trusts

wills

business succession

tax planning

asset protection

Death and Taxes… and Trusts

Oklahoma Society of CPAs

Riley Carbone Kern, Attorney

Tallgrass Estate Planning, LLP

TALLGRASS

ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Tax Planning for Trusts

- Learn to recognize potential trust tax problems or opportunities for tax savings
- Know enough to be part of the solution
- Always consult with client’s attorney and financial advisors

TALLGRASS
ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Taxation of Trusts

- Income is going to be taxed.
- Question is: Who pays the taxes?
- Taxes only paid at one level.
  - Trust pays at trust marginal rate
  - Beneficiary pays at individual marginal rate

TALLGRASS
ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Taxation of Trusts

- Note regarding Grantor trusts:
  - During Grantor’s lifetime, all tax liabilities belong to the Grantor
  - Income not taxed at the trust marginal rate or to beneficiaries

TALLGRASS
ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Taxation of Trusts

- After Grantor dies, or if non-Grantor trust, two possibilities:
  - Simple Trust
    - All income paid to beneficiaries at least annually
    - Beneficiary reports income on 1040
    - Pays individual marginal rate
  - Complex Trust
    - Income accumulates in trust, or
    - Trustee has discretion how and when to distribute income
    - Undistributed income may be added to principal

TALLGRASS
ESTATE PLANNING

Taxation of Trusts

- Fiduciary Tax Return:
  - Form 1041
  - Trust needs TIN/EIN
  - All income over $600

trusts

wills

business succession

tax planning

asset protection

Taxation of Trusts

- Trust Marginal Rate:

Tax Rate	Income Thresholds
10%	$0 - $2,550
24%	$2,551 - $9,150
35%	$9,151 - $12,500
37%	Over $12,500

TALLGRASS

ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Taxation of Trusts

- Note:
  - When client has income producing property that does or will become part of a trust, part of your counseling should deal with when and how such income is to be taxed once the client has died.
  - This happens not only when a trust is a member of an LLC or a shareholder in a corporation, but also when the trust becomes an assignee.

TALLGRASS

ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Taxation of Trusts

- Simple Trust Sample Language:
    - *The Trustee shall distribute all the net income of a beneficiary's trust to the beneficiary at least annually.*

TALLGRASS

ESTATE PLANNING

Taxation of Trusts

- Complex Trust Sample Discretionary Language:
  - *The Trustee shall distribute to the beneficiary as much of the income and principal of the beneficiary's trust as the Trustee determines necessary or advisable for the health, education, maintenance, and support of the beneficiary. The Trustee shall add any undistributed net income to principal.*

trusts

wills

business succession

tax planning

asset protection

Taxation of Trusts

- Complex Trust Sample Unitrust Language:
  - *For each taxable year of a beneficiary's trust, the Trustee shall distribute to the beneficiary a Unitrust Amount of X% of the net fair market value of the beneficiary's trust assets, valued as of the first day of the taxable year. The Trustee shall pay the Unitrust Amount for each taxable year from these sources and in this order: from net income; from net realized short-term capital gains; from long-term capital gains; then from principal in equal annual installments at the end of each the last day of that year. The trustee shall add any undistributed net income to principal.*

TALLGRASS
ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Taxation of Trusts

- Sample Principal/Income Language:
  - *The rights among beneficiaries in matters concerning principal and income are to be determined in accordance with the Oklahoma Uniform Principal and Income Act.*
- OR
  - *The Trustee shall determine how all Trustee fees, disbursements, receipts, and wasting assets will be credited, charged, and apportioned between principal and income in a fair, equitable, and practical manner*

TALLGRASS

ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Accounting vs. Taxable Income

- Accounting Income (TAI/FAI)
  - How much is to be distributed to the beneficiary?
  - Calculated with reference to trust agreement and state law
- Taxable Income
  - How much is taxable?
  - Includes capital gains
  - Calculated with reference to IRS only

