will appear below the options relating to distribution standards, on this screen. Please see the Help Text below for more information about these options.

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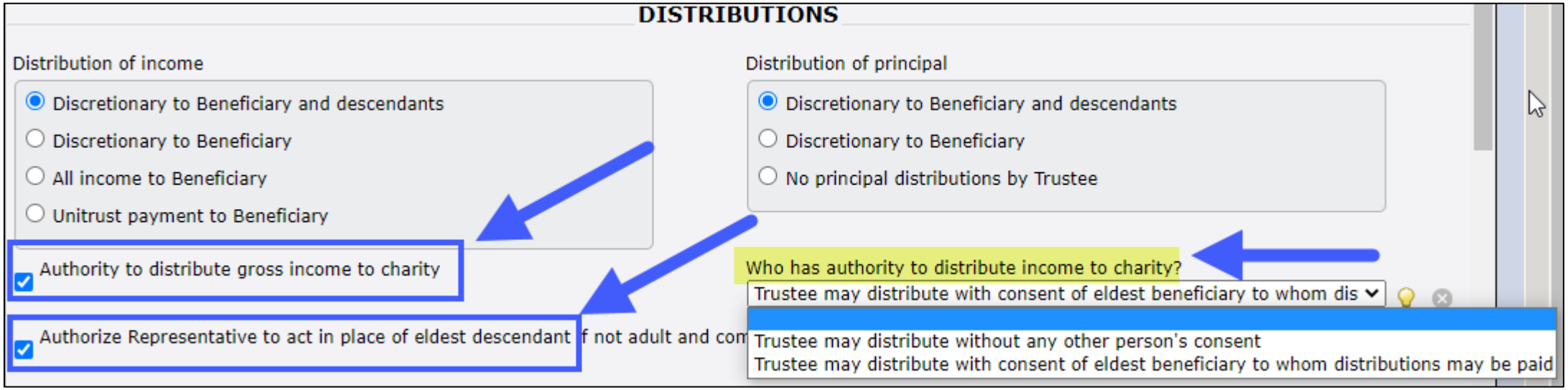
InterActive Legal Drafting Options – Income to Charity

- Note that options for additional beneficiaries will not appear if income is mandatory or the trust is set up as a unitrust
- Includes option to require beneficiary's consent for distributions to charity, if desired
- If eldest beneficiary (who would provide consent) is a minor or incompetent, consent can be given by a representative of that beneficiary



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InterActive Legal Drafting Options - Spouse, CRT, S-Corp

- Choose any or all options for additional beneficiaries – spouses, charitable remainder trusts, or qualifying S corporations
- Adding more potential beneficiaries can provide more flexibility for lowering income taxation and addressing other situations (such as the spendthrift beneficiary or beneficiary with creditor issues)

Give Trustee authority to make distributions to beneficiaries other than descendants and charity

- (●) Yes
- ( ) No

DRAFTING TIP: This option will enable the Trustee to make distributions to certain additional beneficiaries other than descendants. Please see Help Text for details on this option.

Select which of the following beneficiaries to whom the Trustee may make distributions. Select as many as may apply.

- [x] Spouses
- [x] Charitable Remainder Trust
- [x] S Corporation

DRAFTING TIP: The option to make distributions to spouses includes both the spouses and surviving spouses of current beneficiaries of the trust. The option to make distributions to a charitable remainder trust ("CRT") includes only those trusts of which an individual beneficiary of the descendants' single trust is the non-charitable beneficiary. The option to make distributions to an S Corporation includes only those S corporations of which one or more of the individual beneficiaries of the trust are shareholders or of which one or more shareholders are qualified subchapter S trusts ("QSSTs") of which an individual beneficiary of the trust is the sole beneficiary. See Help Text for additional details.

InterActive Legal Drafting Options – More Options for Spouses

- If distributions can be made to a descendant's spouse (or surviving spouse), additional limits can be added, either to require beneficiary's consent, require the beneficiary and spouse to be living together, or both.

Select which of the following beneficiaries to whom the Trustee may make distributions. Select as many as may apply.

- [x] Spouses
- [x] Charitable Remainder Trust
- [x] S Corporation

DRAFTING TIP: The option to make distributions to spouses includes both the spouses and surviving spouses of current beneficiaries of the trust. The option to make distributions to a charitable remainder trust ("CRT") includes only those trusts of which an individual beneficiary of the descendants' single trust is the non-charitable beneficiary. The option to make distributions to an S Corporation includes only those S corporations of which one or more of the individual beneficiaries of the trust are shareholders or of which one or more shareholders are qualified subchapter S trusts ("QSSTs") of which an individual beneficiary of the trust is the sole beneficiary. See Help Text for additional details.

