TAX ON TRUSTS

DRAFTING TIPS THAT MINIMIZE THE INCOME TAX ON TRUSTS—PART 1

With trusts often subject to higher tax rates than their beneficiaries, carefully drafted trust distribution provisions can produce significant tax savings.

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The American Taxpayer Relief Act of 2012, in conjunction with the Health Care and Education Reconciliation Act of 2010, which each became effective on 1/1/2013, continue the unfortunate trend of penalizing clients and their families who establish trusts for legitimate estate planning purposes. Additional tax proposals currently being considered by Congress may exacerbate the situation.

Beginning 1/1/2013, trusts with taxable income in excess of approximately $12,000 (to be precise, $11,950 in 2013) pay an additional aggregate 8.8% tax on capital gains and qualified dividends. This same tax liability is not imposed on most individuals until their taxable incomes exceed $400,000 ($450,000 for married filing jointly), including $200,000 ($250,000 for married filing jointly) of net investment income. The tax rate increase for other forms of taxable income works out to a combined 8.4%. The components of these tax increases are the following:

- The 4.6% increase (from 35% to 39.6%) on to the trust’s general marginal income tax bracket on taxable income over just $12,000.
- A 3.8% tax on undistributed net investment income, including net capital gains, in excess of $12,000.
- An additional 5% tax on net capital gains and qualified dividends where trust taxable income exceeds $12,000.

All of this is in addition to the large disparity in the income tax treatment of trusts versus individuals which had already existed since 1986. In many states, the combined maximum federal and state marginal income tax rate on trusts with as little as $12,000 of income now approaches a whopping 50%. In contrast, individuals need to have taxable incomes in excess of $400,000 (or $450,000, if married) and net investment income exceeding $200,000 ($250,000 for married filing jointly) to approach this same rate.

Thus, estate planners should prepare trust documents in a manner that will minimize this disparity in income tax treatment between an individual and a trust established for legitimate estate planning reasons—and do so without destroying the original purpose of the trust by making larger than necessary distributions of trust income and principal to the beneficiary. This two-part article explores five principal drafting areas to achieve a less punitive “minimum income tax” (MIT) approach for trust instruments:

1 Minimize the effects of the general disparity in income tax brackets between trusts and individuals.

2 Minimize the effects of the 3.8% tax increase on net investment income and the 5% surtax on capital gains and qualified dividends.

3 Permit distributions in excess of the 5% limitation of Section 2514(e)(2).

4 Minimize income taxes and maximize deferral for IRAs, qualified retirement plan benefits, and nonqualified annuities payable to trusts.

5 Maximize the income tax basis step-up at a beneficiary’s death during the trust term.

This first installment of the article describes the first two of these areas; the remaining three will be covered in the second installment in a future issue of Estate Planning.

Planning area #1

The first planning area is to minimize the effects of the general disparity in income tax brackets between trusts and individuals.

Beginning in 2013, the typical complex trust pays federal income taxes after only $100 of income, and pays income taxes at the maximum federal income tax rate of 39.6% when its income exceeds as little as approximately $12,000 (except for tax-favored income such as qualified dividends). In contrast, most married individuals filing jointly pay no federal income taxes on the first $12,000 (or more, when the federal income tax exemptions and deductions are factored in) of their income, and do not pay federal income taxes at the maximum 39.6% rate until their taxable income...
comes exceed $450,000 (or $400,000 for single individuals).

A first grader could recognize the unfairness of this system, especially a first grader for whom a trust was established when parents died a premature death. These young children are effectively taxed like individuals making salaries of well over $400,000, even though the incomes of their trusts may be a small fraction of this amount.

The historical rationale for this inequitable system is that some estate planning attorneys had established multiple trusts for the children of their high net worth clients, in an attempt to achieve multiple runs up the trust income tax brackets. At the time, those trust income tax brackets were structured similar to the tax brackets for single individual taxpayers. Congress closed this loophole in 1986 by drastically compressing the tax brackets of estates¹ and trusts,² even though just two years earlier Congress had already enacted another solution to the problem—the much fairer “multiple trust rule.”³

**Distribution drawbacks.** Of course, the trustee could simply distribute all of the “distributable net income” of the trust to the beneficiary (assuming the trust document clearly authorizes this) as a quick and easy solution to the disparity between trust and individual income tax brackets. This solution to the income tax disparity problem, however, usually has the undesirable subsidiary effect of destroying most if not all of the principal (non-income tax) reasons the trust was established by the grantor in the first place.⁴ These reasons include, but are not limited to:

1 Minimizing estate taxes.
2 Protecting trust income and principal from potential creditors of the beneficiary.
3 Minimizing the rights of an ex-spouse in the event the trust beneficiary divorces.
4 Providing protection for young or spendthrift beneficiaries and special needs beneficiaries.
5 Providing protection for the grantor’s children when a grantor in a second marriage establishes a trust for his or her surviving spouse.

The estate planner’s challenge, therefore, is to minimize the effects of the huge disparity in federal income tax brackets for trusts versus individuals, without destroying all of the non-income tax reasons the grantor chose to establish the trust in the first instance. The discussion below assumes that no portion of the trust income is taxed to the grantor under Sections 673 through 677 (i.e., a trust established either upon the grantor’s death or during the grantor’s lifetime but that is not subject to Sections 673 through 677). Most of the comments also assume that the trust is not required to distribute all income currently, as would be the case for a qualified terminable interest property (QTIP) trust or a qualified Subchapter S trust (QSST).

A partial solution to the problem might be available if the trustee of a complex trust could somehow distribute the “high tax rate items” (such as ordinary interest, nonqualified dividends, rental income, and IRA and qualified retirement plan distributions) to the beneficiary, while retaining the “low or no tax rate items” (such as qualified dividends and tax-exempt interest). This would not be a perfect solution to the problem (i.e., because the high tax rate items would continue to compound in the beneficiary’s individual name), but it would at least allow for the low or no tax rate items to be retained in the trust.

