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Untaxingly Yours

Fiduciary Income Tax—Blocking and Tackling for Simple Trusts

By Brian T. Whitlock and Morgan C. York

Gift and Estate Tax planning is in a constant state of flux. The Basic Exclusion Amount,[1] commonly referred to as the Federal Exemption, over the past 20 years has increased from $1,000,000 in 2002 to nearly $13,000,000 in 2023. The introduction of the Unlimited Marital Deduction[2] in 1982 made it possible to postpone the imposition of the Estate Tax for married couple until the death of the surviving spouse.

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Utilizing the Credit Shelter Amount

Prior to 2011, estate planners worked with clients to divide assets between the spouses (frequently by funding separate revocable living trusts during their individual lifetimes) in an effort to capture the full benefit of the Federal Exemption (*i.e.*, the Credit Shelter) upon the death of the first spouse to die. Since no one had a crystal ball, and we could not accurately predict which spouse will die first, it was important to attempt to fund each revocable trust with an amount of assets that would be greater than the Federal Exemption. At the death of the first spouse, the revocable trust would direct the trustee to allocate the maximum amount of assets necessary to fully utilize the Credit Shelter. The trust that would receive this allocation of assets was commonly referred to as the "B Trust" or the "Credit Shelter Trust." The balance of the trust assets would generally be allocated to one or more trusts that qualified for the Federal and/or State Marital Deduction.[3]

A properly designed Credit Shelter Trust will remain in place for the lifetime of the surviving spouse and it will pass free of any estate tax at the second death. If this trust is invested in a manner that will allow it to grow, then not only the original credit shelter amount, but also all the growth in the value of the trust will escape estate tax at the second death.

Simple Trusts *vs* Accumulation Trusts

The term "Simple Trust" never appears in the Internal Revenue Code. Reg. §1.651(a)-1 uses the term to describe a trust that is required to "distribute all of is income currently for the taxable year." The regulation continues on to state that "[a] trust which Code Sec. 651 applies is referred to in this part as a

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'simple' trust."[4] Although the Code does not define the term Simple Trust, Code Sec. 643(b) does define the term "income" for the purposes of Parts A, B, C, and D of Subchapter J (*i.e.*, the portion of the Code dealing with fiduciary income taxation other than Grantor Type Trusts and some miscellaneous provisions). The term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means "accounting income." Accounting income is determined under the terms of the governing instrument (*i.e.*, the will or the trust), and when the governing instrument is either silent or unclear, then it is determined under local law (*i.e.*, generally, the Uniform Principal and Income Act (UPIA) or the Revised Uniform Principal and Income Act (RUPLA).

Effective planning for the fiduciary income taxation of Simple Trusts requires that we possess a working knowledge of the components of Devil's Triangle: FAI, TTI, and DNI.

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Simple Trusts are not permitted to accumulate accounting income. If the language of the Credit Shelter Trust causes it to be a Simple Trust, then it may be more difficult for the value of the Credit Shelter Trust to grow during the lifetime of the surviving spouse.[5] The trustee will be forced to distribute the income each year to the survivor. If the income is accumulated in the hands of the survivor, then it will be exposed to estate tax at the second death.

Portability of the Credit Shelter Amount

Congress amended Code Sec. 2010(c) in 2010[6] and, in doing so, Congress permitted a deceased person dying after December 31, 2010 to claim not only their own Basic Exclusion Amount but also, in the case of a surviving spouse, the Deceased Spouse's Unused Exclusion Amount (DSUE). In essence, the law permitted the unused Federal credit to carryover and benefit the surviving spouse.

Federal portability has not eliminated the benefits of funding a Credit Shelter Trust. A number of States continue to have an estate (death) tax. The state exemptions/exclusions are not portable under the Federal law and therefore it may still be useful to divide the assets of the first spouse to die and fund a Credit Shelter Amount at the first death or make taxable gifts during lifetime in order to exhaust the available credits during life.[7]

The Impact of Portability on Wills and Trusts

Although portability has not eliminated the benefit of creating Credit Shelter Trusts at the first death, it has removed some of attorney angst in drafting will and trusts. It is common today for attorneys to draft a will or a trust that will leave all of the assets at the first death to a single trust with will qualify for the Marital Deduction. Code Sec. 2056(b) requires that in order to qualify for the Marital Deduction, a trust (otherwise known as a "Qualified Terminable Interest Property" (QTIP) Trust) must give the surviving spouse a "qualifying income interest for life."[8] In essence, the trust must be drafted as a Simple Trust.

