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Estate Planning Strategies for Minimizing the Net Investment Income Tax on Trusts and Estates

Reducing NIIT Through Distribution of Investment Income, Investment Allocation, Use of Grantor Trusts

WEDNESDAY, JULY 22, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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NIIT/Knacks:

Net Investment Income Tax Planning

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Mr. Parthemer is Senior Fiduciary Counsel and Head of Estate Planning for the Southeast Region at Bessemer Trust. He joined Bessemer, an exclusive wealth management firm, in 2004 after private law practice in Pennsylvania and Florida, most recently as a Trust and Estate partner with Duane Morris LLP. He also spent several years at PricewaterhouseCoopers and was involved in private businesses.

Mr. Parthemer is a frequent national lecturer and published author; Co-Chair, ABA Non-Tax Issues of Trusts & Estates; member Florida Bankers Association, Trust Executive Committee and Chair of its Trust Legislation Committee; ABA Liaison to, and Chair of, Synergy Summit; and member, Florida and Pennsylvania Bar Associations. He also writes a regular column for the Journal of Financial Service Professionals magazine and is a member of its editorial staff. He is on the Board of the Palm Beach County Estate Planning Council and Chairs its publication committee.

He has been faculty for the University of Miami's Heckerling Institute, Adjunct Professor, Widener University School of Law, and a guest lecturer at the University of Miami School of Law's LLM program. He frequently has been honored as one of the Best Lawyers in America, is a member of its Lifetime Achievement Award, and a Florida Super Lawyer.

Mr. Parthemer received his J.D. from The Dickinson School of Law, Penn State University, and his B.A. and B.S. degrees from Franklin and Marshall College.

Sasha A. Klein, Esq. LL.M.

Senior Vice President and Director of Trusts & Wealth Services

Sasha A. Klein, J.D., LL.M., is a Senior Vice President and Director of Trusts and Wealth Services for Sabadell Bank & Trust. Ms. Klein is responsible for providing wealth and advisory services for high net worth individuals and families. She oversees Sabadell's estate planning and fiduciary services group for Southeast Florida. Ms. Klein is a national lecturer and frequent published author on taxation, estate planning, trust law and wealth management

"Sasha has extensive experience in handling sophisticated fiduciary services for clients and helping them navigate through multi-generational wealth transfer. She brings both industry depth and leadership to support our growth strategy in the Palm Beach County market", said Palm Beach County Regional President, Debra Vasilopoulos.

Prior to joining Sabadell Bank & Trust, Ms. Klein served as Fiduciary Counsel to Bessemer Trust Company of Florida, where she directed the fiduciary risk management group and chaired the Special Investments and Discretionary Distributions Committee. Prior to Bessemer, Ms. Klein practiced law focusing on sophisticated estate, gift and generation skipping transfer tax issues, fiduciary income tax issues and estate/trust planning and administration.

She is a member of both the District of Columbia and Florida Bars, and serves in numerous leadership positions with those organizations as well as the American Bar Association (Vice Chair, Individual and Fiduciary Income Tax) and Florida Bankers Association (Trust Executive Committee and Trust Legislation Committee). She also serves as the President of the Palm Beach Tax Institute.

Ms. Klein earned a B.S. in Business Administration *Summa Cum Laude* from the University of Florida, Warrington College of Business, a Juris Doctorate and Law and Business Certificate from Vanderbilt University Law School, and a Masters in Laws, LL.M., in Taxation from the University of Florida Frederick G. Levin College of Law.

I. NIIT Basics

Net Investment Income ("NII")

NII Includes	NII Does Not Include
Interest (unless tax exempt)	Salary & Wages
Capital Gains	Bonuses
Dividends	Self Employment Income
Rents (passive)	Active Business Income/Gain from Sale
Royalties	Unemployment Income
Annuity Distributions (non-qualified)	Income exempt under the code, including tax exempt bonds, capital gains excluded under IRC 121, and veteran benefits. Charitable Trusts
Passive Business Activities	Qualified Retirement Income (including IRAs)

Section 1411, Net Investment Income Tax – 3.8% Tax

NIIT applies to the lesser of:

(1) undistributed net investment income (“NII”), and

(2) the excess of Adjusted Gross Income (“AGI”) over the dollar amount at which the top tax bracket applies (*i.e.*, $12,300 for 2015 for trusts; $250,000 for joint filers - unindexed).