Unfortunately, the limited solution outlined in the immediately preceding paragraph is not available under the Code. As most estate planners know, subpart C of Subchapter J (i.e., Sections 661 to 664) does not permit income distributions to be “traced” in the above-outlined fashion, notwithstanding the trustee’s declaration that he or she is retaining the low and no tax rate items, and distributing only the high tax rate items.⁵ An additional prob-

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1 Estates suffer from the same severely compressed federal income tax brackets as trusts.  
2 See Section 1(e).  
3 See Section 643(f). The multiple trust rule in Section 643(f) provides that if trusts have “substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries,” then the trusts will be treated as one trust if “a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.” Section 643(f) also authorizes the IRS to promulgate regulations regarding multiple trusts, but regulations have yet to be issued under this section.  
4 One of the reasons Congress may have chosen to compress estate and trust income tax brackets, just two years after enacting the multiple trust rule, is because the multiple trust rule applies for only tax years beginning after 3/1/1984, with respect to trusts created after that date, as well as to irrevocable trusts created on or before 3/1/1984, but only to that portion attributable to contributions to principal after 3/1/1984. Tax Reform Act of 1986, P.L. 99-514, section 1806(b). Congress may have thus felt the need to address trusts that were created and funded before 3/2/1984.  
5 See Goldberger and Anzivino, “Game Change,” 152 Tr. & Est. 53 (May 2013). A close examination of Section 661(b) leads to the conclusion that it is arguably inconsistent with Section 662(b). Whereas the former section, which deals with the character of the trust’s distribution deduction, together with the regulations thereunder, suggest that a trust instrument could direct that only taxable items are to be distributed to the beneficiary (which in turn will affect the distribution deduction limitation contained in Section 661(c)), while tax-exempt items are to be retained by the trust, a similar conclusion cannot be reached from a reading of Section 662(b) and the regulations thereunder, which deal with the character of the beneficiary’s income from the trust.
The problem is that the trustee’s distribution power would need to be crafted carefully in order to avoid any potential adverse estate and gift tax consequences, because the distribution power would obviously not be limited by an ascertainable standard.

Unless the trustee is prepared to invest the entire trust corpus in federally tax-exempt securities, the grantor trust rules under subpart E of Subchapter J (i.e., Sections 671 to 679), and in particular as applied to a “sole power to vest” under Section 678, may actually present the best solution to minimizing the effects of the severely compressed trust income tax brackets while preserving the principal estate planning goals of the trust.6

Section 678 sole power to vest. The beneficiary would be given a Section 678 sole power to withdraw all of the accounting income of the trust (as modified in the manner described below for payments under IRAs and qualified retirement plans) that exceeds the dollar amount at which the highest tax bracket in Section 1(e) begins for the tax year (e.g., $12,000), and which is not taxed at a maximum tax rate less than the normal maximum income tax bracket for trusts (e.g., qualified dividends and tax-exempt municipal bond interest). This, in essence, gives the beneficiary a Section 678 sole power to withdraw a pecuniary amount of trust accounting income (e.g., certain items of income in excess of $12,000 plus deductible trust expenses) generated by specific trust assets (e.g., trust assets other than stocks and municipal bonds).

For reasons outlined in Planning area #2, below, in addition to non-taxable trust accounting income and income taxed at a special maximum income tax rate under the Code, the last type of trust accounting income that should be withdrawable in excess of the $12,000 level should be trust accounting income not subject to the tax under Section 1411 (e.g., payments to the trust from IRAs and qualified retirement plans).

Grantor trust portion rules. Section 671 offers very little guidance relative to the portion of trust accounting income and income allocable to corpus that is taxed to the “grantor or another person” under subpart E of Subchapter J (Sections 671 through 678), other than to make clear that the grantor or other person may be treated as the owner of “any portion” of a trust:

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. [Emphasis added.]

In sharp contrast to the Code, the regulations include extensive “portion” illustrations and rules applicable under various hypothetical circumstances.7 As potentially applicable to a Section 678 sole power to vest trust “corpus or the income therefrom” in an individual, these examples and principles include the following:

1 A power to withdraw accumulated income allocable to corpus alone causes the power holder to be taxable on the accumulated income allocable to corpus, but does not cause the power holder to be taxed on the trust accounting income generated by the corpus (e.g., interest and dividends) that is not required to be accumulated.8

2 A power to withdraw trust accounting income (e.g., interest and dividends) alone causes the power holder to be taxed on the trust accounting income, but does not cause the power holder to be taxed on other items of taxable income allocable to the corpus of the trust (e.g., capital gains) that generates the trust accounting income.9

3 A power to withdraw a dollar amount of trust accounting income results in the power holder being taxed on a portion of those items of income and expense entering into the computation of trust accounting income sufficient to produce trust accounting income of the dollar amount required.10 The power holder is then attributed to have a pro rata portion of other items entering into the computation of distributable net income under subparts A though D, such as expenses allocable to corpus and a pro rata portion of any credits of the trust.11

4 If the portion treated as owned by the power holder consists of specific trust property and its income, all items directly related to

8 Reg. 1.671-3(b)(2).
9 Reg. 1.671-3(b)(1).
10 Reg. 1.671-3(c).
11 Regs. 1.671-3(c) and 1.677(a)-1(g), Example 2.
that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (Sections 641 and following) of Subchapter J. There should then be attributed to the power holder a pro rata portion of other expenses entering into the computation of distributable net income under subparts A though D.\footnote{Reg. 1.677(a)-1(g), Example 2 includes an example of this computation.}

2 Similarly, a power to withdraw a dollar amount of income allocable to corpus from a specific trust asset (e.g., a dollar amount of capital gains from the sale of the specific trust asset) should result in the income holder being taxed on that income allocable to corpus from the specific trust asset, but no other trust income. There should then be attributed to the power holder a pro rata portion (i.e., based on the dollar amount of income allocable to corpus from the specific assets versus the total income allocable to corpus from the specific asset) of expenses directly attributable to the dollar amount of income allocable to corpus, if any. Expenses that relate both to the portion treated as owned by the power holder and to the balance of the trust should be apportioned in a manner that is reasonable in the light of all the circumstances of the case, including the terms of the trust document, local law, and the practice of the trustee if it is reasonable and consistent.\footnote{Reg. 1.678(a)(1)(a).}

Although the Regulations include no specific examples addressing the situation where an individual possesses severable powers to withdraw either (1) a dollar amount of trust accounting income generated by specific trust property, or (2) a dollar amount of income allocable to corpus from specific trust property, the applicable rules can readily be deduced from a combination of the above examples and illustrations that do exist, as well as from Congress’ use of the phrase “any portion” in both Sections 671 and 678.

