Trusts

Types of Trusts and How Trusts are Taxed

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Why most should have trust

Incapacity planning - among others

- *Finance Commission v. Norwood* - Held that financial power of attorney must have been signed in office of attorney, lender, or title company if used with respect to certain transactions involving principal's homestead; effect is that many custodians of assets refuse to honor an agent's authority, even if the document is represented to have been signed in location and even if the transaction doesn't involve homestead

- Later enacted statute aimed at making power of attorney acceptance more likely has not had the intended effect; many still refuse to accept them; exception: title companies — likely because without the transaction closing, they aren't paid the title policy premium

Revocable v Irrevocation

Trust formation

- IRS - One holds title to assets, with obligation to use for benefit of another
- Trusts are formed under state law; must include settlor’s intention to create
- Trust fails if legal title, beneficial title, and remainder held by one person; exception: if spendthrift, court required to appoint a trustee
- Most “internet” trusts are revocable; “irrevocable” trusts can be drafted for, e.g., exclusion of assets for estate tax, asset protection
- Trusts can be drafted so that grantor or beneficiary(ies) are owners for income tax purposes, similar to an LLC

Simple v complex trusts

Trusts as taxpayers - nongrantor; not taxpayers, grantor trusts

- Simple trusts - all income required to be distributed yearly; all income required to be distributed; cannot distribute principal; charitable distributions prohibited
- Complex trusts can: (i) accumulate income, (ii) distribute principal; (iii) distribute to charitable beneficiaries
- Trusts as taxpayers reach highest income tax bracket at $16,000
- Almost never draft trust as taxpayer; exception for person residing in a high income tax jurisdiction, higher than the 37 percent rate in the US

Complex Trust

Distributions of types of assets

- Distributions from complex trusts first attributed to ordinary income; then dividends, followed by capital gains, then principal
- Distributions must be allocated “equitably” among beneficiaries; exception if the trust contains provisions with specific ownership among beneficiaries; income not distributed — taxed to trust
- 1041 required if income $600 or more; beneficiaries issued K-1s
- Creditors of simple trust should be able to attach income at time it is required to be distributed

Intervivos v Testamentary

One exists during lifetime; other may never exist

- Intervivos: created by declaration of property owner that property is held for benefit of another person
- Testamentary: created in a will — however, the will has no effect unless and until it is admitted to probate
- Four-year statute of limitations on probating will
- Limitations exception: application filed before four years; muniment of title if application is not at fault for tardiness; probate of foreign will; OR probate necessary to receive or recover property due decedent’s estate or protect public regarding estate property being a danger

Any assets - trust needed

Incapacity planning; probate avoidance

- Financial powers of attorney often are not honored by custodians of property
- Should principal become incapacitated, power of attorney not accepted, guardianship may be necessary
- Exception: court with jurisdiction may consider power of attorney validity and enter order that it is valid and be accepted
- Provisions causing issues with powers of attorney not applicable to trusts

Income tax reporting

Grantor trusts

- Avoid trusts as taxpayers, unless high tax in other jurisdiction applicable
- Clifford regulations - 16 USC §§ 671 to 679
- Grantor is “substantial owner” for income tax if grantor retains certain rights
- Beneficiaries, one or more, can be owners for income tax purposes if grantor does not retain rights, and beneficiaries have those rights
- Trust should be funded correctly; sell capital assets to the trust; no capital gain, because beneficiary is selling to himself; loan liquid assets

Toggling Owner

Changing who is to report income tax

- With beneficiary grantor trusts, owner for income tax purposes can change each calendar year, but not within a calendar year
- Owner for income tax purposes (beneficiary) can disclaim that right, thereafter having no rights with respect to the trust
- Include in trust that a third party can appoint differing persons with rights causing ownership for income tax purposes, from calendar year to calendar year
- Also consider allowing trustee to be named for sole purpose of accepting / conveying title

Grantor’s death

Tax consequences

- Grantor as owner for income tax — grantor’s death causes trust to no longer be grantor trust
- Death deemed transfer of all assets to beneficiaries; may cause recognition of gain with capital assets
- If grantor had general power of appointment, capital assets get step up in basis on grantor’s death; use formula limited power of appointment

Reporting

1041; 1099s

- Grantor trust files 1041, with information report on numbers
- Owner(s) for income tax report on their 1040(s)
- Alternative is no 1041, with trustee only issuing 1099s
- Issue if those outside trust issue 1099s with trust name; won’t match
- Filing 1041 causes statute of limitations to begin; only issuing 1099s doesn’t start limitations; with 1041, entries on 1040 can’t be disallowed without first auditing the 1041

Asset valuation; tax consequences

Gift, estate, and generation skipping transfer taxes

- Gift tax annual exclusion - $19,000 per year, per beneficiary
- Present interest - right to withdraw - “5 or 5” powers
- Gift exceeding annual exclusion require 709; reduces remaining applicable exclusion amount
- Estate tax return (706) required if gross estate exceeds $15 million
- Portability