

The taxation of trusts in the United States

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1. Introduction

This chapter attempts to provide an overview of US income taxation primarily of ordinary trusts – that is, trusts subject to Subchapter J of the Internal Revenue Code (Sections 641 to 644; 651 and 652; and 661 to 663), characterised as non-grantor trusts, and grantor trusts (Sections 671 to 679). These trusts are generally created by a person for the benefit of themselves or another. They require:

- a trust instrument;
- a grantor or creator;
- at least one trustee or fiduciary;
- at least one beneficiary; and
- a transfer of property.

Who is taxable and how that is determined is quite complicated. It is helpful to keep the following in mind. A grantor trust is not taxed as a trust. The owner – generally the grantor – is taxed directly as if the trust did not exist. A non-grantor trust is taxed much like an individual, but is allowed a deduction for amounts distributed to beneficiaries as the beneficiaries are taxable on distributions.

This chapter assumes that the reader has a background in US income taxation of individuals and therefore it does not cover that area; nor does it attempt to cover business trusts, real-estate investment trusts, pension and profit-sharing trusts or other similar arrangements that are outside the scope of Subchapter J.

There is no definition of a ‘trust’ in the Internal Revenue Code. There are definitions of certain types of trust in the regulations. The regulations and an abundance of court cases rely on state law, both as to what constitutes a trust and what elements are included or excluded from ‘fiduciary income’, which is the starting point for the calculation of ‘distributable net income’, a key concept that is discussed further on.

A trust is an arrangement by which legal ownership or title to property is held by the trustee or fiduciary for the benefit of another who may or may not yet exist. That benefit can be either an income interest, an interest in principal or both, as well as either a present or future interest. A person can be any or all of the following: a grantor; a trustee; and a beneficiary, which is generally not advisable except, perhaps, for grantor trusts, as it is possible that all of these interests will be merged. If this occurs, the individual will be deemed the owner not just for tax purposes but because the trust will be treated as non-existent for all purposes. The powers and duties of the trustee and the

rights of the beneficiary are controlled by state law. However, state law generally provides a framework within which the governing instrument's provisions can be quite general or very specific, depending on the grantor's express wishes and instructions. There are other arrangements, such as principal and agent, which may also involve holding property for another, but such arrangements are not considered trusts.

A trust can be created either at the time of death by will (a testamentary trust), or during life (an *inter vivos* trust). If, during life, there will be a deed of trust or trust indenture; at death, the operative provisions must be contained in the grantor's validly executed will. However, there can be *inter vivos* trusts where certain provisions become effective only at or upon the death of the grantor. There is virtually no difference between the income taxation of non-grantor *inter vivos* trusts and testamentary trusts.

An understanding of the taxation of trusts and their beneficiaries requires an understanding of basic fiduciary accounting principles, as income tax consequences follow the economics and these fiduciary principles determine the economic allocation.

2. **Fiduciary accounting principles**

A beneficiary can be an income beneficiary, or a principal beneficiary, or both, but each category is a distinct category and the rights of each are quite different, which is why any item received by a trust is allocated to either income or principal. 'Fiduciary income' includes ordinary cash, dividends from stocks, annual interest from bonds and other similar receipts. It does not include capital gains, stock dividends or splits, or the proceeds of sale arising from the sale of assets, as these are generally allocated to principal. Expenses are allocated to income or principal, as appropriate, or in the case of certain fees or charges pro-rated and allocated to both. Income may also include, where there is underproductive property, an allocation (generally 4% to 5%) from principal pursuant to state statute. What is includable or chargeable to either income or principal is a function of the governing instrument and state law – in most cases, the Uniform Principal and Income Act or similar statute, which is quite specific. Income is accounted for on an annual or more frequent basis, even if not required to be distributed. It may be helpful to visualise principal as the farm and income as the annual harvest. Generally speaking, although there are many exceptions, the right to receive income is a current expectation and the right to receive principal is limited or deferred to a later time. For example, a clause that provides for income to the grantor's children during their lifetime, and that upon their death the principal is to go to the grantor's grandchildren, provides for the children currently and the grandchildren some time in the future. Although the law is evolving in this area, most trusts have a limited duration, but state law may vary widely from state to state.