1 For example, a power to withdraw a dollar amount of taxable interest should result in the power holder being taxed on only the income generated by the taxable bonds of the trust that will permit a distribution to the power holder of said dollar amount of taxable interest income. Items directly related to trust property not included in the portion treated as owned by the power holder (including the portion of the taxable bond interest that is not withdrawable by the power holder) are governed by the provisions of subparts A through D (Sections 641 and following) of Subchapter J. There should then be attributed to the power holder a pro rata portion of other expenses entering into the computation of distributable net income under subparts A though D.\footnote{Reg. 1.677(a)-1(g), Example 2 includes an example of this computation.}

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Application of the grantor trust portion rules to minimize income taxes. Applying the above-outlined statutory and regulatory concepts, it is therefore apparent that a beneficiary of a trust may possess a Section 678 sole power to withdraw a dollar amount of income from specific trust assets. If our goal as estate planners is to minimize the disparity in income tax brackets and rates between trusts and individuals, but without seriously damaging the primary non-income tax reasons for establishing the trust in the first instance by making unnecessary distributions of income and principal to the trust beneficiary, we need to take advantage of this potential in trust drafting.

Exhibit 1 contains a sample clause from an estate and generation-skipping transfer tax-exempt trust that is intended to cause most of the trust’s income to be taxed at a rate that is no higher than the tax rate of the beneficiary. Notice in particular the ordering of the withdrawable trust income, which is intended to “push out” first to the beneficiary the most highly taxed forms of trust income, which currently include interest on taxable bonds, nonqualified dividends, and receipts from rental properties, royalties, and the taxable portion of nonqualified annuities (the latter of which is subject to the 3.8% tax on net investment income discussed below), followed by distributions from IRAs and qualified retirement plans (which are each subject to ordinary income tax rates but are not subject to the Section 1411 income tax on net investment income discussed below).

Drafting comments. When analyzing the sample drafting language in Exhibit 1, consider the following points:

1 A legal representative of a beneficiary under a legal incapacity is granted the power to withdraw on that beneficiary’s behalf.

2 A trustee not having a beneficial interest in the trust\footnote{If the holder of the power of withdrawal possesses the power to suspend the same, he or she would likely continue to be taxed on the trust income. See Reg. 1.678(a)(1)(a).} is granted the power, prior to each calendar year of the trust, to suspend any Section 678 power of withdrawal.
For the succeeding calendar year. This ability could also be important for a variety of "beneficiary" issues, including protecting a younger, spendthrift, or otherwise troubled child. Prior to including such a "suspension power" in the trust document, however, the planner should be sure not to create any transfer tax issues for the trustee or other person who will possess the power.  

3 Trust accounting income is deemed to include all receipts from retirement assets because, as discussed below, states adopting the Uniform Principal and Income Act (and the laws of other states) treat only 10% of those receipts as trust accounting income, yet the intent is for the beneficiary to have the sole power to withdraw all of the same.

4 Retirement assets not yet paid to the trust are included within the scope of the trustee’s 5% computation because elsewhere in the trust instrument the trustee is given the power to use the same in satisfying the beneficiary’s withdrawal power, thereby expanding the available 5% portion of the trust under Section 2514(e)(2).

5 The client may choose not to use this form where there is a second marriage, one or more spendthrift children, or one or more children who are in high net worth situations and will not benefit from a withdrawal power over income from a trust that is not exempt from the generation-skipping transfer tax.

6 The portion of the trust income that is not subject to the beneficiary’s withdrawal rights under subsection 1.1 of the form is taxed pursuant to subparts A through D of subchapter J.

7 The language in Exhibit 1, although seemingly complicated to administer at first blush, actually is no more complicated to administer than a client’s brokerage account that contains two “subaccounts” (i.e., an IRA and a separate account for taxable investments).

Special considerations for IRAs and qualified retirement plan benefits payable to trusts. IRA and qualified retirement plan benefits payable to a trust are not always considered trust accounting income under a particular state’s default rules. In fact, the general default provision under the Uniform Principal and Income Act (UPIA) is that only 10% of required distributions are allocable to trust income; the balance of the required distributions and all other payments are allocable to principal. Although the Uniform Principal and Income Act allows the trustee to make a different allocation than this, if authorized in the trust document, care should be taken in drafting these types of clauses in order to avoid potential adverse estate, gift, and generation-skipping transfer (GST) tax consequences. In most instances these transfer tax concerns are minimized by the inclusion of the Section 2514(e) 5% limitation on the withdrawal power holder.

There really are no “definition of income” concerns for a Section 678 power as there are for distributions pursuant to Sections 661 and 662 because, as discussed above, a Section 678 withdrawal power holder may possess a withdrawal power over (and therefore be taxed) on either the ordinary income portion of the trust or the corpus portion of the trust. Thus, it really does not matter what label is put on the IRA or qualified retirement plan distribution in the case of a Section 678 sole

as an owner of the trust even though he has partially released or otherwise modified the power so that he can no longer vest the corpus or income in himself, if he has retained such control of the trust as would, if retained by a grantor, subject the grantor to treatment as the owner under section 671 to 677, inclusive.

