A Fiduciary Income Tax Potpourri

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Agenda

Cornerstones of Fiduciary Taxation

Legislative Updates

Net Investment Income Tax

Material Participation for a Trust

Planning Tips and Trust Termination

Common Pitfalls

Charitable Entities
Grantor vs Non-Grantor

Intentional Grantor Trusts

• The grantor intentionally drafts the trust to run afoul of the grantor trust rules (IRC §671 – 679) resulting in the grantor being treated as the owner of the trust for income tax purposes

• Typical Powers
  – Power to reacquire assets (§675(4)(C))
  – Power to add to the class of beneficiaries (§674(a))
  – Power to lend to the grantor or the grantor’s spouse without adequate security (§675(2))
  – Spouse as discretionary beneficiary (§677)
Summary of Different GST Categories

- GST tax not applicable — No GST tax; no tax reporting
- GST exemption allocated — Documentation necessary (709 or 706) and tax reporting required on Form 706–GS(D-1)
- Subject to GST tax — Form 706–GS(D-1) and/or Form 706–GS(T)
- Potentially subject to GST tax — may become subject to GST upon some occurrence of a future event — Possible Form 706–GS(D-1) and/or Form 706–GS(T)
- Waiting on documents
- GST Exempt — Need annual documentation
State Income Taxation

Nexus Considerations

- Intervivos vs. Testamentary
- Grantor
- Residence of Trustee
- Where the trust is administered
- Resident state of Beneficiary
  - Contingent vs. Non contingent
- Governing Law

New Jersey
- Kassner Case; January 3, 2013

Illinois
- Linn Case; December 18, 2013

Pennsylvania
- McNeil Case; May 24 2013

Delaware
- Residency of grantor or trustee.  Be aware of 3rd Party advisors
- Nonresident beneficiary deduction

New York
- Statutory exception to taxation of resident trust (Sec. 605(b)(3)(D))
Legislative Updates

IRC §67(e) — Costs paid or incurred by estates or non-grantor trusts

• Final regulations apply to taxable years beginning on or after May 9, 2014
• “Commonly” or “Customarily” Incurred
• Bundled Fees
  – Must be allocated using any reasonable method
  – Facts to be considered include, but are not limited to:
    • Percentage of corpus subject to investment advice
    • Comparable fees for similar services charged by third parties
    • Amount of fiduciary’s attention to investment advice vs. other fiduciary decisions

2014 Form 1099 reporting of corporate bonds and amortization of bond premium

• IRC 171(c) Election

New York State “Changes to the Taxation of New York Estates, Gifts and Income of Certain Trusts”
Net Investment Income Tax (3.8% Medicare Surtax)

- Historical Tax Rates
- Basic Statutory Structure
- Inclusions / Exclusions
- Undistributed Net Investment Income
- Capital Gains
- To Distribute or Not Distribute
- Planning and Other Considerations
Top Marginal Tax Rates: 1916–2010

Personal Income, Capital Gains and Corporate Tax Rates

Tax Data Tables: TaxPolicyCenter.org and Citizens for Tax Justice (ctj.org)
# Taxes Increase for Trusts

- Top Marginal Tax Rates—2013 threshold of $11,950, 2014 threshold of $12,150
- Taxed: @39.6% Ordinary Income; @20% Capital Gains/Qualified Dividends
- Plus the 3.8% Net Investment Income Tax or “NIIT”

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top rate on Ordinary Income</td>
<td>35% Threshold $11,650</td>
<td>39.6% Threshold $11,950</td>
<td>13%</td>
</tr>
<tr>
<td>Top rate on Long-Term Capital Gains \ (LTCG) &amp; Qualified Dividends \ (QD)</td>
<td>15% Threshold $11,650</td>
<td>20% Threshold $11,950</td>
<td>33%</td>
</tr>
<tr>
<td>Net Investment Income Tax \ (“NIIT”)</td>
<td>None</td>
<td>3.8% Threshold $11,950</td>
<td>N/A</td>
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<tr>
<td>Top rate on ordinary income plus NIIT</td>
<td>35%</td>
<td>43.4%</td>
<td>24%</td>
</tr>
<tr>
<td>Top rate on LTCG &amp; QD plus NIIT</td>
<td>15%</td>
<td>23.8%</td>
<td>59%</td>
</tr>
</tbody>
</table>
## 2013 Tax Rate Comparison