Computation of the NIIT

Individuals

3.8% X
the lesser of

1. Net Investment Income

and

2. The excess (if any) of:
   - Modified Adjusted Gross Income (MAGI)
   - less the Threshold Amount

Estates and Trusts

3.8% X
the lesser of

1. Undistributed Net Investment Income

and

2. The excess (if any) of:
   - Adjusted Gross Income (AGI)
   - less the Threshold Amount

II. NIIT and Trusts

ATRA Impact on Trust Taxes

- Top Marginal Tax Rates:
  - 39.6% Ordinary Income.
  - 20% Capital Gains/Qualified Dividends.
  - 3.8% Net Investment Income Tax or “NIIT”.
- 2015 Threshold of $12,300.

	2012	2013-Current	Increase
Top Rate on Ordinary Income	35%	39.6%	13%
Top Rate on Long Term Capital Gains (LTCG) and Qualified Dividends (QD)	15%	20%	33%
Net Investment Income Tax	None	3.8%	N/A
Top rate on ordinary income plus NIIT	35%	43.4%	24%
Top rate on LTCG & QD plus NIIT	15%	23.8%	59%

2015 Trust Example – Impact of NIIT

$260,000 of undistributed net investment income

- $160,000 ordinary ($100,000 passive, $60,000 active)
- $100,000 LTCG

AGI is $247,500 and NII is $200,000 (excludes the active business income)

NIIT = $7,600 (3.8% * $200,000, the lesser of AGI & NII)

Increasing Tax Liability…

Trust has $260,000 of undistributed net income ($160,000 of ordinary [$100,000 passive; $60,000 active] & $100,000 LTCG)*

2012 Tax = $71,000

2013 Tax = $90,960
($83,360 income tax; $7,600 NIIT)

Total Tax Increase: $19,960

<u>28.1% Increase</u>

*For illustration purposes, all income is assumed taxable at the top marginal rate & personal exemptions/deductions are ignored.

Trusts Are Not Dead

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.

(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.*

(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.

Material Participation ("MP") & Trusts

§469

§1.469-5(T)(g) reserved for Regulations applying MP to Trusts.

Currently no guidance in Regulations.

Look to 7 tests in §1.469-5(T)(a) for MP - okay if Trustee meets 1 of the 7.

But the 7 Tests apply to Individuals not Trusts or Trustees.

Apply §469(h)(1) – "regular, continuous & substantial" standard to Trusts/Trustees.

MP requires Trust show regular, continuous and substantial involvement in operations to rise to the requirements of §469(h).

BUT, there is NO statute or regulation directly addressing HOW a Trust materially participates.

Trust Material Participation: Whose Actions Matter?

Senate Report No. 99-313 (1986)
Treat a Trust as MP "*if fiduciary, in his capacity as such, is so participating*."

TAM 201317010
Determine MP through the actions of the fiduciaries in their capacity ONLY as fiduciaries. Under this extreme view almost no trust could MP.

TAM 200733023
Merely labeling a person involved in the business as a "special trustee" will not work. Main factor is whether special trustee can exercise powers without the approval of another trustee. If lacking, unknown whether majority of trustees would be required.

IRS

Taxpayers

Mattie K. Carter Trust
256 F. Supp.2d 536 (N.D. Tex. 2003)
- Trusts do not operate businesses directly.
- Consider entire relationship between trust & business.
- All of the actions of the fiduciary & its employees and agents count toward MP.