The Trustee through a series of disclaimers and elections will generally be permitted to divide the Marital Trust in separate smaller trusts. For example, if the State in which the deceased lived or owned property had a State Death Tax that was assessed at a level below the Basic Exclusion Amount, then the trustee may want to create a separate trust to hold that State Exempt amount as a typical Credit Shelter Trust and elect out of both Federal and State QTIP Treatment. The amount above the State Exemption but below the Federal Basic Exclusion Amount could be carved out next and the trustee could elect to qualify the trust under the State QTIP law, but not elect QTIP treatment under the Federal law. This would cause the State QTIP Trust to be taxable at the second death under the State Death Tax but it would be exempt from the Federal Estate Tax. Finally, the trustee could elect Federal QTIP treatment for the value of any assets in excess of both the State and Federal exemption amounts.

This simplified method of drafting reduces the pressure on the drafting attorney related to lifetime funding of the trusts, and it transfers the burden into the hands of the person who will handle the post-mortem administration.

This single trust that is eligible for marital deduction, however, must be drafted as a Simple Trust, and as discussed above, it may be difficult for the value of the Credit Shelter Trust to grow during the lifetime of the surviving spouse.

The Importance of Blocking and Tackling

If we want to be able to effectively grow the assets of a Simple Trust, we must return to the basic principle of fiduciary income taxation. Similar to American football, it becomes a matter of basic Blocking and Tackling. However, in this context we are not attacking other players on the football field, but rather we are taking aim at the assets of the Simple Trust and the income taxes that might be imposed on that income.

When analyzing any fiduciary income tax issue, we must be cognizant of the three pillars: Fiduciary Accounting Income (FAI), Trust Taxable Income (TTI), and Distributable Net Income (DNI). Some joking refer to these as the "Devil's Triangle," partly because we have a devil of a time remembering them and keeping them straight. Before we go any further, let us make sure we are working from a common definitional base.

FAI, as mentioned earlier in Code Sec. 643(b), is determined under the language of the document (*i.e.*, the Will or the Trust) or where the document is unclear then under the state law (*i.e.*, the Income and Principal Act of the state where the Will or Trust is resident).

TTI is effectively determined under the same rules as applicable to individuals. For example: Qualified Dividends and Long-Term Capital Gains are tax at preferential rates for individuals and for Trusts.[9] Trade or business expenses are deductible.[10] Expenses incurred for the production of income are deductible.[11] Personal living expenses are not deductible. Investment advisory fees are not deductible.[12] The bottom line is two-fold: first, that TTI will be taxed to someone, either the trust or a beneficiary, but it will only be taxed once. Second, regardless of who is taxed on Qualified Dividends or Long-Term Capital Gains (either the trust or an individual beneficiary), the rate will be the same preferential rate.

DNI is equal to TTI before any personal exemption or distribution deduction, minus capital gains and losses allocated to principal, plus net tax-exempt income.[13] DNI is the concept that helps us to determine exactly who will pay the income tax on the TTI. If some or all of the DNI is accumulated in the trust, the trust will pay income tax on the portion that is accumulated. If the DNI is distributed, then the beneficiary receiving the distribution will be responsible for reporting their share of the income and pay the income tax.

Two fundamental rules from the above should stand out. First, capital gains and losses are generally not included in the DNI. The capital gains may well be TTI, but they are excluded from the DNI, and therefore they will not be carried out to the beneficiary if distributions are in fact made.[14] Second, the key to blocking DNI from being taxed to the beneficiary is to eliminate distributions completely. If nothing is in fact distributed, then all of the TTI will be taxed to the trust. Distributions, whether they are from FAI or Principal will pull TTI out of the trust and force it to be taxed to the beneficiary. Blocking distributions from discretionary trusts is relatively easy—Do Not Do It. Blocking distributions from Simple Trusts (where the language of the trust requires the trustee to distribute income) is more challenging.

Applying the Fundamentals—Blocking Accounting Income

Let us look at a real-world example involving Simple Trusts. H (age 82 years) is worth $50 million. H's spouse died in 2010 when the Basic Exclusion Amount was $5,000,000. The Credit Shelter Trust was structured as a Simple Trust and as such it has paid out 100% of its income each year. H is frustrated because the trust has grown very little over the past 12 plus years. Today, the assets held by the Credit Shelter Trust are worth $6,000,000. H does not want the income from the Trust. H would like to terminate the trust and give the trust assets to the two children who are remainder beneficiaries.

> *Understanding how FAI, TTI, and DNI each perform, and how they can be best manipulated is basic Blocking and Tackling.*

Using the Internal Revenue Service (IRS) Actuarial Table S (the current life expectancy tables) and the current Code Sec. 7520 interest rate, H's life estate in the trust is worth roughly 1/3 of the total value of the trust. One-third of $6,000,000 means that H's life estate is worth $2 million. If H disclaimed its interest in the trust, today 12 plus years after the death of the spouse, the non-qualified disclaimer would constitute a taxable gift under Code Sec. 2518. This is not a good result as at a 40% estate/gift tax rate, the effective tax would be $800,000. If H holds the life estate until death, no portion of the Credit Shelter Trust will be included in H's taxable estate at death, and no additional estate tax would be paid.

