# MICHIGAN PROBATE & ESTATE PLANNING JOURNAL

Vol. 36 • Winter 2016 • No. 1

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STATE BAR OF MICHIGAN PROBATE AND ESTATE PLANNING SECTION

# New Year's Resolutions for Trustees and Beneficiaries: Ten Fiduciary Income Tax Planning Considerations

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As we reflect on this past year, much has happened in the estate planning arena. With the current Federal transfer tax exemption at over $5 million, adjusted each year for inflation, and the repeal of the federal estate tax a priority under President Trump's administration, practitioners may be wondering what will occupy their time in 2017. But transfer tax planning is only one component the Trusts & Estates practice; income tax planning of non-grantor trusts should continue to be a source of ongoing work for practitioners. This article will highlight several income tax planning considerations for these trusts that are often overlooked and can provide a source of reoccurring an important planning work for fiduciaries. The ultimate goal: Bringing good cheer to Trustees and beneficiaries (and practitioners).

## Primer on Fiduciary Income Taxation of Trusts

Before understanding income tax management techniques that are available in the administration of a non-grantor trust, a refresher on the fiduciary income tax rules under Chapter 1, Subchapter J, Subparts A, B and C of the Internal Revenue Code[1] (IRC 641 et. seq.) is warranted. In general, Subchapter J taxes trust income once–either to the trust that receives it, or to the beneficiary to whom such income is distributed. Distributions of income from a trust to its beneficiaries qualify the trust for an income tax deduction known as the "distribution deduction").[2] Effectively, Subchapter J treats a trust as a conduit to the extent income is distributed, and as an entity to the extent income is accumulated. Many of the planning considerations addressed in this article involve the interplay between the conduit vs. entity regimes of fiduciary income taxation.[3]

## Trusts and Estates as Taxable Entities

In general, trusts and estates are separate taxable entities and must file a U.S. Income Tax Return for Estate and Trusts (Form 1041) and have a separate taxpayer identification number.[4] (There are some exceptions for certain grantor trusts.[5]) The taxable income of an estate or trust is computed the same way as individual income taxes, but with some modifications.[6] In effect, the fiduciary income tax rules bifurcate tax liability. For taxable income retained by the trust or estate, the entity calculates and pays the income tax under an entity regime of taxation.[7] However, when distributions of income are not accumulated and are made to beneficiaries, the trust or estate is treated as a conduit and the income distributed is taxed to the beneficiaries rather than the entity.[8]

## Fiduciary Income Tax Terminology

Some of the common terms used in the fiduciary income tax rules are as follows:

a. **Simple Trust.** A trust is a simple trust if it requires that all of the trust accounting income be distributed currently, it does not provide for any payment to or set aside for charitable purposes, *and* it does not actually distribute any trust principal during the year.[9]

b. **Complex Trust.** Any trust that is not simple is a complex trust.[10] Trusts that do not require distribution of all income annually or provide for charities will always be complex.[11] Estates are also treated as complex.[12]

c. **Trust Accounting Income.** Trust accounting income, also known as fiduciary accounting income, is governed by the trust instrument and applicable local law, such as the Michigan Uniform Principal and Income

Act.[13] Although it is not a tax concept, trust accounting income is important in determining whether the fiduciary or the beneficiaries pay tax on the trust's income. When the Code refers to "income" in connection with trusts and estates, the reference is to the definition of trust accounting income.[14]

d. **Distribution Deduction.** A trust or estate may either retain income or distribute it to beneficiaries, or both, according to the terms of the trust agreement or Will and applicable state law. The trust is taxed only on the income it retains,[15] while the beneficiaries are taxed on the income distributed or required to be distributed.[16] The trust receives a deduction for the net income distributable to the beneficiaries.[17]

e. **Distributable Net Income.** The concept of distributable net income ("DNI") is unique to fiduciary income taxation. Logically, the distribution deduction should be limited to the taxable income of the trust. However, the deduction is based on DNI, which is derived under the rules of IRC 643. To oversimplify, DNI is the taxable income of a trust, but after a series of adjustments are made.[18] DNI serves as the overall limitation on the amount of distribution deduction available to an estate or trust, as well as a limitation of the amount taxable to beneficiaries.[19]