Frank Aragona Trust
142 T.C. No. 9 (3/27/2014)
-Trusts can qualify for the real estate professional exception in §469(c)(7), which includes MP requirement.
- 3 of 6 co-trustees as employees of the business count in determining MP, suggests that majority of trustees involved in the business not required.
- Tax Court Decision

Treas. Reg. 20.2032A-3(f) & *PLR 201029014*
"Multiple Hats": fiduciary's actions in any capacity (even as employee) count toward MP.

III. NIIT Planning

NIIT – and Income Tax Strategies in General

(1) Minimize Passive Income via Investment Allocation (Municipal Bonds, Annuities, PPLI, deferred income accounts).

(2) Defer via Installment Sales, 1031 Exchanges and Charitable Remainder Trusts.

(3) Convert Passive to Active: Material Participation (TAM 201317010; April 26, 2013).

(4) Shift Capital Gains to Trust Beneficiaries.

NIIT Strategies Include

A. Shifting Strategies

1. 743 Regs – tax capital gains to trust beneficiaries or Grantors (NINGs and DINGs?).

2. In-kind Distributions – could trigger built-in gains, but then carried out as “actually distributed?”

3. Flow Through Entity – To tax to beneficiary, sell inside entity; to tax to trust, distribute to trust and then sell.

B. Minimization Strategies

1. Reduce Passive Income via Investment Allocation (Municipal Bonds, Annuities, PPLI, deferred income accounts, convert to non-passive via material participation TAM 201317010).

2. Charitable Contribution Sourcing – 170 vs. 642(c).

3. Defer - Installment Sales, 1031 Exchanges, Charitable Remainder Trusts – and return of the NIMCRUT!

Capital Gains Strategy

<u>General Rule:</u> Except for the final year of a non-grantor trust or estate, capital gains are excluded from DNI and thus taxed at the trust level.

<u>Three Methods to Shift Capital Gains to the Beneficiary</u>

1. Treat Capital Gains as part of the DNI deduction.
2. Use a unitrust.
3. Trigger §678(a) by having someone other than the Grantor hold a power to appoint trust property, or the income from it, to him or herself.

Capital Gains Strategy

Which method is best?

1. Treating Capital Gains as part of the DNI deduction may be optimal as gains passed through on a K-1; trust enjoys a corresponding deduction.
2. Use a unitrust.
3. IRC §678(a).

The second and third methods have various disadvantages, such as less creditor protection or increased estate tax. Unitrust – potential for over or under distribution & Section 678 – may cause a partial grantor trust.

Include Capital Gains in DNI – 3 Ways

Treasury Regulation section 1.643(a)-3(b)(1)-(3) – capital gains “not excluded” from DNI if (1) authorized under state law/ trust agreement **and** (2) allocated:

1. The trustee allocates gains to income *(Income Exception)*.
2. The default allocation to principal applies, but gains consistently treated on the trust’s books, records, and tax returns as part of a distribution to a beneficiary *(Deeming Rule Exception)*.
3. The default rules apply, but gains actually distributed to the beneficiary or utilized in determining the amount that is distributed or required to be distributed *(Utilization Exception)*.

Digging Down Deeper Into the 3 Options

Income Exception. Treasury Regulation section 1.643(a)-3(b)(1) empowers the Trustee with broad discretion. Can get complicated because it may alter the allocation rules between principal and income, but provides the most flexibility.

Digging Down Deeper Into the 3 Options

Deeming Rule Exception. Treasury Regulation section 1.643(a)-3(b)(2) applies if the Trustee consistently treats capital gains as part of the beneficiary's distribution. Easy for new Trusts; may have barriers for existing Trusts.

Digging Down Deeper Into the 3 Options

Utilization Exception. Treasury Regulation section 1.643(a)-3(b)(3) is triggered if the trust <u>actually distributes</u> capital gains. Has various disadvantages, including asset protection and inflexibility.

<u>Planning Pointer:</u> Whether any of these approaches are available and relevant to existing trusts, drafting attorneys should review "boilerplate" provisions that govern how capital gains are to be characterized and what, if any, discretion the Trustee has or should have over making the determination.