15 If the withdrawal power holder designated an independent co-trustee who in turn is authorized to exercise the restriction power, the IRS may attempt to argue that the withdrawal power holder has, in effect, made a gift of the entire present value of his or her withdrawal right, calculated over the shorter of the beneficiary’s or trustee’s life expectancy, at least if the co-trustee actually exercises the restriction power. The withdrawal power holder’s counter arguments include: (1) there is zero assurance he or she would even be the trustee for the rest of his or her life (e.g., he or she could become incapacitated the next day, at which time the successor trustee could suspend the withdrawal power); (2) he or she has no control over the actions of the co-trustee, including the co-trustee’s decisions regarding trust investments, so at best there would be only an annual gift protected by Section 2514(e), because the co-trustee could restore the trustee’s withdrawal right each year; (3) assuming he or she is found to have control over the co-trustee’s actions, how can there also be a gift of any more than a one year’s 5% withdrawal right (i.e., more than an annual release protected by Section 2514(e)), because the withdrawal power holder would presumably then retain the ability to persuade the co-trustee to restore his or her withdrawal right each year; and (4) how would the gift be valued if there is no way of knowing what the withdrawable income will be each year (i.e., would the withdrawal power holder’s annual withdrawal rights over his or her lifetime equal 1%, 5%, or somewhere in between?).
power of withdrawal.\textsuperscript{20} Nevertheless, it is important to identify clearly the items of gross income that are withdrawable by the beneficiary.

The trust instrument may expressly overrule the UPIA general provisions, or the trustee may be given the discretion to overrule the general provision to the extent that the terms of the trust "clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries."\textsuperscript{21} The trust instrument should, therefore, either clearly provide the beneficiary with a withdrawal power over all taxable IRA and qualified plan receipts, or authorize the trustee to allocate the same items to trust accounting income, grant the beneficiary a withdrawal power over the same, and clearly manifest an intention that the trustee shall or may favor the beneficiary or beneficiaries possessing the withdrawal power. The above form treats all receipts under IRAs and qualified plan receipts as "trust accounting income" for purpose of determining the scope of the beneficiary's withdrawal power.

\textbf{Avoiding taxable transfer of property upon annual lapse of power of withdrawal.} A "release" of a power of withdrawal over trust property is treated as a transfer of the property subject to the power of withdrawal for federal estate, gift, and GST tax purposes.\textsuperscript{22} As all estate planner are aware, however, pursuant to Section 2514(e), an annual lapse of a power of withdrawal over trust property is treated as a release of a power under Sections 2514 and 2041 only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of (1) $5,000 or (2) 5% "of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied."\textsuperscript{23}

The income tax portion rules of subpart E of Subchapter J are couched in terms of rights over "income" and "principal" of the trust, whereas the estate and gift tax rules of Sections 2514 and 2041 use the terms "property," "assets," and "proceeds." The relevance is that a withdrawal power over the accounting income of a trust has associated estate and gift tax consequences if the power is not carefully phrased and limited.

The drafting language in Exhibit 1 is designed to include the appropriate Section 2514(e) limitations in order to avoid any taxable transfer on the annual lapse of the beneficiary’s power of withdrawal over a portion of the trust accounting income. The reason the beneficiary is not granted a power of withdrawal over tax-exempt items of income and items of income taxed at lower maximum tax rates (e.g., qualified dividends), as well as other taxable income filling out the lower tax brackets of the trust, is to ensure a higher likelihood that the higher tax rate income items that are withdrawable by the beneficiary do not exceed the 5% limitation.

The restriction on the beneficiary’s withdrawal power discussed in the preceding paragraph is also intended as a balancing between the benefit of potential estate tax savings at the beneficiary’s death, on the one hand (i.e., by having the beneficiary pay the income taxes attributable to the transfer tax-exempt trust), and the disadvantage of increased exposure to lawsuits, etc., on the other. If the estate planner is not concerned about the latter issues, and is concerned with only saving estate taxes at the beneficiary’s death, the withdrawal power can be broadened to include all taxable trust accounting income falling within the overall 5% limitation, but with the beneficiary’s withdrawal power being over the highest tax rate forms of income, first.

The drafting language in Exhibit 1 should be combined with the following additional trust clause in order to broaden the Section 2514(e) "5% piece of pie" to the greatest extent possible, thereby allowing the maximum desired level and items of trust income to be taxed to the beneficiary at his or her tax brackets and rates, without any offsetting negative estate or gift tax consequences:

\textbf{Make Distributions in Cash or in Kind.} To make distributions of income and principal in cash or in kind, or partly in cash and partly in kind, without any requirement to make pro rata distributions of specific assets and without any requirement to allocate equitably the basis of property for income tax purposes; \textbf{PROVIDED, HOWEVER,} that satisfactions of any right of withdrawal in any beneficiary hereunder must be made in cash, although the trustee may liquidate any asset of the trust (including but not limited to by withdrawing retirement assets (as defined below, but ignoring the last proviso of the definition) and other assets that are payable to the trust over time and not yet paid to the trust) in order to generate said cash. In order to make any division of trust assets to be distributed to two or more persons, the trustee may determine the fair market

\textsuperscript{20} Note that Reg. 1.671-2(b) makes reference to the definition of income under Reg. 1.643(b)-1. \textsuperscript{21} UPIA section 103(b). \textsuperscript{22} Sections 2514(b) and 2041(a)(2). \textsuperscript{23} Section 2514(e).
value of those assets to be distributed in kind on the approximate date of distribution and may allot the same as between the various distributees, and the values placed on such assets and the particular assets selected by the trustees for distribution to any particular distributee shall be binding upon all persons having an interest in this trust estate.

Special considerations for trusts required to distribute all income currently. As is apparent, at least from an estate planning standpoint, trust instruments generally should not be drafted to require all trust income to be distributed to the beneficiary currently, because the beneficiary then has more assets exposed to estate taxes, creditors, and the rights of an ex-spouse than he or she would have had otherwise. Nevertheless, in certain situations a trust needs to be drafted so that all of the trust income is required to be distributed currently. A QTIP trust and a QSST are probably the two most notable examples of this.

At first blush, no benefit would appear to be derived from using the Section 678 sole power of withdrawal approach in conjunction with a trust that is required by its terms to distribute all income currently to the beneficiary anyway. The actual benefits can be substantial, however, especially if IRA or qualified retirement plan benefits are payable to the trust over time.