## Fiduciary Income Tax Brackets

Compared to individual income tax brackets, the fiduciary income tax brackets are compressed. The rate schedule that applies to taxable income for estate and trusts for 2016 is as follows:[20]

| | |
|---|---|
| Not over $2,550 | 15% |
| Over $2,550 up to $5,950 | $382.50 plus 25% of the excess |
| Over $5,950 up to $9,050 | $1,232.50 plus 28% of the excess |
| Over $9,050 up to $12,400 | $2,100.50 plus 33% of the excess |
| Over $12,400 | $3,206 plus 39.6% of the excess |

In addition, at $12,400 in income, trusts are subject to the higher 20% capital gains rate and may also be subject to the additional 3.8% net investment income tax.[21]

## Calculation of Tax

Form 1041 is constructed similarly to Form 1040; income minus deductions equals taxable income. The steps for the calculation are the same; however, the rules are different depending on whether the trust is simple or complex.[22] The instructions to Form 1041 are also extremely helpful in calculating the tax. The preparation and analysis of these tax forms, while critical in engaging in fiduciary income tax planning, are beyond the scope of this article.

## Determine Trust Accounting Income

Trust accounting income must first be determined by referring to the governing instrument and then by referring to the Michigan Uniform Income and Principal Act or any other applicable state law.[23] Trust accounting income is focused principally on whether funds coming into the trust and expenses being paid from the trust are allocated to principal (corpus) or income.[24] Interest, dividends on investments, and short-term capital gains/losses are allocated to income whereas long-term capital gains/losses and return of principal are allocated to principal.[25] The same is also true for expenses.[26] Attorney and accounting fees, for example, are typically allocated 50% to income and 50% to principal.[27] Estate and income taxes are allocable to principal, but real estate taxes are allocable to income.[28] It is important to be familiar with the principal and income rules for each state, as they are not always intuitive.

Net income is determined by totaling trust

accounting income minus expenses allocable to income.[29] After determining net income, the trustee then looks to the document to determine whether income is required to be distributed. When the income is required to be distributed, the beneficiary holds a mandatory income interest.[30] The most common example is a Qualified Terminable Interest Property Trust ("QTIP"), which requires all net income be distributed to the surviving spouse.[31] Alternately, the trust may contain provisions which allow the trustee to exercise its discretion to accumulate or distribute income and principal according to the standards set forth in the document. These are referred to as discretionary distributions.[32] A trust that is required to distribute net income and makes no principal distributions will be a simple trust.[33] For such trusts, the mandatory income interest will be the trust accounting income.[34] If a trustee exercises discretion to accumulate or distribute income or principal, it will be a complex trust.[35]

### Determine Trust Taxable Income

Once trust accounting income is determined, taxable income is determined. A trust's taxable income is calculated in the same manner as the individual income tax rules unless there is an express provision to the contrary.[36] The general modifications to the individual income tax rules are set forth below.

### Exemption

Estates and trusts are not permitted to take the standard deduction permitted by individuals. The exemption varies depending upon the type of trust.[37]

- Estates are permitted a $600 personal exemption.[38]
- Trusts required to distribute all of their income currently are permitted a $300 personal exemption.[39]
- All other trusts are permitted a $100 personal exemption.[40] (However, certain complex trusts may be permitted a $300 personal exemption.[41])

### Determine DNI

DNI is essential to the calculation of taxable income because it limits the amount of the distribution deduction.[42] IRC 643 defines DNI as "the taxable income of the trust or estate computed with the following modifications."[43]

### Extraordinary Dividends and Taxable Stock Dividends

Extraordinary dividends and taxable stock dividends are excluded from DNI if they are received by a simple trust and not distributed because they are allocated to corpus by the fiduciary in good faith and in accordance with the instrument and local law.[44]

