FIDUCIARY INCOME TAXES
THE NEW EPICENTER OF TAX SAVINGS FOR TRUSTS AND ESTATES

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INTRODUCTION

Income and capital gain tax planning has soared in importance relative to traditional estate tax planning. This is a direct result of the high federal estate/gift tax exemption and the new income tax, capital gain tax, net investment income tax (NIIT) and estate/gift tax rates, effective as of 2013.

This memorandum focuses on the impact that these changes have had on fiduciary income tax planning for estates and non-grantor trusts. It highlights some of the important, and potentially tax saving choices available to trustees and executors. Making the right choice can result in savings of tens of thousands (or even hundreds of thousand) dollars in fiduciary income and capital gains taxes. Failure to at least consider the alternatives could possibly lead to a claim for professional malpractice.

I. AT THE BEGINNING

A) Selection of Fiscal Year (for Estates)

Use of a fiscal (non-calendar) year for an estate is almost always preferable from a tax and planning perspective. First, it allows more time to make planning decisions such as those discussed below. (The fiduciary income tax return, with extension, is not due until 8 1/2 months after the end of the fiscal year, which could be as long as 20 1/2 months after the date of death.) Additionally, a fiscal year allows deferral of the time at which beneficiaries of the estate (individuals or trusts) must recognize taxable income of the estate which is passed through to them. (Please see Illustration #1.)

B) Electing Cash or Accrual Method

The great majority of estates and trusts utilize the cash method of accounting. This is typically quite acceptable since the cash method is much simpler to utilize and, with proper planning and anticipation, can be just as effective from a tax perspective as the accrual basis method. However, it is important to remember that the election to use the accrual method is fully available to an estate or trust. This can be especially valuable when there is an unavoidable or unintentional mis-match in the timing of the receipt of income and the payment of deductible expenses. (Please see Illustration #2.)

C) Planning for Basis

As a result of the tax rate and exemption changes previously mentioned, it has become more common that potential capital gains taxes on the sale of an asset are greater than the incremental estate taxes which would be incurred on including that asset at a higher value for estate tax purposes. Naturally, assets must be included in the gross estate at their fair market value. But, as we know, the value of many assets is not easily determinable, and reasonable arguments often can be made for a higher or lower value. Therefore, it is recommended that estate and income tax projections be made at the higher and lower end of the reasonable range of values prior to the filing of estate tax returns, especially with respect to assets which are expected to be sold in the relatively near future. Note that this type of planning can be especially valuable when the estate is below the threshold of incurring a federal estate tax or when the assets are passing to a surviving spouse. (Please see Illustration #3.)

Planning for basis has also become more vital when making lifetime gifts to a non-grantor trust. For example, the transfer of low basis assets to a trust, which assets are later sold by the trust, can result in substantially higher taxes than if held until death or, in some cases, if sold by the donor. (Please see our article in the July 2013 issue of Practical Tax Strategies, "Estate Planning With Gifts: Basis Can Bite", for a comprehensive discussion of this topic.)

D) Administration Expenses

Many administration expenses can be deducted either for estate tax or fiduciary income tax purposes. It is important to make the determination, early in the estate administration, which alternative will result in the greatest tax savings. This is recommended since if deduction for fiduciary income tax purposes is desirable, planning must be done to ensure the maximum benefit of these deductions (for example, planning for sufficient fiduciary income in the year the deductions are taken, or that they are taken in the final year of the entity so that any excess of these deductions over income for the year can carry over to the beneficiaries as "excess deductions").

II. RETROACTICE PLANNING:

A) Flexibility Until Initial Return Filed

Many important determinations, such as election of a fiscal ear and election of cash or accrual basis, are not "locked-in" until the actual filing of the initial fiduciary income tax return. This is true even if the return is filed late or if an application for extension of time has been filed indicating a different fiscal year.

B) Use of an Initial Short Fiscal Year

It sometimes occurs that a client seeks advice at a later time in the administration of an estate. In such a case, for example, it might be desirable to "draw-out" income to the beneficiaries and that a fiscal year which ends greater than one year after death is necessary to do so. Consider an initial short year of sufficient duration to allow the second year to end at an appropriate time to include such income and permit timely distributions to beneficiaries. If the initial short year contains little or no taxable income, it will be possible to file a fiduciary return for such short year without incurring significant penalties or interest, even if the return is filed late. Note that this planning technique can also be used to maximize the benefit of administration expense deductions. (Please see Illustration #4.)

III. DISTRIBUTIONS FOR TAX SAVINGS:

A) Distributable Net Income (DNI)

As you know, ordinary net income is generally included in DNI. However, for such income to be drawn-out and taxed to beneficiaries, it must also be distributed or "required to be distributed" under Treasury Regulations. Since net ordinary income (other than qualified dividends) of a trust or estate is typically taxed at combined Federal, NIIT and New York State rates of approximately 50%, often a significant tax saving can be achieved by drawing out such income to beneficiaries. There may be significant non-tax reasons for not making discretionary distributions to beneficiaries. However, when distributions to beneficiaries are appropriate from a fiduciary perspective, tax projections should be made to determine the potential tax benefit of making distributions. (Please see Illustration.)

B) Capital Gains

In many cases, capital gains can be included in DNI, and therefore should be considered for distribution to beneficiaries for the same reasons and under the same circumstances as discussed in "A" above. Please note that the combined capital gain rate for a New York State "resident" trust or estate typically exceeds 30%, while the rate for beneficiaries is often substantially less. (Please see Illustration #5. For a complete discussion of including capital gains in DNI, please see the Rynkar, Vail & Barrett Guide on the subject.)