In the case of a QTIP trust, for example, concerns stem from the fact that the UPIA treats only 10% of receipts from the IRA or qualified retirement plan as trust accounting income. The default rule under Section 651 is, therefore, that 90% of the IRA and qualified retirement plan benefits paid to the trust are taxed to the trust, at the compressed trust income tax brackets and high rates.

The trust instrument can provide that any such excess IRA and qualified retirement plan benefits paid to the beneficiary even though the excess benefits are not trust accounting income, or the trust instrument can authorize an independent trustee to make such distributions. In either case, the distributions will be deductible to the trust under Section 661. The problem is that this "excess" distribution is unnecessary.

As already discussed above, the primary advantage of the Section 678 withdrawal approach is that it does not require that the beneficiary actually withdraw the trust income, in order for it to be taxed at the beneficiary's tax rate. Distributing the trust income to the beneficiary in order to achieve the lower tax rate obviously carries the greater potential for loss in the event of a creditor attack against the beneficiary, a greater potential for adverse consequences in the event of divorce, etc. This "overfunding" problem is further compounded by the fact that items of tax-exempt income may also need to be distributed in order to achieve the goal of having all of the IRA and qualified retirement plan benefits taxed to the beneficiary. This result ensues because, as discussed above, the Code does not trace the tax characteristics of distributions of distributable net income.

A better alternative would therefore be to use the Section 678 sole power of withdrawal approach to target the withdrawal power to the excess IRA and qualified retirement plan benefits only, thus providing greater protection in the event the surviving spouse should remarry or become a defendant in a subsequent lawsuit. An independent trustee could also be given the power to suspend the surviving spouse's withdrawal power, for added protection.

A QSST presents a somewhat similar, although also somewhat more complex, set of issues. Only the income attributable to the S corporation is taxed under Section 678; without more, the balance of the trust income is subject to the normal subparts A through D of Subchapter J rules, unless subpart E applies. The preferable approach would be to use separate shares for the S stock versus all of the other assets of the trust, and then apply the Section 678 right of withdrawal approach to the non-QSST share. The QSST share can then be drafted so that, if the trust should no longer own stock in an S corporation, i.e., either because the stock is sold or because the S election is revoked, the trust will no longer be required to distribute all of its income currently to the beneficiary, and the Section 678 right of withdrawal approach can then apply to the entire trust, thus preventing an unnecessary overfunding of the beneficiary's estate.

The higher maximum income tax rate applicable to trust income in excess of only $12,000 should cause trust drafters greater pause before deciding which trust vehicle to employ to hold stock in an S corporation. The QSST may be the drafting technique of choice when the trust beneficiary is anticipated to be in a substantially lower income tax bracket than the trust, whereas an electing small business trust

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24 See UPIA section 409(c).
25 Section 662(b).
26 Reg. 1.1361-1(j)(8). The beneficiary is not taxed pursuant to Section 678 on the sale of the Subchapter S stock. Id.
(ESBT), which is automatically taxed at the highest trust income tax bracket, may be the desired vehicle if it is anticipated that the trust beneficiary will be in the highest income tax brackets even without the S corporation income.

Except for the portion of a QSST’s income that is attributable to the S corporation, Sections 652(b) and 662(b) automatically apportion the character of each item of income required to be distributed currently to the beneficiary. Using the Section 678 withdrawal approach in conjunction with a trust that is required by its terms to distribute all trust accounting income currently therefore requires a reference to these Code sections in order to best characterize the nature of any remaining items of income (e.g., the items that are not trust accounting income) which are withdrawable by the beneficiary under Section 678.

Preserving the integrity of the trust. The aim of the MIT approach is to minimize income taxes on trust income while preserving, to the greatest extent possible, the primary goals of the trust. As described above, these goals may include:

1. Minimizing estate taxes at the beneficiary’s death.
2. Insulating assets from lawsuits.
3. Protecting assets from the rights of the beneficiary’s ex-spouse in the event of a divorce.
4. Protecting assets from a spendthrift child.
5. Preserving trust assets for children of the grantor’s spouse in the case of a second marriage.

How does a Section 678 sole power to vest income minimize income taxes while preserving the integrity of the trust?

As already discussed above, if it were possible to apply subpart C of Subchapter J (Section 661 and following) in a fashion that would only push out to the beneficiary income taxed at the highest rates, and nothing more, this would not be an all bad approach. Tax-exempt income and qualified dividends taxed at favorable rates could be retained in the trust, while high tax rate taxable interest and distributions from IRAs and qualified plans could be distributed to the beneficiary, to be taxed at the beneficiary’s income tax rate and brackets—which will obviously never be any higher than those of the trust. The plan would not be perfect, because all of the interest and distributions from IRAs and qualified plans would then be included in the beneficiary’s taxable estate, etc., but at least it would alleviate the tax bracket and rate disparity unfairness somewhat.

Unfortunately, subpart C of Subchapter J does not allow this type of “tracing” of trust distributions pursuant to Sections 661 and 662. As a consequence, in order to avoid the trust versus individual tax bracket and tax rate disparity, trustees are forced to distribute essentially all of the trust’s distributable net income (including tax-exempt income) to or for the benefit of the beneficiary of the trust. This annual compounded accumulation of potentially significant taxable and tax-exempt income on the part of the beneficiary is then subject to future estate taxes at the beneficiary’s death, creditor attack, potential divorce rights, etc. As described above, the MIT approach to drafting trust instruments allows the grantor to pick and choose the types of income he or she desires that the beneficiary be able to withdraw, which will at least include income items that are taxed at normal income tax rates, such as taxable interest, nonqualified dividends, receipts from rental properties, and distributions from regular IRAs and qualified retirement plans.

Importantly, and contrary to the result when using the subpart C of Subchapter J system for reducing the income tax burden, because of the Section 2514(e) nontaxable annual lapse of the powers, nothing is added to the beneficiary’s taxable estate as a consequence of each annual lapse of his or her power of withdrawal (aside from the value of the beneficiary’s annual withdrawal power in the year of his or her death). This is the main reason the MIT approach to trust drafting can be said to preserve the integrity of the trust itself.

