# MCF Private Trust

## GET F.I.T.! FUNDAMENTALS OF FIDUCIARY INCOME TAX

Fiduciary Income Taxation is a logistical necessity in the world of estates and trusts and yet not clearly understood by many beyond the tax professions. We will shed light on a few key issues and create awareness of several more issues to promote a keen understanding of the role each team member plays in planning, administration, investment, drafting, and tax preparation, related to Fiduciary Income Taxation.

The Taxation of an estate or trust is much like that of us as individuals: taxable income, deductions, net income, and the calculation of taxes due. Yet, there are a few items that make Fiduciary Income Taxation quite different that need to be understood to 1) not make errors causing greater tax, 2) facilitate planning to minimize tax effects, and 3) to understand the impact of distributions on taxation and its effect on investment decisions.

You cannot properly invest for an estate or trust if you do not understand the principles of Fiduciary Income Taxation and, in fact, may do harm. This is because estates and trust do not have one tax payer like we do as individuals they have one of two potential taxpayers, and knowing which will be the taxpayer a year in advance may be important to achieve optimal investment choice.

Begin by understanding that "Grantor Trusts," including all Revocable Trusts, are flow through entities and do not have this dual-potential taxpayer issue. Those can lead to strategies of their own, but let's begin with Estates and Irrevocable Trusts which are taxpayers like you and I, yet have the unique quality of either having their income either taxed to the estate or trust as an entity, or taxed to the beneficiary(ies) based upon distributions. This can be important because who the eventual taxpayer is may make the difference between buying municipal bonds or corporate bonds for the best after tax return. The tax rates of individuals and trusts are the same, yet trusts reach the top tax bracket on significantly less income, thus usually having a much higher tax rate on the same amount of income as an individual. Therefore the language of the trust is crucial with regard to the treatment of income: is it automatically all distributed, or is distribution discretionary? And if it is discretionary, what is the likelihood of making distributions in the coming year, and of how much? This is where effective and ongoing communication between the Executor or Trustee and the Investment Advisor with the beneficiaries becomes important for income tax planning in such accounts. When the trust or estate is the taxpayer, the Investment Advisor may be better off investing in lower tax rate strategies as well like qualified dividends and long-term capital gains.

It is also important to understand that trust beneficiaries will generally need to file an extension for their individual income tax returns. This is due to the fact that two parallel income tax return reporting periods are overlapping each other. The trust files on a calendar year-end basis the same as an individual, therefore the trust's tax return is due on April 15, and since part of that tax return, the K-1, is needed to file the beneficiary's tax return, the timing is problematic.

Some distributions do not carry out income tax consequences to the beneficiary, notably specific bequests. A specific bequest is a bequest of specific property, such as a car, or a specific amount of money, such as $100,000. In this case the intent of the decedent is assumed to be to get the beneficiary that item or amount of money unreduced by the random amount of income taxation generated that year. Specific bequests can also be drafted as formulas and are harder to distinguish which is another reason to have professionals assist in the settlement of the estate. Imagine a beneficiary having to sell the beloved item they just inherited in order to meet the tax obligation. That doesn't make sense does it? Of course not.

There are a number of post mortem decisions that need to be made in order generate the most positive tax result. Among these are the 65-day rule involving which year to tax the income, decisions about dealing with Income in Respect of a Decedent, or IRD, which is income earned before death but received after death, and construction issues like the Multiple Trust Rule and Separate Share Rule which involve single or multiple entity reporting and records. The trustee must be aware of all these implications in order to make the appropriate elections to optimize tax efficiency for all involved. Even the tax reporting period elected for an estate can create advantages of "trapping" or deferring the taxation of income for up to a year. Again, using an executor who has the understanding to elect an appropriate tax year can enhance the tax effectiveness of the arrangement.

Finally, Grantor Trusts which break all the rules of "normal" trust taxation and thus are sometimes known as "defective" trusts. These can be created for very simple reasons or to facilitate very complex strategies.

On the simple side, all Revocable Living Trusts are Grantor Trusts. And thus the income tax consequences simply flow out to the individual who retained the power to revoke the trust. This makes Revocable Trusts look and act similar to a regular brokerage account, and is one of the reasons some investment managers don't recognize that a change in tax status occurs at the death of the grantor. But Grantor Trusts can be used in several other ways as well, sometimes drafting the trust to purposefully tax the income to either the beneficiary rather than at the higher income tax brackets of the trust, or to shift the taxation back to the grantor even when they are not a beneficiary of the trust, in order to enhance the effectiveness of certain gifting techniques. By doing this the grantor can further reduce their estate by paying the taxes of the children without that being treated as an additional gift, and as a result, the children's interest in the trust grow undiminished by taxation. In highly advanced applications this can even permit tax free sales of assets to the children's trust. All of this is perfectly legal, it just requires a detailed understanding of how income taxation of estates and trusts works.

Taxation is a fact of life and we won't avoid it, but that doesn't mean that we have to succumb to it either. Working with a knowledgeable team of advisor partners who can help guide your clients and their families through the complexities of the tax law is important to helping them getting the most from their plan.