3. **Other necessary definitions**

There are certain concepts that must be understood in order to explain the income taxation of trusts:

- 'Income' (without a modifier) generally refers to fiduciary accounting income as defined by state law.

- 'Corpus' is another term for principal.
- 'Taxable income' is the income subject to tax, as defined by the Internal Revenue Code, which generally differs from fiduciary accounting income.
- 'Distributable net income' is discussed in section 5 below but is generally defined by the Internal Revenue Code as taxable income modified generally by excluding capital gains or other losses, but including tax-exempt income. There are other adjustments as well discussed below.
- 'Grantor trust' is a trust where the grantor is treated as the owner of all or a portion of the trust for tax purposes and that portion of the trust so treated is not subject to the general rules of Subchapter J.
- 'Non-grantor trust' is any other trust.
- 'Simple trust' is a trust pursuant to Subchapter J required to distribute all of its income currently and that does not distribute principal during the taxable year.
- 'Complex trust' is any other trust.
- 'Tier-one distribution' is a common way to describe mandatory distribution of income required to be made currently.
- 'Tier-two distribution' is any other amount distributed during the taxable year.
- 'Sprinkle' is a term used to describe the trustee's right to allocate and distribute income among a class of beneficiaries.
- 'Spray' is a term used to describe the trustee's right to allocate and distribute principal among a class of beneficiaries.

4. Basic tax rules

A trust is a taxable entity whose taxable income is determined as if the trust were an individual, with certain modifications. The most important modification is the deduction for distributions to beneficiaries (distributable net income). This deduction is the essential principle by which double taxation (ie taxing the same income more than once) is avoided. To the extent that taxable income is deemed distributed, it is taxable to the beneficiary not the trust; if not distributed, it is taxable to the trust not the beneficiary. The concept of distributable net income and many of the complexities and complications that arise in the taxation of trusts begin with the computation of the distribution deduction. Distributable net income is important to determine not only who bears the tax burden, but also the rate at which the income is taxed. As of 2010, the maximum federal rate of 35% for a single individual applies to taxable income above \$373,650. For trusts, the graduated rates are compressed so that the 35% bracket applies to taxable income above \$11,200. Unless new legislation is passed in 2010, the 2011 rates, while not finalised, are estimated to be 39.6% for individuals on income above \$380,000 and for trusts on income above \$11,500.

In general, any current taxable income distributed to a beneficiary retains its character and is added to his other taxable income. A trust is taxable only upon taxable income retained or allocated to principal. Trusts are required to file annual income tax returns and are calendar-year taxpayers. A trust's taxable income is first computed without regard to the distribution deduction in a manner similar to an

individual. For a simple trust, the computation of the distribution deduction would then be made. The deduction is limited to the lesser of the actual income distribution or distributable net income. This generally results in a simple trust being taxed only on capital gains and for the actual income distribution to exceed distributable net income. This is due to either deductible expenses being allocated to principal and not reducing fiduciary income but reducing taxable income, or tax-exempt income being included in fiduciary income but not taxable income. Since a simple trust is defined as a trust that does not distribute principal or provide for amounts to be paid or set aside for charitable purposes, no charitable deduction is available either to the trust or to a beneficiary.