Use of a Section 678 withdrawal power generally furthers the integrity of the trust by causing the beneficiary to be liable for a significant portion of the trust’s income taxes. For a trust intended to be exempt from either estate taxes or GST taxes at the beneficiary’s death, the eventual estate or GST tax savings of having the beneficiary pay a significant portion of the trust’s income tax each year could obviously grow to be very large.

Depending on the particular state law, past and future withdrawal powers may or may not have relevance for purposes of determining the rights of the beneficiary’s creditors or ex-spouse. Nevertheless, as extremely cumbersome to administer, and the IRS might attempt to consolidate the two trusts in any event, pursuant to Section 643(f).
described above, using Section 678 does not require that the beneficiary possesses withdrawal powers over all of the trust’s accounting income, including nontaxable interest and qualified dividends. As a result, even if a creditor or ex-spouse would have rights in what is withdrawable by the beneficiary, those rights would be much less than if the nontaxable interest and qualified dividends needed to be distributed to the beneficiary in order to reduce income taxes (as would be required for distribution of distributable net income under subpart C of Subchapter J).

Section 662(b) effectively requires that the trustee distribute all of the trust’s distributable net income (including tax-exempt income\(^ {31} \)) to the beneficiary, if the trustee desires that any of the trust’s income be taxed at the beneficiary’s tax rates. This means that a much larger portion of the trust income would be subject to potential creditor attack as well as the rights of an ex-spouse, including distributed income that has been accumulated by the beneficiary over the years.

It should also be possible for a trustee not having a beneficial interest in the trust to suspend the beneficiary’s withdrawal power, in whole or in part, for reasons relating to such matters as:

1. To attain overall tax savings for the trust and its beneficiaries (including remainder beneficiaries).

2. To protect the beneficiary against the rights of creditors or of a former spouse.

3. To preserve assets against unwise or immature use of withdrawn funds by the beneficiary.

4. To provide protection for trust remaindermen in the case of a second marriage.

The trust instrument should thus be drafted to ensure the availability of a trustee who does not have a beneficial interest in the trust, other than as a contingent remainderman.

If the beneficiary is older and as such may be serving as sole trustee of the trust, he or she should have the power under the trust document to designate a co-trustee, including one who or which does not have a beneficial interest in the trust (other than as a contingent taker). The impartial trustee would then have the ability to suspend the beneficiary’s withdrawal power if advisable in order to achieve overall tax savings, to protect the beneficiary against the rights of a creditor or of a former spouse, etc. Because there is no assurance under the trust instrument that the beneficiary would serve as trustee forever, and because the beneficiary’s right of withdrawal from the trust is dependent’s on the trust’s accounting income, the rights of the beneficiary’s creditors or former spouse in the trust would be severely limited, at best.

The ability of a trustee not having a beneficial interest in the trust to suspend the beneficiary’s withdrawal power could also come in handy in the unlikely event Congress were to ever restore the pre-1986 rules and tax trusts and estates the same as individuals. In this situation it might actually be more advantageous to tax a significant portion of the trust’s income to the trust itself, rather than to the trust beneficiary, and the suspension of the beneficiary’s withdrawal power would allow for this.

**Income tax consequences to beneficiary as each independent annual power of withdrawal lapses.**

The lapse of the beneficiary’s withdrawal power each year raises a theoretical issue of whether the beneficiary continues to be taxed on a portion of the trust income. Section 678(a)(2) provides that a withdrawal power holder continues to be treated as the owner of any portion of a trust with respect to which he or she “has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject the grantor of a trust to treatment as the owner thereof.”\(^ {32} \) The reason the issue is largely theoretical is that taxing the beneficiary on a greater portion of the trust income is usually the goal anyway, and the more income that can be taxed to the beneficiary, in general, the larger the estate and GST tax savings at the beneficiary’s death.

Whether this theoretical issue applies is first conditioned on whether the annual lapse of each independent beneficiary power of withdrawal is a “partial release” within the meaning of the above-quoted language from Section 678. Although the trust is designed so that the annual lapse is not considered a “release,” and therefore a transfer, under Section 2514(e), the separate income tax versus estate and gift tax Code sections, of course, will not necessarily be read in harmony. The other theoretical issue concerns whether the annual lapse of each independent beneficiary power of withdrawal should be considered a “full” release of the beneficiary’s independent annual power of withdrawal, or a “partial” release causing taxation under Section 678(a)(2).

**Planning area #2**

The second planning area involves minimizing the effects of the 3.8% tax increase on net investment in-
come and the 5% surtax on capital gains and qualified dividends.

New Section 1411, enacted as part of the Health Care and Education Reconciliation Act of 2010, adds a 3.8% tax on net investment income, effective for 2013 trust years. Once again, this tax is imposed at trust net investment levels of as little as $12,000, whereas single individuals generally pay the tax at only levels of net investment income that exceed $200,000 ($250,000 for married individuals filing jointly). Specifically, as applied to trusts and estates generally, new Section 1411(a)(2) provides:

In the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax of 3.8 percent of the lesser of—

(A) the undistributed net investment income for such taxable year, or

(B) the excess (if any) of—

(i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over

(ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

The term “net investment income” is defined in Section 1411(c)(1) to mean the excess (if any) of:

(A) the sum of—

(i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2),

(ii) other gross income from a trade or business described in paragraph (2), and

(iii) net gain (to the extent taken into accounting in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in paragraph (2), over

(B) the deductions allowed by this subtitle which are properly allocable to such gross income or net gain.

The “paragraph (2)” trades and business to which the Section 1411 tax applies include:

(A) a passive activity (within the meaning of section 469) with respect to the trust, or

(B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

Significantly, Section 1411(c)(5) excludes from the definition of net investment income “any distribution from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A or 457(b),” which includes distributions from IRAs and qualified retirement plans. Also significantly, the definition does not exclude typical net capital gains from the sale or exchange of investments.

The Taxpayer Relief Act of 2012 also increases the maximum income tax rate on qualified dividends and capital gains from 15% to 20%. The extra 5% tax, however, does not kick in until an individual’s taxable income exceeds $400,000 ($450,000 for a married couple filing jointly). An estate or trust, on the other hand, need only have $12,000 of taxable income before its capital gains and qualified dividends become subject to the new 5% surtax.