Example - Impact of a Beneficiary Distribution - 2013

Fully discretionary trust beneficiary with annual income of $0. The Trust has ordinary (and accounting) income of $40,000 ($30,000 passive; $10,000 active) and LTCG of $60,000.*

Scenario 1: No distributions & LTCG allocated to principal.

- Total Tax: $29,278 (all paid by the Trust)

Scenario 2: Distribution of accounting income to beneficiary; LTCG allocated to principal.

- Total Tax: $19,755 (Trust pays $13,825.90 & Beneficiary pays $5,929)
  - $9,528 or 33% less tax than scenario #1

Scenario 3: Entire $100,000 is distributed to the beneficiary; LTCG included in DNI.

- Total Tax: $14,929 (all paid by the beneficiary)
  - $14,349 or 49% less tax than scenario #1

*For illustration purposes, all income is assumed to be taxable income & or each of comparison, personal exemptions and deductions are ignored.

Shift to Optimize Tax Rate

2014 Tax Rates			Single		Married Filing Jointly		Complex Trust	
Ordinary Income	*Long Term Capital Gains and Qualified Dividends*	*Net Investment Income Tax*	NIIT (MAGI)	*Taxable Income to*	NIIT (MAGI)	*Taxable Income to*	NIIT (AGI)	*Taxable Income to*
10%	0%	0%		$9,075		$18,150		n/a
15%	0%	0%		$36,900		$73,800		$2,500
25%	15%	0%		$89,350		$148,850		$5,800
28%	15%	0%		$186,350		$226,850		$8,900
33%	15%	3.8%	**$200,000***	$405,100	**$250,000***	$405,100	**$12,150***	$12,150
35%	15%	3.8%		$406,750		$457,600		n/a
39.6%	20%	3.8%		--		--		--

*Threshold amounts for individuals are NOT inflation protected; threshold amount for trusts IS inflation protected.

Strategies to Manage Net Investment Income Tax:
The Trustee's Hobson's Choice

SHIFTING	MINIMIZATION/DEFERRAL	CONVERT
Capital Gains Allocated to Income *"The Income Exception"* Treas. Reg. §1.643(a)-3(b)(1)	Investment Allocation	Convert Passive Income to Active – Material Participation
Capital Gains Consistently Treated as Part of Distribution (from inception, no fresh start election) *"The Deeming Rule"* Treas. Reg. §1.643(a)-3(b)(2)	Charitable Deduction Planning	
Capital Gains Actually Distributed/Utilized in Determining Distribution (decided annually, no consistency requirement) *"The Utilization Exception"* Treas. Reg. §1.643(a)-3(b)(3)	Charitable Remainder Trusts (& NIMCRUTS)	
Flow Through Entities – entity distributions of accounting income that include capital gains *See Crisp v. US*	Installment Sales	
In Kind Distribution	PPLI (private placement life insurance)	
Unitrust	1031 Exchanges / 1035 Exchanges	
§678(a) partial grantor trust (non-Grantor holds power to appoint trust property or income to him or herself)	Annuities	
Planning Pointer - Power to withdraw income will not shift capital gains		

9 Shifting Strategies and an Example

In 2013, a Trust with $140,000 capital gains, $90,000 interest income and $90,000 dividends (total $320,000) distributes $60,000 to two beneficiaries (total $120,000) with no other income.

Scenario I – No distribution.

Scenario II – DNI does not include capital gains – Default Rule.

Scenario III – DNI is "topped off" with capital gains – Income Exception.

Scenario IV – DNI includes capital gains pro rata – Deeming Exception.

Scenario V – All taxable income, including capital gains, is distributed – Utilization Exception.

Scenario VI – In Kind satisfaction of a mandatory income or unitrust distribution – Utilization Exception (typically triggers gain to beneficiary).

Scenario VII – In Kind satisfaction of a discretionary principal distribution – Utilization Exception (gain unrecognized until beneficiary realizes).