TALLGRASS
ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Accounting vs. Taxable Income

- Effects of the TCJA
  - Eliminated certain deductions
    - Investment management fees
    - Personal casualty or theft losses
  - But retained others
    - Depreciation and depletion
    - State and local taxes on entity-owned businesses
    - Net operating losses
  - Pass-through deduction under 199(A)

trusts

wills

business succession

tax planning

asset protection

Accounting vs. Taxable Income

- Simple vs. Complex Trust
  - Simple Trust
    - Easy for the trustee
    - Accounting is beneficiary’s responsibility
  - Complex Trust
    - If filing 1041, reporting taxable income, rather than accounting income (TAI), is critical
    - Must avoid penalties, interest, and audit

trusts

wills

business succession

tax planning

asset protection

Tax on Distributions

- Types of Distributions
  - Income
  - Capital Gains
  - Principal

TALLGRASS
ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Tax on Distributions

- Types of Distributions
  - Income
    - Already discussed in previous sections

trusts

wills

business succession

tax planning

asset protection

Tax on Distributions

- Types of Distributions
  - Capital Gains
    - Depends on trust language
    - If trust is silent on the issue, state law is NOT likely to treat capital gains as income
    - Remains undistributed
    - Taxable to the trust

Tax on Distributions

- Types of Distributions
  - Capital Gains
    - Important issue if client wishes beneficiaries to receive capital gains along with income

  - Sample Trust Language:
    - *The Trustee may allocate capital gains to income rather than principal.*

trusts

wills

business succession

tax planning

asset protection

Tax on Distributions

- Types of Distributions
  - Principal
    - Distributions of principal are likely tax-free
      - Assumes taxes have been paid by grantor
    - Income generated FROM principal is taxable either to beneficiary or trust
    - Distributions in excess of income will likely be treated as tax-free distributions of principal

TALLGRASS
ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Accumulation Distributions

- DNI vs. UNI
  - DNI
    - Distributable Net Income
  - UNI
    - Undistributed Net Income
    - Considered accumulated by trust
    - Reportable on 1041

TALLGRASS
ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Accumulation Distributions

- UNI
  - If trustee fails to report UNI, future distributions of principal will not be tax-free
  - Principal is first considered UNI and must be taxed
    - Penalties and interest are likely
  - After all “throwback income” is reported and taxes paid, then tax-free distributions

TALLGRASS

ESTATE PLANNING

Accumulation Distributions

- UNI
  - Penalties and interest on UNI might be avoided by using certain trust-to-trust distributions
    - Involves the use of foreign nongrantor trusts
    - Income converted to principal owned by foreign entity that does not trigger throwback rules
  - This strategy must be handled carefully

trusts

wills

business succession

tax planning

asset protection

Material Participation

- Can deductions for “passive activity loss” reduce or eliminate the net investment income tax (NIIT) for a trust?
  - Depends on whether the trustee “materially participated” in the investment activity producing the income.

trusts

wills

business succession

tax planning

asset protection

Material Participation

- What is NIIT?
  - Net Investment Income Tax
  - Federal tax of 3.8% imposed on investment income from sources such as stocks, bonds, mutual funds, royalties, mineral interests, real estate, etc.
  - For trust, NIIT is lesser of:
    - UNI
    - Excess (if any) of the AGI over the dollar amount at which the highest tax bracket for a trust for the tax year (2019: $12,500)

TALLGRASS

ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Material Participation

NOTE:

The IRS stipulates that several types of trusts are not subject to the NIIT, including grantor trusts, trusts exempt from income taxes, perpetual care trusts, or Electing Alaska Native Settlement Trusts.