In essence, then, and as a combination of the 3.8% tax on net investment income and the 5% surtax on capital gains and qualified dividends, most trusts are required to pay an additional 8.8% tax on capital gains and qualified dividends. This is in addition to the already-described significant disparity in income tax rates and brackets for trusts versus individuals generally.

Similar to the above-described technique for reducing the income tax disparity for trusts versus individuals generally, the new 3.8% tax on trust net investment income and the 5% surtax on trust capital gains and qualified dividends, each on levels of trust income of as low as $12,000, can also be avoided or minimized by granting the beneficiary a withdrawal right over the net investment income (which, as defined above, includes net capital gains) which is not already withdrawable by the beneficiary pursuant to his or her withdrawal right over trust accounting income taxed at the highest rates. Unique issues, however, are associated with the 3.8% tax on net investment income and the 5% surtax on qualified dividends and capital gains. The following concerns, among others, should cause the estate planner to pause before automatically inserting withdrawal rights over this additional trust income into the client’s trust document:

1 The fact that the Section 2514(e) 5% limitation is more likely to be exceeded if qualified dividends and capital gains are added to the equation.

2 Many clients do not desire for their trust beneficiaries, or at least one or more of them, to be able to access this greater level of trust income (including qualified dividends and capital gains), either because the beneficiary is too young or a spendthrift, or in situations in...
volving a second marriage or a special needs beneficiary.

For the above reasons, the estate planner should normally treat the Section 1411 issue separately, and include Section 678 withdrawal rights over the excess net investment income only if the client indicates a desire for that. Exhibit 2 contains one attempt at this additional trust clause.

**Drafting comments.** When analyzing the sample drafting language in Exhibit 2, consider the following points:

1. This optional clause, designed to avoid the Section 1411 tax on additional “net investment income” and the 5% surtax on qualified dividends and capital gains, accounts and adjusts for the larger pool of taxable income now subject to the 5% limitation of Section 2514(e), as well as the fact that a portion of net investment income is already withdrawable by the beneficiary pursuant to the beneficiary's withdrawal power over trust accounting income otherwise subject to the maximum trust income tax rate.

2. Similar to the general withdrawal form in Exhibit 1, the client may choose not to use this optional form in Exhibit 2 in situations involving a second marriage, one or more spendthrift children, or one or more children who are in high net worth situations and will not benefit from a withdrawal power over income from a trust that is not exempt from the GST tax.

3. A further advantage of including this second withdrawal power as a separate section 1.2, to apply only after the provisions of section 1.1 have been applied, is that it ensures that the types of income that normally carry with them the greatest disparity in income tax treatment between trusts and individuals (e.g., interest, nonqualified dividends, rents, retirement benefits, and IRA distributions) are taxable to the beneficiary first, with the “less punitive” section 1.2 (i.e., Exhibit 2) items of income taxed to the beneficiary only to the extent room is still left under the 5% exception to Section 2514’s lapse rule.

**Conclusion**

The severely compressed federal income tax brackets for estates and trusts can have a drastic impact on even relatively low trust income. Recent legislative changes increasing the top tax rate on ordinary income and capital gains, along with a new additional tax on certain investment income, have added to this tax burden. The above discussion offers two arrangements for structuring trusts to minimize the negative impact of these tax rules. Part 2 of this article, which will be published in a subsequent issue of *Estate Planning*, will provide additional suggestions for drafting trusts to minimize income taxes.

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**Exhibit 1**

**Sample Drafting Language From an Estate and Generation-Skipping Transfer Tax Exempt Trust**

1.1 During the beneficiary’s lifetime, the beneficiary (including any legal representative acting on behalf of any beneficiary under a legal incapacity) shall have the annual noncumulative power to withdraw all or any portion of the trust accounting income on or before December 31 of the calendar year; PROVIDED, HOWEVER, that (i) the foregoing power of withdrawal shall not extend to the portion of the trust accounting income which, for the calendar year, would be either exempt from federal income tax or subject to federal income tax to the trust, after all deductions and exemptions (but determined as though the trustee made no other income or principal distributions or encroachments during the year other than for trust expenses and taxes), at less than the general maximum federal income tax rate applicable to trusts (and for this purpose said excluded portion (I) shall begin with any dividends, capital gains, or other items of trust accounting income that are subject to a maximum federal income tax rate which is lower than the general maximum federal income tax rate applicable to trusts, (II) shall next include any
items of trust accounting income filling out the lower income tax brackets of the trust which do not constitute “net investment income” as defined in Section 1411(c) of the Internal Revenue Code, or any successor section thereto, (III) shall next include any additional items of trust accounting income filling out the lower income tax brackets of the trust which constitute “net investment income” as defined in Section 1411(c) of the Internal Revenue Code, or any successor section thereto, and (IV) shall assume that all items of federal gross income of the trust that do not constitute trust accounting income and that are not subject to a maximum federal income tax rate that is lower than the general maximum federal income tax rate applicable to trusts, are using up the lower income tax brackets of the trust first, before the aforesaid items of trust accounting income) and (ii) if Section 2514(e) of the Internal Revenue Code, or any successor section thereto, is in effect during the calendar year, the amount of trust accounting income subject to the foregoing power of withdrawal during the calendar year shall not exceed five percent (5%) (or such other percentage as shall be provided for in Section 2514(e)(2) of the Internal Revenue Code, or any successor section thereto) of the combined value of the principal and income of the trust on December 31 of the calendar year (or on the date of the beneficiary’s death, if earlier).

If more than one item of trust accounting income is withdrawable by the beneficiary pursuant to the foregoing provisions of this subsection 1.1 (e.g., taxable interest from corporate bonds and distributions from retirement assets (as defined below)), but the above-described limitation of Section 2514(e) of the Internal Revenue Code, or any successor section thereto, shall apply, the beneficiary’s power of withdrawal shall extend to a pro rata portion of each of such items based upon the ratio in which the total amount of each of such items bears to the total amount of all of such items (assuming the above-described limitation of Section 2514(e) of the Internal Revenue Code, or any successor section thereto, does not apply).