Require consent of the Beneficiary to make distributions to Spouse of the Beneficiary

- (●) Yes
- ( ) No

Limit distributions to spouse to periods when spouse is living with the Beneficiary

- (●) Yes
- ( ) No

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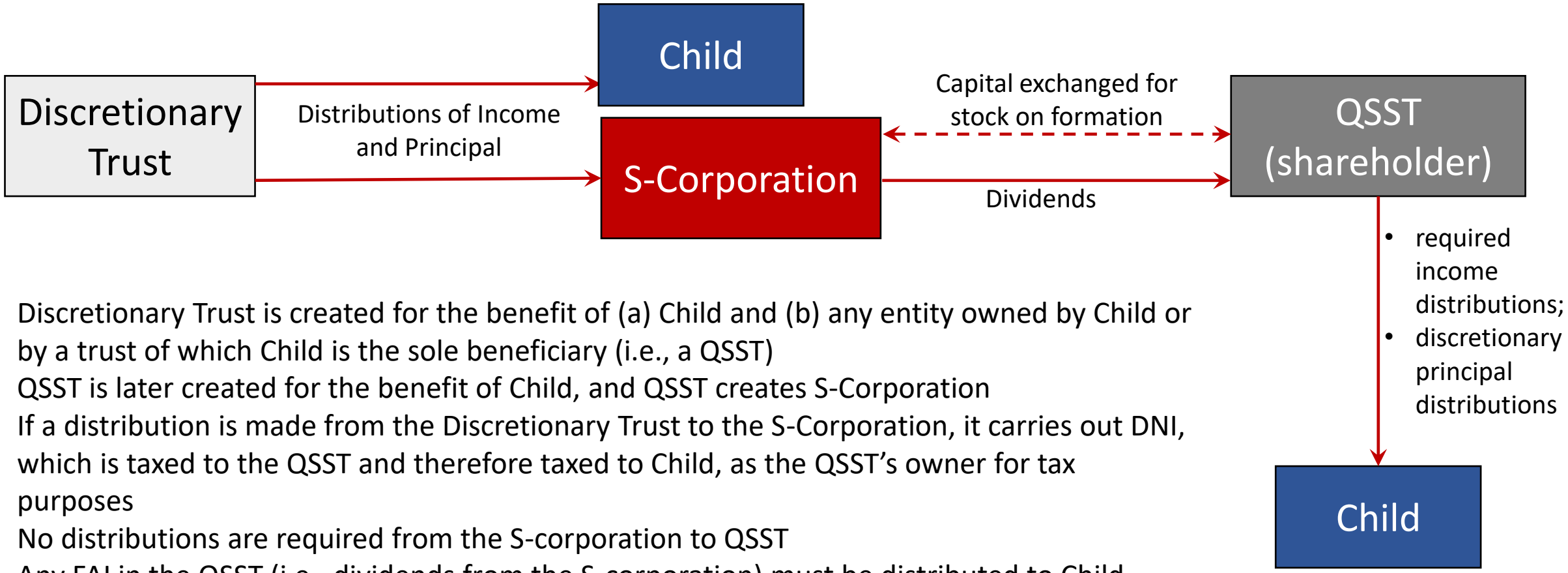
Non-grantor trust with beneficiary as taxpayer using QSST/S-Corp



- Discretionary Trust is created for the benefit of (a) Child and (b) any entity owned by Child or by a trust of which Child is the sole beneficiary (i.e., a QSST)
- QSST is later created for the benefit of Child, and QSST creates S-Corporation
- If a distribution is made from the Discretionary Trust to the S-Corporation, it carries out DNI, which is taxed to the QSST and therefore taxed to Child, as the QSST's owner for tax purposes
- No distributions are required from the S-corporation to QSST
- Any FAI in the QSST (i.e., dividends from the S-corporation) must be distributed to Child
- Accordingly, assets can be accumulated at the S-corporation level, and only pass to Child when a dividend is declared, but income is taxed to Child (at individual rates, instead of trust rates)

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Summary & Conclusions

- Under current law, grantor trusts are often an effective tool for estate planning.
- However, a trust cannot be governed by the grantor trust rules once its "deemed owner" dies
- Non-grantor trusts may be beneficial for certain purposes, such as avoiding state income tax or providing certain additional tax benefits (such as an additional SALT deduction or Section 199A deduction)
- Unfortunately, non-grantor trusts face extremely high federal income taxes compared to individuals, but distributions of trust income can, in a flexibly drafted trust, be distributed to charity and/or non-charitable beneficiaries that may include descendants, their spouses, CRTs for them and S corporations of which descendants or QSSTs for them are the shareholders
- And remember the flexibility of the Section 663(b) sixty-five day rule that applies to distributions of DNI (and for Section 642(c) the trust has the entire next year to make the distribution)
- View related blog: https://blog.interactivelegal.com/2022/01/flex-your-beneficiaries.html