C) Distribution of Appreciated Assets

Care must be taken when distributing appreciated assets. When distributed in satisfaction of a fixed/ pecuniary distribution obligation, the trust or estate must recognize gain upon the distribution. However, when there is no such obligation, the assets are passed through to the beneficiary without gain recognition, with the beneficiary obtaining the estate's or trust's basis. (This is one way to draw out capital gains to beneficiaries when circumstances do not permit including capital gains in DNI.)

D) 65 Day Rule

In order to draw-out DNI to beneficiaries, distributions must be made within the trust's or estate's fiscal year or, if elected, within the first 65 days of the next succeeding year. This election is made on an annual basis in the fiduciary income tax return filed for the year and is not binding for subsequent years. Note that since the election is made on the return for the year, where there is any doubt, a distribution can be made within the 65 day period and either be treated as made in the prior year, or not, at the time of filing the fiduciary return.

IV. CONCLUSION

The preceding discussion highlights some notable techniques for addressing the increased impact of fiduciary income taxes on overall gift, trust and estate planning. However, the key takeaway is that this impact can be huge and must be carefully considered in the context of every planning engagement, whether the client' s assets are great or moderate.

ILLUSTRATIONS

Illustration #1 - Fiscal Year

Facts: Decedent died 2/1/15. A fiscal year ending January 31st is selected.

Results:

(a) Filing of initial fiduciary income tax return (with extension) can be delayed until 10/15/16 (20 1/2 months after death).

(b) If the estate recognizes net income in its FYE 1/31/16 and distributions are made to residuary beneficiaries within 65 days of that year-end, the beneficiaries would report that income in their 2016 personal income tax returns, with the tax payable as late as 4/15/17.

Illustration #2 - Accrual Method

Facts: Decedent died 2/1/15. The attorney is first contacted in August 2016. Upon review of the estate's records, it is determined that the estate received $500,000 of ordinary income in June 2015, incurring $250,000 in administration expenses and state income taxes which were not paid until July 2016. Since the administration expenses and taxes were paid more that one year after the income was received, it would be impossible to elect a fiscal year which would include both the receipt of income and the payment of the expenses. It is decided to elect a fiscal year ending January 31st and to elect accrual method when filing the initial fiduciary income tax return. (Note that circumstances exist which prevent the closing of this estate until after 2017.)

Results: In FYE 1/31/16, the accrued $250,000 of administration expenses and state taxes will be available to offset the $500,000 of income received in that year, reducing the tax by $125,000 ($250,000 x 50%, the assumed combined ordinary tax rate). Assuming little or no net income in FYE 1/31/17, the $250,000 of expenses and taxes would be lost and could not be carried over to the beneficiaries as "excess deductions" since FYE 1/31/17 would not be the final year of the estate.

Illustration #3 - Planning for Basis

Facts: Decedent owned a fifty percent interest in an LLC which owns commercial real estate with a fair market value of between $5,000,000 and $6,000,000. Subsequent to the date of death, LLC management lists the property for sale at $6,000,000 (which they believe can be realized after an appropriate marketing period). Decedent's 50% interest can reasonably be valued, after appropriate discounts, at between $1,700,000 and $2,700,000. The estate is not subject to Federal estate tax but is subject to a state estate tax at an incremental rate of 10%.

Results: If the decedent's interest in the LLC is valued for estate tax purposes at the higher end of the reasonable range ($2,700,000), an additional state estate tax will be incurred in the amount of $100,000 ($1,000,000 x 10%). Upon sale at $6,000,000, the estate' s share of the proceeds would be $3,000,000 and the gain would be $300,000 ($3,000,000 $2,700,000 If the value of the interest had been reported at $1,700,000 (and that value was held to be the fair market value as of the date of death), the gain would have been $1,300,000 ($3,000,000 - $1,700,000), an increase in gain of $1,000,000. Assuming a combined federal and state capital gain rate of 30%, the additional capital gain tax would have been $300,000 ($1,000,000 x 30%). The net result of using the higher reasonable value of $2,700,000 for estate tax purposes would be a net savings of $200,000 ($300,000 - $100,000).

Illustration #4 Short Fiscal Year

Facts: Decedent died 2/1/15. In May 2016, it is determined that the estate realized net ordinary income of $400,000 during its initial year, primarily in the period 4/1/15 - 12/31/15. It is also determined that the four residuary beneficiaries have little taxable income of their own, so if the income can be drawn out and taxed to them, the combined taxes on the $400,000 of income would be $100,000. on May 31st, residuary distributions of $100,000 are made to each of the four beneficiaries. A short taxable year return is filed for the two months ended 3/31/15, in which period there is no net taxable income. Also, a return for the FYE 3/31/16 is filed, electing to treat distributions to beneficiaries made within 65 days of the year-end as distributions for the year.

Results:

(a) No penalty or interest is incurred for the short year ended 3/31/15, even though it is filed late, since there is no net taxable income in the period.

(b) The $400,000 of net taxable income is taxed to the four residuary beneficiaries in 2016, incurring total taxes of $100,000 (which would be due as late as 4/15/17). If the $400,000 of income had been taxed to the estate, combined taxes would have been approximately $200,000 ($400,000 x 50%, the assumed combined tax rate). The result is a net tax saving for the family of $100,000 ($200,000 - $100,000).

Illustration #5 – Distributions for Tax Savings (Detailed Analysis)

Facts: Assume a trust or estate with taxable income of $400,000 consisting of $200,000 interest income and $200,000 qualified dividends/capital gains. Also, assume four equal residuary beneficiaries of an estate (or four beneficiaries of a trust which allows discretionary distributions of income and principal.)

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