Any such withdrawable trust accounting income that is not withdrawn by the beneficiary or by the beneficiary’s legal representative by the end of any calendar year (or by the time of the beneficiary’s death, if earlier) shall be added to the principal of the trust estate, and the beneficiary’s power of withdrawal for such calendar year shall lapse. For purposes of this subsection 1.1, the term “trust accounting income” shall include all retirement assets (as defined below, but ignoring the last proviso of the definition) paid to the trust during the year regardless of whether all of said retirement assets paid to the trust during the year are otherwise considered to be trust accounting income, and the principal of the trust shall include the underlying value of all retirement assets (as defined below, but ignoring the last proviso of the definition) and other assets that are payable to the trust over time and not yet paid to the trust. The trustee or trustees other than a trustee having any beneficial interest in the trust (other than solely as a contingent taker under ARTICLE ___, below) may, in the sole and absolute discretion of said trustee(s), suspend the beneficiary’s withdrawal power under this subsection 1.1, in whole or part, by instrument in writing executed by said trustee(s) before January 1 of the calendar year in which such withdrawal power would otherwise exist. Reasons for such suspension may include, but shall not be limited to, overall tax savings for the trust and its beneficiaries (including remainder beneficiaries), creditor protection for the beneficiary, and unwise or immature use of withdrawn funds by the beneficiary.

The term “retirement assets” shall mean any asset classified as part of a qualified plan pursuant to Section 401 of the Internal Revenue Code, or any successor section thereto, as part of a nonqualified annuity, as part of an annuity payable under Section 403(a) or 403(b) of the Internal Revenue Code, or any successor sections thereto, as part of an individual retirement account (including a simplified employee pension) pursuant to Section 408 of the Internal Revenue Code, or any successor section thereto, as part of a Roth IRA pursuant to Section 408A of the Internal Revenue Code, or any successor section thereto, as part of an inherited IRA established by the trustee pursuant to Section 402(c)(11) of the Internal Revenue Code, or any successor section thereto, as part of a retirement plan pursuant to Section 457 of the Internal Revenue Code, or any successor section thereto, or as part of any similar qualified retirement arrangement under the Internal Revenue Code; PROVIDED, HOWEVER, that any of the aforementioned assets shall not be deemed to be a “retirement asset” for purposes of this agreement if it is not permissible (other than as a result of this proviso), under the governing instrument or otherwise, to make payments to the trust in a form other than in a lump sum or over a maximum term certain (other than a maximum term certain based on the life expectancy of any of the grantor’s descendants, of any heir-at-law of the grantor, or of any actual or hypothetical spouse of any of the grantor’s descendants).

Exhibit 2
Sample Drafting Language to Minimize Effects of New Tax on Net Investment Income

1.2 During the beneficiary’s lifetime, the beneficiary (including any legal representative acting on behalf of any beneficiary under a legal incapacity) shall also have the annual noncumulative power to withdraw all or any portion of the “net investment income” of the trust (as defined in Section 1411(c) of the Internal Revenue Code, or any successor section thereto) that is not already withdrawable pursuant to the provisions of subsection 1.1, above, and which is not described in clause (III) of subsection 1.1, above (hereinafter “the excess net investment income”), on or before December 31 of the calendar year; PROVIDED, HOWEVER, that (i) the foregoing power of withdrawal shall not extend to the portion of the excess net investment income of the trust which, for the calendar year, is less than the dollar amount at which the highest tax bracket in section 1(e) of the Internal Revenue Code, or any successor section thereto, begins for such calendar year (but with said dollar amount being reduced, but not below zero, by any net investment income, as defined in Section 1411(c) of the Internal Revenue Code, or any successor section thereto, which is not withdrawable by the beneficiary pursuant to the provisions of clause (III) of subsection 1.1, above), and (ii) if Section 2514(e) of the Internal Revenue Code, or any successor section thereto, is in effect during the calendar year, the amount of the excess net investment income subject to the foregoing power of withdrawal during the calendar year shall not exceed (A) five percent (5%) (or such other percentage as shall be provided for in Section 2514(e)(2) of the Internal Revenue Code, or any successor section thereto) of the combined value of the principal and income of the trust on December 31 of the calendar year (or on the date of the beneficiary’s death, if earlier), less (B) any amount that is withdrawable by the beneficiary during the calendar year pursuant to the provisions of subsection 1.1, above.

If more than one item of excess net investment income is withdrawable by the beneficiary pursuant to the foregoing provisions of this subsection 1.2 (e.g., capital gains from the sale of various corporate stocks and dividend distributions on various corporate stocks), but the above-described limitation of Section 2514(e) of the Internal Revenue Code, or any successor section thereto, shall apply, the beneficiary’s power of withdrawal shall extend to a pro rata portion of each of such items based upon the ratio in which the total amount of each of such items bears to the total amount of all of such items (assuming the above-described limitation of Section 2514(e) of the Internal Revenue Code, or any successor section thereto, does not apply). Any such withdrawable excess net investment income that is not withdrawable by the beneficiary or by the beneficiary’s legal representative by the end of any calendar year (or by the time of the beneficiary’s death, if earlier) shall not be withdrawable by the beneficiary in any subsequent calendar year.

For purposes of this subsection 1.2, the principal of the trust shall include the underlying value of all retirement assets (as defined in ARTICLE ___, below, but ignoring the last proviso of the definition) and other assets that are payable to the trust over time and not yet paid to the trust. The trustee or trustees other than a trustee having any beneficial interest in the trust (other than solely as a contingent taker under ARTICLE ___, below) may, in the sole and absolute discretion of said trustee(s), suspend the beneficiary’s withdrawal power under this subsection 1.2, in whole or part, by instrument in writing executed by said trustee(s) before January 1 of the calendar year in which such withdrawal power would otherwise exist. Reasons for such suspension may include, but shall not be limited to, overall tax savings for the trust and its beneficiaries (including remainder beneficiaries), creditor protection for the beneficiary, and unwise or immature use of withdrawn funds by the beneficiary.