### Tax-Exempt Interest and Income from Foreign Trusts

Tax exempt interest and income from foreign trusts are included in DNI, but are reduced by any amounts disallowed by IRC 265 and by the share of the charitable deduction allowed by the trust or estate.[45] When tax-exempt income is included in DNI, a proportionate share of the expenses of the trust not allocable to particular items of income must be allocated to tax-exempt income and are not deductible.[46] The net tax-exempt income must be allocated to the beneficiaries if distributions are made.[47]

### Capital Gains (Losses)

Capital gains (losses) are generally excluded from DNI to the extent they are allocated to corpus and are not paid, credited or required to be distributed to a beneficiary or paid to or set aside for charity.[48] Several exceptions to this rule apply. Capital gains are included in DNI for the final tax year for a trust or estate.[49] Prior to the final tax year, the trustee has the ability to manage capital gain income and potentially include such income in DNI if one of the two following prerequisites is first satisfied: (i) pursuant to the terms of the trust and Michigan law (the "first

prerequisite") or (ii) pursuant to the trustee's reasonable and impartial exercise of discretion (the "second prerequisite"),[50] and pursuant to one of the three available methods provided under the Treasury Regulations. The first method generally encompasses what practitioners refer to as a "power to adjust" between fiduciary income accounting and principal under Michigan law.[51] Finally, in recognition that modern portfolio theory focuses on total return, many states have adopted laws that permit a trustee to convert to a unitrust.[52]

### Exclusions from DNI

Certain specific distributions cannot carry out DNI. Any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property which is paid or credited all at once or in not more than three installments shall be considered a gift or bequest of money or specific property.[53]

### Determine Distribution Deduction

Once DNI has been calculated, the distribution deduction and taxable income can be calculated. For simple trusts, the trust receives a distribution deduction for the amount of income that is required to be distributed currently, limited to the amount of DNI.[54] For complex trusts, the trust receives a distribution deduction for the amount of income required to be distributed currently and for any other amounts of income or corpus properly paid, credited or required to be distributed limited to DNI.[55] No deductions are allowed for an item of DNI that is not part of the trust's gross income; therefore, the trust must subtract from its distribution deduction that portion of any distributions considered to be tax-exempt.[56]

### Tax Year Reporting

In general, a trust uses a calendar year for its tax year, but can elect to be treated as the estate by making a certain election (discussed later).[57] An estate may report on calendar or fiscal year basis. A fiscal year may end on the last day of any month but can extend no longer than 12 months.

### Taxation to Beneficiary

Distributed income retains the same character in the hands of the beneficiary as it had when earned by the trust or estate.[58]

a) Simple Trusts. The beneficiary must include in his or her gross income the amount of income required to be distributed, up to DNI, even if the income is not in fact distributed.59 The amount is allocated among the beneficiaries according to the amounts they actually received from the trust, or ratably if the income was not distributed.60 The beneficiaries are usually treated as receiving a proportionate share of each type of income included in DNI.61
b) Complex Trusts. The beneficiaries are treated as if they received the DNI distributed by the trust on the last day of the trust's taxable year and must include the taxable portions of DNI in their income for the tax year in which the trust's tax year ends.62
c) Tier System. DNI is allocated among beneficiaries according to a tier system.63 The purpose of the tier system is to expose mandatory income beneficiaries to the maximum amount of DNI based on the income they receive. The remaining DNI is allocated among the remaining beneficiaries.64 A detailed explanation of the tier system is beyond the scope of this article.

### Separate Share Rule

A separate and independent share of a trust or estate for a beneficiary is treated as a separate entity for the purpose of determining distributable net income.[65] A distribution to that beneficiary will carry out only income attributable to that separate

share and not the greater amount attributable to the trust or estate.[66] The separate share rule will also apply for purposes of allocating income in an estate that creates a marital and a credit shelter trust.[67]