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Similarly, if H sold the life estate to the children in a Marital Trust, then Code Sec. 2519 would apply to tax the entire value of the trust. If H sold the life estate of the Credit Shelter Trust (for its actuarial value as calculated above), Code Sec. 2519 would not apply, and H would report the $2,000,000 as the sales proceeds. However, Code Sec. 1001(e) would step in to preclude H from claiming any portion of the trust's tax basis as his own. As a result, H would report a long-term capital gain of $2,000,000 at 20% capital gains rate plus a 3.8% Net Investment Income Tax and a roughly 6% state income tax, and H would pay approximately $600,000 of tax if the life estate was sold. Not a good result.

Investing solely for capital gains is one option. However, the roller coaster nature of the stock market leaves H with few options in terms of having the trustee invest solely for long-term capital gains. How else might we "tackle" this issue?

Let us return to the principle of a Simple Trust. Under the terms of the trust agreement, the trustee must distribute all of its FAI. One solution would be to consider changing the trust if the trustee and the beneficiaries could all agree it may be possible to "Decant" or change the terms of the trust and convert it into a purely discretionary trust. In order to be safe, it may be prudent to ask for a private letter ruling from the IRS asking them to rule that such a decanting did not amount to a gift of the life estate. All of that costs professional time and money, but it is a possible approach. The other alternative is to block the investment returns from the FAI. If there is no FAI, then accounting income is required to be distributed by the trustee.

The second option would be to create an entity that would "block" the FAI from the trust. Similar to charitable organizations that create C Corporations to "block" Unrelated Business Income (UBI) from the charity, the trust could invest the assets of the trust in a corporation or a partnership. The income earned inside of the corporation would be blocked from FAI, but it would also be exposed to a second level of income tax. That renders the C Corporation unattractive. If the trust created an investment partnership with another individual or entity, the income earned inside of the partnership would not be exposed to double taxation. All of the taxable income of the partnership would flow to the trust. How is that income treated for FAI? It would be rare for a trust agreement to speak about investments in partnerships, so we would likely look to state law. The Uniform Income and Principal Acts all treat only the distributions made from the partnership as FAI. If the partnership has taxable income but it makes no distributions, or only distributions that are sufficient to cover the Fiduciary Income Tax, then the trust will have no FAI and it will not be required to make any distributions to the beneficiary.

Summary

Effective planning for the fiduciary income taxation of Simple Trusts requires that we possess a working knowledge of the components of Devil's Triangle: FAI, TTI, and DNI. A Simple Trust is required to distribute all of its FAI. A Simple Trust is not required to distribute either TTI or its DNI. Understanding how FAI, TTI, and DNI each perform, and how they can be best manipulated is basic Blocking and Tackling. We must be proficient in the fundamentals if we hope to succeed at game time.

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ENDNOTES

1 Code Sec. 2010(c)(2). The Basic Exclusion Amount in 2023 is $12,920,000. This amount increases by inflation until the end of 2025. In January 2026, the Basic Exclusion Amount is expected be reduced by 50% as the sunsets on the Tax Cuts and Job Act of 2017 (TCJA).

2 Code Sec. 2523(a) provides an unlimited marital deduction for gift taxes, and Code Sec. 2056(a) provides an unlimited marital deduction for estate taxes.

3 Some states (*e.g.*, Connecticut, New York, and Illinois, to name a few) continue to impose State Estate Taxes ("Death Taxes"). In these jurisdictions, the amount allocated to the Credit Shelter Trust will generally be reduced to the level of applicable State Exemption.

4 Reg. §1.651(a)-1(b). (T.D. 6217, Dec. 19, 1956).

5 Nevertheless, there may be good and valid reasons for designing the Credit Shelter Trust as a Simple Trust. For example, the trustee of the Credit Shelter Trust may be independent or even adverse in relationship to the surviving spouse. If the trustee is required to distribute all income to the spouse as the sole income beneficiary, then there may be less conflict between the surviving spouse and the trustee.

6 The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 20210 (TRUIRJCA), (P.L. 111-312) December 10, 2010.

7 Lifetime gifting to irrevocable trusts that benefit the spouse and descendants (frequently referred to as Spousal Lifetime Access Trusts) continues to be a popular estate planning strategy to safeguard against the possible sunset of TCJA and the reduction in the available Basic Exclusion Amount.

8 Code Sec. 2056(b)(7)(B)(ii).

9 Code Sec. 1(h).

10 Code Sec. 162(a).

11 Code Sec. 212.

12 Code Sec. 67(e).

13 Code Sec. 643(a).

14 Code Sec. 643(a)(3) does permit a trustee to include capital gains in accounting income; however, the regulations under 1.643 make it clear that the decision to allocate capital gains to income must be done by the trustee on a consistent basis.

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