Upcoming Events*

- InterActive Legal Subscriber All-Access Live Q&A with today's speakers
  - Friday, February 11, 2022, 12pm ET.
- Understanding and Planning for Life Insurance
  - Wednesday, February 23, 2022, 4pm ET
- Trust Administration - Practical Tips for All Practitioners
  - Wednesday, March 9, 2022, 4pm ET
- InterActive Legal's Heckerling Round-Up
  - Wednesday, April 20, 2022, 4pm ET

*Dates and times subject to change

Douglas Blattmachr, Marty Shenkman and Jonathan Blattmachr: How to Reduce the Income Tax Burden on Non-Grantor Trusts

"Although the Build Back Better bill has not been enacted (yet) which would impose 5% and 8% surcharges on individuals with income over $10 million and $25 million and on decedents' estates and non-grantor trusts at just $200,000 and $500,000, estates and trusts will continue to be subject to very heavy income and net investment income taxes even without the surcharges. We are fortunate to have three of the country's top estate planners share a synopsis of what their upcoming article, which appear in full in the next issue of the ACTEC Journal about the heavy income tax burden trusts face and some of the way to reduce it.

Some of their suggestions initially may seem downright bizarre: Allow distributions from a trust to charitable remainder trusts and to S corporations. But there is plenty of gold there if you take the time to think their recommendations through."

Douglas Blattmachr, **Martin Shenkman** and **Jonathan Blattmachr** provide members with commentary that examines how to reduce the income tax burden on non-grantor trust. Members who wish to learn more about this topic should consider joining Doug/Marty/Jonathan in their exclusive **LISI** Webinar on January 7th at 1pm titled: "How to Reduce the Income Tax Burden on Non-Grantor Trusts."

Douglas J. Blattmachr is the chair of the board of **Peak Trust Company** with offices in Anchorage and Las Vegas. Doug was instrumental in the enactment of the Alaska Trust Act, passed in 1997, one of the most important laws passed in modern time for estate and tax planning. It has been copied (sometimes with changes) in at least nineteen states.

Martin M. Shenkman is one of the country's most prolific authors and speakers in the country on estate and tax planning and one of the earliest grantors of an Alaska Trust. Marty practices in New York and New Jersey.

Jonathan G. Blattmachr is author or co-author of several books and many articles. He is a director at **Pioneer Wealth Partners LLC**, director of estate planning for the **Alaska Trust Company** and co-developer with Michael L. Graham, Esq., of Dallas, Texas of **Wealth Transfer Planning**, a software system for lawyers, published by Interactive Legal LLC (www.interactivelegal.com).

Now, here is Doug, Marty and Jonathan's commentary:

EXECUTIVE SUMMARY:

Since 1986, non-grantor trusts have faced much higher federal income taxes that an individual would, in most cases. There are many reasons for that phenomenon. One is that such trusts reach the highest federal income tax bracket and must pay net investment income tax (NIIT) on much lower levels of income. Another reason is that trusts (other than disability trusts) are essentially denied any standard deduction for income tax purposes. Trusts may provide enhanced income tax benefits such as being allowed their own state and local tax (SALT) deduction, at least under current law. Moreover, a trust is allowed a deduction for contributions of its gross income for a charitable purpose regardless of the level of adjusted gross income (except when the gross income includes unrelated business taxable income defined in Internal Revenue Code Sec. 512). But by using a discretionary trust under which the trustee may make distributions, not just to the loved ones of the property owner, but other trusts, including charitable remainder trusts, qualified subchapter S trusts (QSSTs) and S corporations which have QSSTs as their shareholders, the heavy income tax burden the income tax earned by the trust may be significantly reduced.

COMMENT:

Trusts Usually Pay More Federal Income Tax. Overall, and in general, trusts will face higher taxes on income than would an individual. Here is a list estimating how much more a trust may be burdened by federal income tax compared to a single and or married individual (who has no other income):

- Tax due on $25,000 of income by Single Individual ($1,350), by a Married Couple ($60), and by a Trust ($7,500)
- Tax due on $100,000 of income by Single Individual ($15,250), by a Married Couple ($8,700), and by a Trust ($35,000)
- Tax due on $200,000 of income by Single Individual ($41,500), by a Married Couple ($30,500), and by a Trust ($72,000)

And these comparisons will be worse for trusts (and decedents' estates) if the surcharges that have been proposed in the Congress of 5% and 8% are imposed on non-grantor trusts on income above $200,000 and $500,000, while the surcharges on individuals would not occur until their incomes exceed $10 million and $25 million. Trusts (and decedents' estates) can reduce the amount of taxable income upon which they pay income tax or upon which they pay NIIT by distributing distributable net income (DNI), defined in Code Sec. 643(a), to a beneficiary as described in Code Sec. 651 and 661.

