

YEAR END TAX PLANNING OPPORTUNITIES FOR TRUSTS

Presented by:

WEALTH MANAGEMENT ROUNDTABLE

&

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Simple v. Complex trusts.

- Simple Trusts – defined by statute
 1. Terms of trust must require that all financial accounting income (“FAI”) is required to be distributed currently.
 2. The terms of the trust must not provide for any amounts to be paid, permanently set aside, for the charitable purposes set forth in section 642(c)
 3. The trust must not distribute any amounts during the year other than the income required to be distributed currently.



Complex trusts

- ANY TRUST OTHER THAN A SIMPLE TRUST.

The designation as a simple or complex trust is thus determined by the terms of the trust document itself and how it is administered during the year.



BASICS OF TRUST TAXATION

- ANYTHING NOT TAXED AT THE BENEFICIARY LEVEL AS A CONSEQUENCE OF DISTRIBUTIONS IS TAXED AT THE TRUST LEVEL.

Trust tax rates on ordinary income are extremely onerous. Taxable ordinary income over \$10,050 (2006) is taxed at 35%.



Trust taxation

The simple rule to remember is that income is taxed to the beneficiaries, and not the trust, if distributions are made to the beneficiaries during the trust's taxable year.

In general, income flows through the trust and is of a character identical to its nature in the trust. Thus, dividends flow through as dividends, interest as interest, royalties as royalties, tax exempt as tax exempt, etc.



Planning opportunities

1. Contact the beneficiaries and determine if they are in a tax bracket that would permit tax arbitrage from a distribution. If the trust is going to be taxed at 35% and the beneficiary at 28%, then a 7% savings could be achieved simply by making a trust distribution to the beneficiary, all other things being equal.



Tax planning.

- Caution must be exercised however in determining the amount of taxable income. There are two types of income for trust purposes: financial accounting income ("FAI") and taxable income. Both are computed differently. Financial accounting income is determined by reference to state law (the "Uniform Principal and Income Act") and the trust document itself while taxable income is determined solely by the Internal Revenue Code.



Tax Planning.

The key words for your understanding of these issues are “Distributable Net Income” or DNI. It is equal to the following:

1. Taxable income determined without the DNI deduction and the personal exemption;
2. less net capital gains; and
3. plus net tax exempt income reduced by expenses allocable to tax exempt income, including the charitable deduction.



Tax planning.

- Under most FAI computations capital gains are allocated to principal and not to income. However, this might not always be the case.



Planning example.

- Trust 1 has the following amounts of income and expenses for the year ended December 31, 2006. You have been asked by the sole beneficiary, B, who has a discretionary right to income and principal, whether it makes sense from a tax perspective, for him to receive a distribution from the trust created by his grandmother at her death. As trustee you have no problems making distributions to B as he lives frugally and is a relatively sophisticated investor. The trust has a principal balance on December 1, 2006 of \$1,500,000 and has generated the following income and expenses: dividends - \$30,000; taxable interest - \$20,000; tax exempt interest - \$10,000; long term capital gains - \$10,000 and trustee fees of \$5,000. The trust provides that all capital gains are allocated to principal. B is in the 28% tax bracket.



Tax planning.

What is financial accounting income (FAI)?



Tax Planning.

- What is DNI?



Tax Planning.

- What will the tax be on the DNI?
(Assume all capital gains are taxed at 15% long term capital gains rates.)



The 65 day rule of section 663(b).

- It must be remembered that in a simple trust situation income does not need to be distributed for it to be taxed to the beneficiary because it is deemed under the Internal Revenue Code to be taxed to the beneficiary.
- However, in a complex trust situation the distribution must actually occur for the income to be taxed to the beneficiary and not the trust. Prior to year end the trustee may not know the extent of the income or expenses.



Section 663(b) election.

- Therefore the Internal Revenue Code at section 663(b) provides that, if properly elected on the trust tax return, a trustee may treat distributions made during the first 65 days after the trust's year end as having occurred on the last day of the trust's taxable year.



Thanks for attending!

Please fill out the evaluations.