TALLGRASS
ESTATE PLANNING

Material Participation

- Avoiding NIIT
  - If individual “materially participates” in the investment activity, typically “passive activity” is recharacterized as a non-passive activity
  - No NIIT

trusts

wills

business succession

tax planning

asset protection

Material Participation

- IRC 469
  - Taxpayer not allowed to avoid NIIT unless they “materially participate” in investment activity
- 26 U.S. Code § 469(h) Material participation defined:
  - (1) In general, a taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is
    - (A) regular,
    - (B) continuous, and
    - (C) substantial.

trusts

wills

business succession

tax planning

asset protection

Material Participation

- How do we know involvement is “regular, continuous, and substantial”?
- IRS has clearly defined regs for individuals.

TALLGRASS
ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Material Participation

1) Does the taxpayer participate in the activity for more than 500 hours during the tax year?
2) Does the participation of the taxpayer constitute substantially all the participation for that activity, including non-owner employees?
3) Does the taxpayer spend more than 100 hours in the activity, which is more than the participation of any other individuals?
4) Does the taxpayer's aggregate participation in other activities exceed 500 hours, where the taxpayer has at least significant participation in each activity?
5) Did the taxpayer materially participate in any 5, not necessarily consecutive, of the previous 10 tax years?
6) If the activity was a personal service activity, was the taxpayer active in the same activity during any of the 3 preceding taxable years?
7) Does the taxpayer participate in the activity in a way that is regular, continuous, and substantial?

Material Participation

- However, IRS has no such clarity for trusts.
- Default IRS position:
  - Trusts cannot meet the requirements of material participation.
  - BUT IF THEY CAN, only the activity of the trustee is considered.
- IRS and courts agree:
  - Activity of the beneficiary is irrelevant.

Material Participation

- Standards:
  - TAM 201317010
  - PLR 201029014
  - *Mattie K. Carter Trust*, 256 F. Supp. 2d 536 (N.D. Tex. 2003)
  - *Frank Aragona Trust*, 142 T.C. No. 9 (2014)

Material Participation

- Standards:
  - TAM 201317010 and PLR 201029014
    - A trust may materially participate in entity's activities if the fiduciary - <u>in their capacity as fiduciary</u> - is involved in entity operations on a "regular, continuous, and substantial" basis.
    - See Factor #7 for individuals

Material Participation

- Standards:
  - *Mattie K. Carter Trust*, 256 F. Supp. 2d 536 (N.D. Tex. 2003)
    - Court held that activities of employees and agents, not just fiduciaries, should be considered when determining whether a trust has met the "material participation" standard.
    - IRS has yet to adopt and apply the standard in *Carter.*

trusts

wills

business succession

tax planning

asset protection

Material Participation

- Standards:
  - *Frank Aragona Trust*, 142 T.C. No. 9 (2014)
    - Court held that a trust materially participates in an investment activity if the activity of the trustee is "regular, continuous, and substantial" *EVEN IF* the trustee is also an employee, officer, or agent of the company.
    - *Aaragona* serves as a sort of bridge between *Carter* and the IRS in TAM 201317010 and PLR 201029014.

TALLGRASS

ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Material Participation

- Standards:
  - *Frank Aragona Trust*, 142 T.C. No. 9 (2014)
    - When individual is both fiduciary of a trust and agent of an entity, difficult to characterize activities as fiduciary and non-fiduciary
    - So long as fiduciary standard met, doesn’t matter that fiduciary is also an employee or agent of the entity

Material Participation

- What about “special trustees”?
  - TAM 200733023
  - Trust did not meet the material participation standard because the special trustees should not be considered "fiduciaries" under the meaning of IRC 469.
  - Investment activities by special trustee may be outside the scope of fiduciary duties and only apply to agency on behalf of the business or investment.
  - Do not allow the trust to meet the "material participation" standard.

Material Participation

- Drafting:
  - Important to give trustee guidelines or recommendations regarding investments, tax issues, and business powers
  - Sample language in following slide.