Shifting Trust Income to Others. In general, but subject to exceptions and special rules, any distribution to a beneficiary is treated as consisting of the trust's DNI to the extent of the lesser of its DNI or the distribution. This has the effect of "shifting" the income from the trust to the beneficiary so the trust pays no tax on the distribution and the beneficiary must include it in gross income. Nonetheless, it may not be possible for a beneficiary who is subject to state income tax to avoid that tax while a trust usually can be structured and administered to avoid it. See, generally, Blattmachr & Shenkman, "State Income Taxation of Trusts: Some Lessons of *Kaestner*,*"* 46 Estate Planning 3 (October 2019).

When distributions from a trust are required, as they generally are for marital deduction trusts described in Sections 2056(b) and 2523, the DNI to the extent of the required distribution will be so shifted. In such cases, the ability to shift income will be automatic whether or not that is beneficial from an income tax reduction perspective. In general, DNI is the trust's taxable income for the year determined without regard to the deduction for the distribution of DNI to beneficiaries. In some cases, capital gain income of a trust (or a decedent's estate) does not form

part of DNI. (For a discussion of whether capital gain will form or be forced to form part of DNI, see Blattmachr & Gans, "The Final 'Income' Regulations: Their Meaning and Importance," Tax Notes 891, May 17, 2004).

Taxation of a QSST or CRT. A qualified subchapter S trust (QSST), described in Section 1361(d)(3), like most marital deduction trusts, is required to currently distribute its fiduciary accounting income (FAI), described in Section 643(b), to its beneficiary; however, all tax income of the S corporation, to the extent the QSST is a shareholder, is attributed to the trust beneficiary regardless of whether the income would constitute DNI. Distributions are also required for a charitable remainder trust (CRT) described in Section 664. However, a CRT is exempt from income tax; distributions to beneficiaries may be included in their gross income but not using traditional notions based upon DNI. See Section 664(c).

How a Discretionary Trust May Reduce Income Tax

Probably, a majority of large trusts created today, other than most marital deduction trusts, QSSTs and CRTs, do not mandate distributions but grant the trustees the discretion to make or not make distributions either for one or more specific purposes (such as health, education, maintenance and/or support) or for any reason to or among one of more beneficiaries. That discretion may permit the trustees to shift the DNI to a beneficiary who would pay lower taxes on the DNI than would the trust. Although the shift is limited to DNI for the year (and all trusts are required to use a calendar year for tax purposes), Section 663(b) allows the trustees to elect to treat any distribution within 65 days of the close of the year to be treated as made in the prior year up to the extent of the greater of the trust's FAI or DNI for the year to the extent not already distributed.

Hence, if the trust has several beneficiaries (such as all of the descendants of the person whose property was used to fund the trust), the trustees of a discretionary trust may decide as to which descendant or descendants to whom to shift DNI for the year by making distributions only to such beneficiary or beneficiaries. That may reduce the overall income tax on the DNI earned in the trust.

Of course, for one or for several reasons, it may not be appropriate to make distributions to certain beneficiaries. For example, the beneficiary

may be subject to a state income tax that the trust would not have to pay or would pay a lower state income tax. (See, generally, Blattmachr & Shenkman, supra.) Another reason it may not be wise to make a distribution to a beneficiary is because the beneficiary will foolishly dissipate the distribution or because the beneficiary is experiencing or is anticipated to experience claims of creditors. Any distribution to the beneficiary might be attached by a creditor of the beneficiary.

Another reason why it may not be appropriate to make a trust distribution is when the beneficiary is receiving certain government payments or benefits. A person may be denied government benefits (such as Medicaid) if the individual's "non-exempt" assets or income exceeds a certain threshold. (The income and asset value levels in some cases are relatively low, subject to exceptions and special rules. See, generally, Feke, "Medicaid Eligibility: MAGI and Your Assets," available at https://www.verywellhealth.com/your-assets-magi-and-medicaid-eligibility-4144975).

Distributions to an individual may also mean subjecting the amount of the distribution at the beneficiary's death to federal or state death tax that otherwise would not be imposed.