A complex trust's taxable income is also computed in a similar manner. Like a simple trust, there are proscribed modifications, again the most important of which is the distribution deduction, which becomes a two-level computation rather than a single-level one. A beneficiary of a complex trust includes in income, just as he would for a simple trust, the amount of distributable net income attributable to income required to be currently distributed to him (a tier-one distribution). In addition, he or any other beneficiary must include the distributable net income attributable to all other amounts, whether from income or principal, distributed to him for the taxable year (a tier-two distribution). That simple appearing statement regarding two tiers has driven many tax practitioners to tears (forgive the pun). It is possible for the same beneficiary to be an income beneficiary and also be entitled to receive distributions of principal. It is also possible that another class of beneficiaries would also be entitled to receive income and yet a third class of beneficiaries would be entitled to receive only principal distributions. That is why distributable net income is allocated by tier and then pro-rated among each class of beneficiary to prevent the mismatch of tax liability and economic benefit.

A complex trust, like an individual, is permitted a charitable deduction; however, this deduction is not subject to a percentage limitation as is an individual. Distributions in excess of taxable income are not taxable to the beneficiary, except in the possible, but unlikely, event that the beneficiary is subject to the 'throwback' rule, discussed later in this chapter.

To the extent income is not deemed distributed, the trust is taxable and the character of the income is allocated between the trust and the beneficiary as required by the governing instrument or state law – that is, for example, dividends to the income beneficiary and capital gains to the trust. Similarly, the governing instrument or income tax regulations provide the methodology for allocating a charitable deduction either to the trust or to a beneficiary, or both, and among the various classes of income, such as taxable and non-taxable interest.

When principal is distributed, a capital gain realised during the taxable year will be included in distributable net income and deemed to be distributed as a tier-two distribution, and will retain its character in the hands of a beneficiary receiving a tier-two distribution.

As previously noted, a beneficiary can be either a tier-one or tier-two beneficiary, or both. It is clear that the timing of distributions of principal (tier-two) can alter the tax consequences. Consider such a distribution occurring either in a year with

realised taxable income where the beneficiary bears the tax burden or in a subsequent year where there is no realised taxable income, which causes the trust to bear the income tax obligation. The income having been taxable in the prior year, but with no distribution, the trust was taxable. This is both a planning opportunity and a shift of economic benefit, which can create issues of fairness for the trustee. In the absence of specific instruction in the governing instrument, a trustee cannot favour one beneficiary or class of beneficiary over another.

5. Distributable net income

Distributable net income determines not only the amount of taxable income, but also its character. Each type of income is deemed to be distributed *pro rata* to the class of beneficiaries who receive a distribution, adjusted as appropriate between tier-one and tier-two beneficiaries. Distributable net income is defined as taxable income modified for capital gains or losses, tax-exempt interest and extraordinary dividends which in good faith are allocated to principal. While capital gains are generally allocated to principal, it has been held that:

- short-term gains from mutual fund distributions are to be included in distributable net income, even if allocated to principal and not distributed (tier one); and
- capital gains allocated to income by the governing instrument or state law attributable to unproductive or underproductive property are to be included in distributable net income (tier one).

Again, there are both substantial overlaps and outright inconsistencies between the concept of fiduciary income applicable to a trust, taxable income of a trust and distributable net income.

6. 'Throwback' rule

For most domestic trusts, this rule was repealed in 1997. However, the rule still applies to pre-1984 trusts treated as multiple trusts; and, more importantly, to a foreign trust or a domestic trust that was formerly a foreign trust. The 'throwback rule' treats any distribution in excess of current distributable net income as a distribution of undistributed net income: essentially, accumulated but undistributed distributable net income from all prior years of the trust's existence.

For a domestic trust, the distribution is divided by the number of years for which the distribution is deemed applicable. This average is added to each of the beneficiary's last three out of five taxable years, eliminating the highest and the lowest. The average increase in tax liability for the three years, multiplied by the number of years deemed applicable, adjusted by taxes paid by the trust, is the tax due on the distribution. If the distribution is from a foreign trust, the tax is determined somewhat differently, as explained further on, and also, unlike a domestic trust, the tax is to be computed with interest. The interest calculation is compounded utilising a formula that often causes the interest due to exceed the tax liability itself. There is, however, a limitation which prevents the total amount due, comprising tax and interest, from exceeding the amount distributed.