<table>
<thead>
<tr>
<th></th>
<th>Single Individual</th>
<th>Married Filing Joint</th>
<th>Trusts/Estates</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Top Tax Rate</strong>&lt;br&gt;(includes Medicare Tax)</td>
<td>43.40%</td>
<td>43.40%</td>
<td>43.40%</td>
</tr>
<tr>
<td><strong>Ordinary Investment Income and Short Term Gains</strong></td>
<td>Over $400,000</td>
<td>Over $450,000</td>
<td>Over $11,950</td>
</tr>
<tr>
<td><strong>Qualified Dividends and Long Term Gains</strong>&lt;br&gt;0%</td>
<td>Under $36,250</td>
<td>Under $72,500</td>
<td>Under $2,450</td>
</tr>
<tr>
<td></td>
<td>$36,251–$200,000</td>
<td>$72,501–$250,000</td>
<td>$2,451–$11,950</td>
</tr>
<tr>
<td></td>
<td>20%</td>
<td>15%</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Medicare Tax 3.8%</strong></td>
<td>Over $200,000</td>
<td>Over $250,000</td>
<td>Over $11,950</td>
</tr>
</tbody>
</table>
NIIT – 3.8% Tax—Basic Statutory Structure

NIIT applies to the lesser of:

(1) Undistributed Net Investment Income ("NII") or

(2) The excess of Adjusted Gross Income ("AGI") over the dollar amount at which the top tax bracket applies (i.e., $11,950 for 2013, $12,150 for 2014).
### Net Investment Income (‘‘NII’’)

<table>
<thead>
<tr>
<th>INCLUDES</th>
<th>DOES NOT INCLUDE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>Salary, wages or bonuses</td>
</tr>
<tr>
<td>Dividends</td>
<td>Distributions from IRAs or qualified plans. §1411(c)(5).</td>
</tr>
<tr>
<td>Annuity distributions</td>
<td>Any income subject to self employment tax.</td>
</tr>
<tr>
<td>Rents</td>
<td>Income from active business</td>
</tr>
<tr>
<td>Royalties</td>
<td>Gain on the sale of an active interest in a partnership or S corporation</td>
</tr>
<tr>
<td>Net capital gain derived from the disposition of property (other than property held in a trade or business)</td>
<td>Items otherwise excluded or exempt from income under the income tax law, such as interest from tax-exempt bonds, capital gain excluded under §121 and veteran’s benefits.</td>
</tr>
<tr>
<td>Trade or business income from a passive activity</td>
<td></td>
</tr>
<tr>
<td>Income or gain from the investment of working capital</td>
<td></td>
</tr>
<tr>
<td>Income from trade or business of trading in financial instruments or commodities</td>
<td></td>
</tr>
<tr>
<td>LESS: ‘‘properly allocable’’ expenses. § 1411(c)(1)</td>
<td></td>
</tr>
</tbody>
</table>

Note: A trade or business under § 1411 refers to a trade or business within the meaning of § 162 rather than § 469.
To Distribute or Not Distribute — That is the Question.

Taxes are not the end game, recognize that there are various benefits to Trusts, including wealth transfer, tax planning, protection from spendthrift beneficiaries and creditors (& potential ex-spouses), ease of management, and combined investment opportunities.

Consider the following 5 “Trust” Factors:

1. **Acknowledge** taxes have increased, crunch the numbers.

2. **Understand** why the trust was created. Income taxes are not the only game in town. Critical aspects that favor retaining include estate and GST tax planning and preserving assets in the family line. Does the trust document provide authority for the trustee to distribute?

3. **Recognize** that distributing income may help in some cases, but not all, e.g., the kiddie tax, beneficiaries already at the highest tax brackets, etc. Additionally, since planning may have been done to eliminate state income taxation at the trust level, including the state income tax impact of distributions to the beneficiary must be part of the analysis.