Scenario VIII – DNI includes capital gains realized in subsidiary flow-through entity – Income Exception.

Scenario IX – DNI does not include capital gains if in kind distribution from a flow-through entity – Default Rule.

9 Shifting Strategies – The Impact

Tax Item	I. No Distribution	II. DNI w/o CG "Default Rule"	III. DNI w/ CG "Income Exception"	IV. DNI w/ CG "Deeming Exception"[1]	V. DNI – w/CG "Utilization Exception"	VI. In Kind – Mandatory Income	VII. In Kind – Discretionary Principal	VIII. Use of an Entity DNI w/CG	IX. Use of An Entity DNI w/o CG
Trust income tax	$79,879	$20,588	$29,588	$49,264	$0	*Same as Solution V*	$0	*Same as Solution III*	*Same as Solution II*
Trust NII tax	$11,706	$4,866	$7,146	$7,146	$0		$0		
Trust total tax	$91,585	$25,453	$36,733	$56,410	$0		$0		
Beneficiaries' income tax	$0	$22,733	$13,733	$5,500	$43,733		$0[2]		
Total tax – trust and Beneficiaries	$91,585	$48,186	$50,466	$61,190	$43,733		$0[2]		
Effective rate	28.62%	15.06%	15.77%	19.35%	13.67%		0%[2]		

[1] See chart on next slide for analysis of tax rate cross-over.
[2] Until asset is sold

Deeming Rule Conundrum – Correlation between Beneficiary AGI & Tax Benefit. *Caution: Swapping Can Result in HIGHER Total Taxes!*

Exception 2 of the Regulations deems capital gains to be included in DNI, suggesting capital gains are included proportionately with other accounting income items. Use of entity also can result in pro-rata inclusion. Trustees must compare total net impact to the trust and beneficiary as swapping out gains may “leave behind” ordinary income items.

Tax Rate Reduction from a Distribution			
Beneficiary AGI	Difference in Ord. Inc. Rates	Difference in Cap. Gains Rates	Benefit/(Cost) to swap
$ -	0.00%	0.00%	0.00%
$ 10,000	-33.40%	-23.80%	9.60%
$ 18,925	-28.40%	-23.80%	4.60%
$ 46,250	-18.40%	-8.80%	9.60%
$ 97,850	-15.40%	-8.80%	6.60%
$ 193,250	-10.40%	-8.80%	1.60%
$ 200,000	-5.57%	-5.00%	0.57%
$ 372,500	-6.60%	-5.00%	1.60%
$ 408,350	-3.60%	-5.00%	-1.40%
$ 410,000	0.00%	0.00%	0.00%