It seems that it may be preferable to have a structure so that trust income taxed may be imposed in an efficient way. That might be accomplished by using a discretionary trust where the trustees could distribute DNI to individuals whom the former property owner would wish to benefit (such as his or her descendants), CRTs of which or more of the same individuals are the beneficiaries, one or more QSSTs of which such individuals are the beneficiaries (note that each QSST may have only one beneficiary who must be a US income taxpayer), one or more S corporations of which a QSST with such a beneficiary is a shareholder. It may also be appropriate to permit distributions to the spouses of the individuals whom the former property owner wishes to benefit, such as his or her descendants, just in case the descendants is under the threat of a creditor claim.

Why Authorize Distributions to a CRT?

Authorizing distributions to a CRT may help avoid, at least temporarily, the income taxation of a trust's DNI. CRTs are income tax exempt. CRT's are subject to a 100% excise tax on unrelated business taxable income (UBTI). However, the character of income as UBTI is lost when

distributed from a trust. See Schmolka, “The Income Taxation of Charitable Remainder Trusts and Decedents’ Estates: Sixty-Six Years of Astigmatism,” 40 Tax L. Rev. 1 (1984).

As detailed in a recent article, a so-called “net income with makeup charitable remainder unitrust,” commonly called a “NIMCRUT,” may provide significant opportunities to defer income taxation and, if the growth in the assets not so taxed is sufficient, the non-charitable beneficiaries may ultimately succeed to more wealth than if s to them had been made earlier. See M. Blattmachr, R. Fox & J. Blattmachr, “Using a Charitable Remainder Trust as the Recipient of Qualified Plan and IRA Interests*”,* 47 Estate Planning 3 (May 2020).

So it may be appropriate to authorize but not mandate distributions to CRTs or NIMCRUTs if one or more of the named or described individual beneficiaries trust of the discretionary trust (such as descendants) are beneficiaries of the CRT or NIMCRUT.

Why Authorize Distributions to a QSST or S Corporation?

A distribution of DNI from a trust (or estate) to a QSST will mean the income will be taxed to the beneficiary of the QSST even if no distribution is made to him or her. To the extent the distribution constitutes FAI of the QSST, it (along with any other FAI the QSST receives) must be distributed, essentially immediately, to beneficiary. That FAI may be subject to claims of creditors of the beneficiary and may cause the beneficiary to have resources so great as to cause a loss of government benefits, such as Medicaid. Therefore, instead of or in addition to authorizing distributions to one or more QSSTs, of which one of the individual beneficiaries of the discretionary trust are beneficiaries, the trustees could be authorized to make distributions to any S corporation of which one or more of the beneficiaries of the discretionary trust are the shareholders or one or more QSSTs are the shareholders and each beneficiary of any such QSST is also an individual beneficiary of the discretionary trust. The S corporation income will be attributed to the beneficiary of any QSST which is a shareholder of the corporation.

In order to be a QSST, its sole beneficiary must be a US individual taxpayer and the beneficiary must elect to be taxed as though the trust were described in Section 678 to the extent of the income of the S corporation. If a beneficiary refused to make the election, the trustees

may simply refuse to make any distribution to or for the beneficiary. Fortunately, the trustees of a QSST may be authorized to and may make payments on behalf of beneficiary, such as paying the income taxes on the income imputed to the QSST beneficiary. (It probably would be wise to have someone other than the beneficiary or the trustee hold the only voting share in the S corporation and who, therefore, would control distributions from the corporation, which should foreclose a state agency from successfully contending the trust is an available resource.) This imputed income should not cause the beneficiary to be treated as having resources for purposes of government benefits and should not be subject to the claims of creditors of the QSST beneficiary. Furthermore, even though S corporation income may be imputed to the beneficiary for income tax purposes, that income, if not distributed, will not become part of the beneficiary's wealth for estate tax purposes.

Conclusion

Grantor trusts have been the main chassis upon which much of lifetime estate planning has been built. Proposals have been made which could make at least "new" grantor trusts adverse. In any case, a trust may be a grantor trust only while the trust's grantor is living. Although, in effect, a grantor trust may be created under Code Sec. 678 for a beneficiary by granting the beneficiary the unilateral right to withdraw property from the trust, such a power, in most jurisdictions, will make the trust assets, to the extent of the withdrawal power, subject to the claims of the creditors of the beneficiary.

In any case, authorizing trust distributions to charity, to the spouse of the beneficiary, to a CRT for the beneficiary or to an S corporation which has a QSST for the beneficiary as the shareholder may avoid attachment by the creditors of a beneficiary and provide opportunities to reduce income taxation of the trust's income.

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CITE AS:

LISI Estate Planning Newsletter #2930 (December 27, 2021) at http://www.leimbergservices.com.

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