4. **Honor** the fact that a “one size” fits all approach often fails to capture the nuances in many family situations.

5. **Focus** on strategies that could minimize a Trust’s exposure to the “new” taxes.
Capital Gains

• Capital Gains are an item of NII
• Can’t be distributed to beneficiaries without authority in trust instrument or state law
• Ordinarily excluded from DNI
• Regulations provide guidance as to when gains can be included in DNI
• Special rule for Capital Gains from pass-through entities (see CRISP case in handout)
Include Capital Gains in DNI — 3 Options

Treasury Regulation section 1.643(a)-3(b)(1)-(3) — capital gains are included in DNI if any one of the following are true:

(1) the trustee allocates gains to income;

(2) the default allocation to principal applies, but gains consistently are treated by the fiduciary on the trust’s books, records, and tax returns as part of a distribution to a beneficiary; or

(3) the default rules apply, but gains are actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.
Observations

• Allocations of expenses between Section 1411 Income and Non 1411 Income
• State Taxes paid in 2013
• Beneficiary’s 14H adjustment is limited to items of regular income tax on K-1
• Income from passive and non passive activities
  – Tax Software coding
Planning and Other Considerations

• 65 Day Election
• Tax Exempt Bonds
• Passive Income / Material Participation
• Harvest Year End Capital Losses
• Tax Efficient Mutual Funds / ETF’s
• In-kind Distributions Under 643 (e)
• CLT’s
• CRT’s
How Can a Trust Materially Participate?

• Regulations are silent regarding trusts materially participating: Section 469

• Prior Rulings

• Frank Aragona Trust v. Commissioner; March 27, 2014
  – Fiduciary’s involvement in the operations of the activity on a Regular, Continuous and Substantial basis.
  – “Regular” Tax Court Opinion
  – Possibility of IRS Guidance Project
Planning Tips

• Utilizing the 642(c) charitable deduction
• Not taking a deduction
• Distribution of low basis securities
• Qualified Severance
  – Purpose, Timing and Notification
  – Form 706-GS(T)
Trust Termination

• Lost Deductions
• Passive Activity Losses
• Carryovers
• State Tax; Trust vs. Individual
• 1041-T
• GST Tax Consequences
Common Pitfalls

Grantor vs Non-Grantor treatment
• Proper analysis

State Returns
• Nexus issues

Allocation of Expenses
• Direct vs. Indirect

NOL’s
• Carryback vs. Carryforward
• New lines on Form 1041

Partnership and LLC interests
• Cash receipts vs. Tax items
• NAI and DNI
• Passive vs. Non-passive
Charitable Trusts

Private Foundations
• Foreign Currency
• Offshore Hedge funds/ Form 926
• Election to treat qualifying distributions as made out of corpus
• Net capital loss — harvest capital gains/ buy back securities / step-up basis
• Distribute low basis securities to charity
• Initial year

Type III – Supporting Organizations
• Final Regulations Issued December 2012

CRT’s
• NIIT only applies to post 1/1/13 accumulated NII
• Rate change for cumulative buckets
• Simplified Net Investment Income Calculation Election (SNIIC Election)

CLT’s
• Utilize full annual 642(c) charitable deduction (harvest capital gains/ buy back securities / step-up basis)
Biographies

Jeff Winter, Principal

Mr. Winter joined Bessemer Trust in 1985 and is the Director of Fiduciary Tax Services within the Client Tax Services Department, overseeing the review and preparation of fiduciary income tax returns, as well as planning and compliance for Private Foundations, Charitable Lead Trusts and Charitable Remainder Trusts. He is also involved with the preparation of individual tax returns.

Prior to joining Bessemer Trust, Mr. Winter was employed by Citibank, N.A. and The Bank of New York, where he handled trust and charitable taxation matters in their Fiduciary Tax Departments.

Mr. Winter received a B.B.A. degree in Accounting from Hofstra University. He is a past member of the Executive Committee of the Committee of Banking Institutions on Taxation.

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