Minimization Strategy: Charitable Deduction Planning

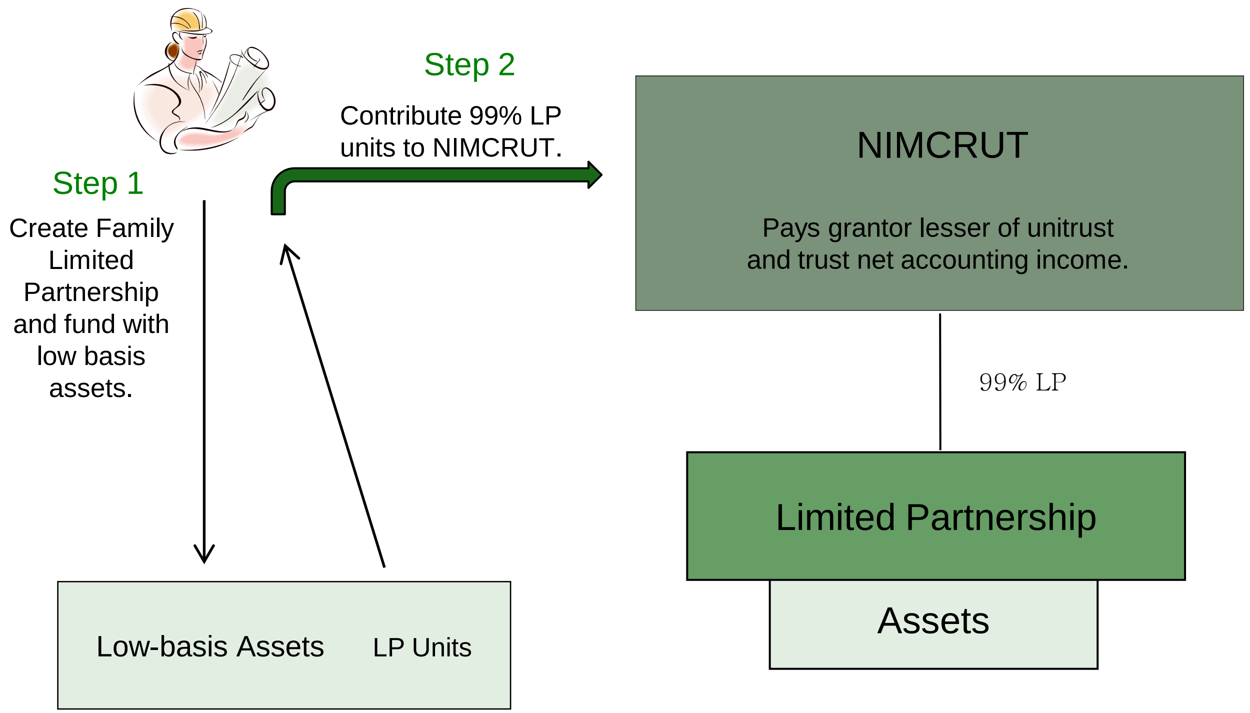
- Trust charitable deductions (§642(c)) reduce AGI because they are "above-the-line" and thus reduce NII dollar-for-dollar.
- Individual charitable deductions (§170) do not reduce MAGI because they are "below-the-line" and thus do not reduce NII at all.

Married Individual IRC §170 Deduction		Trust - IRC §642(c) Deduction	
Wage Income	$ 260,000		
Interest Income	$ 100,000	Interest Income	$ 100,000
Dividend Income	$ 50,000	Dividend Income	$ 50,000
MAGI	$ 410,000	AGI	$ 150,000
Less: Threshold Exemption	($ 250,000)	Less: Charitable Deduction	$ 150,000
Subtotal	$ 160,000	AGI	$ 0
Lesser of (1) excess of MAGI over Threshold and (2) NII	**$ 150,000**	NII Tax at 3.8%	$ 0
NII Tax at 3.8%	$ 5,700		

Elimination/Deferral Strategy: Charitable Remainder Trust

Charitable Remainder Trust	Not subject to NIIT or 5% incremental capital gains tax.	Character of income controlled by tier rules of 664(c).	NIMCRUT (see next slide).
Impact	Harbors "NII" in a tax exempt environment.	Reduces/Defers NIIT & the 5% incremental capital gains tax.	May keep MAGI below the threshold amount by leveling income over a longer period of time.
Stronger Strategy if	Use highly appreciated assets.		
Benefit	Family benefits from the sale proceeds for a longer time by deferring the payment of capital gains tax/NIIT.	Remainder interest benefits from investing gross proceeds longer.	
Charitable Deduction	Donor receives immediate deduction equal to present value of remainder interest (at least 10% of the assets contributed).		

Going One More Step: FLP in a NIMCRUT?



<u>Planning Pointer</u>
Structure to eliminate self-dealing, including separate GP and trustee.

By reinvesting earnings within the partnership, the NIMCRUT would have no “income” to distribute. For tax purposes, 99% of the income is reported by the NIMCRUT a tax exempt entity…creating a deferral until the partnership makes a distribution.

Warning: this strategy has been on the IRS “no ruling” list for over 10 years.

“There’s nothing wrong with the younger generation that becoming taxpayers won’t cure.”

- Dan Bennett

“Why does a slight tax increase cost you two hundred dollars and a substantial tax cut save you thirty cents?” **- Peg Bracken**