



Welcome to *Trust Connection*, our monthly newsletter highlighting Trust news and information. Each month we will feature timely articles of interest.

About Us

At Halliday Private Trust, it is our mission to assist our clients in the process of providing solutions, specifically through a wide range of financial advice.

Since 1982, we have utilized a full spectrum of financial services to help our clients navigate every major hurdle in their financial lives. Because we are an independent financial services firm, we utilize an open architecture approach to locating the most suitable investment options for our clients.

Our role is to help clients make smart decisions about their money. We understand that each client has unique needs and requires personalized solutions based on their goals, objectives and concerns.

Get Outta Here! Getting Capital Gains Out of Trusts

All revocable living trusts are, effectively, flow-through entities for income tax purposes. They are not treated as an independent taxpayer, but irrevocable trusts are. An irrevocable trust's income is made up of the character of the returns from its investments. Thus, the investment choices in irrevocable trusts make a big difference to the net after-tax returns of the trust and its beneficiaries.

Essentially, an irrevocable trust is a taxpayer, much like a person is. However, when distributions are made in the same year the income is earned, the tax burden shifts to the beneficiary, at least to the extent of the distribution amount. To provide consistency in this shift, and to limit the beneficiary's tax liability to the income earned that year, an allocation method was devised by the IRS. This allocation method, Distributable Net Income (DNI), generally limits the income "pass-through" to the beneficiary of an irrevocable trust to the current year's income, and does not include net long-term capital gains. The reason gains are excluded is because they are considered to be related to the rise and fall of the value of the underlying asset, which is to pass to the remainder beneficiary, not as "income" to the current beneficiary.

Historically, income tax rates were similar for trusts and most beneficiaries with long-term rates at about 20 percent on normal long-term capital gains. However, recent years have brought changes and the future may intensify this difference. Currently, for trust income, the top tax bracket is reached at \$12,400 of income. So, for example, a minor beneficiary may effectively be in a zero tax bracket for income and gains, yet a trust for her benefit may have income over \$12,400 in 2016, putting it in the top tax bracket on additional marginal income and subjecting the trust to the Net Investment Income Tax of 3.8 percent. This could mean the trust would have a 23.8 percent tax rate on long-term capital gains, whereas if it were distributed to the beneficiary the rate would be zero. This rate gap encourages us to examine when and how capital gains may be passed through to the beneficiary instead of being taxed to the trust.

At this point we must rely on IRC Reg. 1.643(a)3. The default rule here is that DNI does not include capital gains because they are not typically considered ordinary income. Gains are included in DNI in two situations: when the document or local law requires it, and when the trustee using permissible discretion consistently (every year) treats it as distributed. The first part of that rule means we have no choice; the document or local law requires capital gain to be treated as income. This is very unusual because it would add an element of inflexibility to

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A LOCAL TRUST SOLUTION

Call us today at (800) 786-1598 to learn more about working with Halliday Private Trust.

For information and assistance, please feel free to contact one of our Trust Advisors:

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the trust. Maybe this looks attractive today, but laws could be different in 10 years. So flexibility is crucial for planners. This leaves us with the trustee's discretion, which gives some flexibility to manage tax implications. However, the fact that it must be done consistently is often a problem for existing trusts. Unless the trustee has been treating the trust this way in the past, they can't start now – or can they?

There are two ways that you may be able to “restart” the tax treatment of capital gains generated in an existing trust. One way is “decanting” into a new trust. Because decanting involves one trust distributing to a new trust, that new entity could presumably start a new method of capital gains treatment. The other way is to convert to a unitrust standard permissible under state law. This alteration in the definition of “income” should be sufficient to change the treatment of the taxation of that income.

Assuming we have a new trust or a “restarted” trust, then the trustee's discretion drives the capital gain treatment. The trustee may choose to allocate capital gains to income. The trustee in a unitrust may also do so as long as gain is only passed out in excess of the normal DNI. If the trustee does not choose to call the gains income, it can still be treated as part of DNI if it is treated consistently by the trustee as part of a distribution to a beneficiary, or is actually distributed because trust language makes a partial termination or defines a distribution amount which includes capital gain. For example, if a trust calls for the trustee to “distribute one half of the sales proceeds,” then capital gains can be treated as income. It is particular to the trust language.

One final way a trust may be able to “restart” without a change to the trust when such discretion is permitted by the document or state law, is to treat sales of certain specified assets or a particular class of investments as a distribution of net capital gains.

If any of the above “remedies” is permissible and practical and would save the trust and its beneficiaries substantial taxes, the trustee should look into implementing those ideas. In the absence of availability of one of these remedies, the trustee's properly investing trust assets can play a critical role in minimizing the total combined tax bill of the trust and its beneficiaries by paying close attention to the needs of the beneficiaries, the expected and required distributions from the trust, and the income tax rates of the expected taxpayers.

Summary

Clearly there are complicated decisions to be made, not just initially but also during the entire term of the trust. In addition, the trustee's role in carrying out your wishes involves your thoughts, purposes, and desires as well as the legal and tax knowledge to best bring your wishes to fruition. Choose experienced and specialized legal, tax, investment, and trustee team members to aid you in achieving your goals, keeping them up-to-date, and creating a flexible framework for the future.

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