Material Participation

INVESTMENT CONSIDERATIONS

The Trustee may invest in any type of investment that the Trustee determines is consistent with the investment goals of the trust, whether inside or outside the geographic borders of the United States of America and its possessions or territories, taking into account the overall investment portfolio of the trust. Without limiting the trustee's investment authority in any way, we request that the trustee exercise reasonable care and skill in selecting and retaining trust investments. We also request that the trustee take into account the following factors in choosing investments: the potential return from the investment, both in income and appreciation; the potential income tax consequences of the investment; the investment's potential for volatility; and the role the investment will play in the trust's portfolio. We request that the trustee also consider the possible effects of inflation or deflation, changes in global and US economic conditions, transaction expenses, and the trust's need for liquidity while arranging the trust's investment portfolio. The Trustee may delegate his or her discretion to manage trust investments to any registered investment advisor or corporate fiduciary.

trusts

wills

business succession

tax planning

asset protection

Material Participation

BUSINESS MANAGEMENT POWERS

The trustee has all power and authority necessary to manage and operate any business owned by the trust, whether directly or indirectly. The trustee may participate directly in the conduct of the business, by serving as a general partner of a limited partnership, a member, manager or managing member of a limited liability company, or a shareholder of a corporation, or may employ others to serve in that capacity.

The trustee may participate in the management of the business and delegate management duties and powers to any employee, manager, partner, or associate of the business, without incurring any liability for the delegation. To the extent that the business interest held by the trust is not one that includes management powers (such as a minority stock interest, limited partnership interest, or a membership interest in a limited liability company), the trustee has no obligation to supervise the management of the underlying assets, and no liability for the actions of those who do manage the business.

Material Participation

BUSINESS MANAGEMENT POWERS (continued)

The trustee may enter management trusts and nominee trusts in which the trustee and the trust may serve as the exclusive manager or nominee of property or property interests on behalf of any limited partnership, limited liability company, or corporation.

The trustee, individually, or if the trustee is a corporate fiduciary, then an employee of the trustee, may act as a director, general or limited partner, associate, or officer of the business.

The trustee may participate with any other person or entity in the formation or continuation of a partnership either as a general or limited partner, or in any joint venture. The trustee may exercise all the powers of management necessary and incidental to a membership in the partnership, limited partnership, or joint venture, including making charitable contributions.

trusts

wills

business succession

tax planning

asset protection

Material Participation

BUSINESS MANAGEMENT POWERS (continued)

The trustee may reduce, expand, limit, or otherwise adjust the operation or policy of the business. The trustee may subject the trust's principal and income to the risks of the business for any term or period, as the trustee determines.

The trustee may select and vote for directors, partners, associates, and officers of the business. The trustee may enter into owners' agreements with a business in which the trust has an interest or with the other owners of the business.

The trustee may execute agreements and amendments to agreements as may be necessary to the operation of the business, including stockholder agreements, partnership agreements, buy-sell agreements, and operating agreements for limited liability companies.

The trustee may generally exercise any powers necessary for the continuation, management, sale, or dissolution of the business.

TALLGRASS

ESTATE PLANNING

trusts

wills

business succession

tax planning

asset protection

Material Participation

BUSINESS MANAGEMENT POWERS (continued)

The trustee may participate in the sale, reorganization, merger, consolidation, recapitalization, or liquidation of the business. The trustee may sell or liquidate the business or business interest on terms the trustee deems advisable and in the best interests of the trust and the beneficiaries. The trustee may sell any business interest held by the trust to one or more of the beneficiaries of this trust or to any trust in which a majority of the beneficiaries are beneficiaries of this trust. The trustee may make the sale in exchange for cash, a private annuity, an installment note, or any combination of those.

The trustee may exercise all of the business powers granted in this trust even though the trustee may be personally invested in or otherwise involved with the business.

TALLGRASS
ESTATE PLANNING

trusts

wills

business
succession

tax
planning

asset
protection

Thank you!

TALLGRASS
ESTATE PLANNING