## Ten Planning Considerations[68]

### Calendar Year vs. Fiscal Year Planning

For an estate plan that incorporates a revocable living trust which becomes irrevocable at Settlor's death, the Trustee can elect to combine the trust with the estate for all tax years of the estate ending after the date of the decedent's death and before the "applicable date."[69] This is known as a 645 election and effectively treats the trust administration as part of the estate administration for income tax purposes. The election is only available for a "qualified revocable trust" (QRT).[70] A QRT is a trust that was revocable during Settlor's lifetime and treated as owned by the Settlor under a grantor power to revoke.[71] The applicable date (duration of the 645 election) depends on whether an estate tax return is filed. If no estate tax return is required to be filed, the 645 election lasts for two years after the date of the decedent's death.[72] If an estate tax return is required to be filed, the election ends upon the later of (i) six months after the date of the final determination of estate tax liability or (ii) two years after the date of the decedent's death.[73]

The 645 election allows for deferral of recognition of taxable income and tax planning by strategically "bunching" income and deductions in a time period.[74] The fiscal year is beneficial because the beneficiary is not taxed on income received until the fiscal year ends.[75] The benefit of this election can best be illustrated with the following example:

Example: Decedent died June 1, 2016. Estate owns shares of family business taxed as C corp. Company expected to declare dividends in fall of 2016. Estate receives dividend of $50,000 in the third quarter. Executor immediately distributes dividends to Estate beneficiaries as part of DNI. If planning in advance, Executor can elect fiscal year end (June 2, 2016 through May 31, 2017) and won't file tax return until fall of 2017. Beneficiary will receive a Schedule K-1 from Estate at that time reflecting items of taxable income received. Result is tax deferral: that beneficiary will enjoy income in 2016, but won't report until 2017 Form 1040, which isn't due until April 15, 2018.

A 645 election is made on Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate."[76] No probate estate needs to be opened for the election to be made.[77] If no probate estate has commenced, the Trustee of the QRT signs the election.[78] Form 8855 is attached to Form 1041 for first taxable year of decedent's estate or if no probate estate, for first taxable year of the QRT.[79] The Trustee of QRT signs Form 8855 and agrees to various conditions on form.[80] The election must be filed no later than the time prescribed for filing of Form 1041 for first tax year of Estate, including extensions.[81]

### Distributions within 65 Days of Close of Tax Year

Tax planning can involve deemed retroactive distribution opportunities. Such an opportunity is in form of election known as "663(b) election" or "65-day rule" and allows a fiduciary to make distributions that were accumulated in a trust within first 65 days after close of the tax year, and attribute those distributions to the last day of the preceding tax year for income tax purposes.[82] This flexibility gives the fiduciary the ability to gather tax year-end financial results after the close of a tax year, assess each beneficiary's personal tax attributes and determine the optimal income tax result. While this assessment is being made, the taxable income is accumulated into the next tax year. After the assessment is made, the fiduciary can distribute the taxable income to the beneficiaries and attribute it as part of the preceding tax year, as long as the distribution occurs within 65 days after the close of the trust's tax year.[83] The benefit of this election can best

be illustrated with the following example:
Example: In 2016, complex trust (on calendar year filing) received $18,000 of passive income from Partnership X. The trust's sole income beneficiary is uncertain on his personal tax bracket until end of calendar year. Additional income from other accounts is expected to be earned by the trust. The trustee exercises discretionary authority to accumulate all 2016 income. The trustee receives resource documents from various financial institutions in February 2017 reflecting sufficient taxable income for 2016. The trustee concludes the beneficiary will not be in highest tax bracket and has capital loss carry forwards to use for 2016. Within 65 days after close of calendar year, the trustee distributes all income of the trust to beneficiary and makes 65-day election on the trust's 2016 income tax return, to effectively treat 2017 distributions as if been made by December year end. This allows 2016 DNI to be carried out to beneficiaries on Schedule K-1. Tax savings are achieved because the income is taxed at the beneficiary's lower rate, is not subject to 3.8% NIIT and the beneficiary's capital loss carry forwards can be utilized.

A 663(b) election is made on the Form 1041 itself, page 2 of the return under "Other Information" at line 6.[84] The election is only applicable to complex trusts (non-simple trusts).[85] The amount to which election applies cannot exceed greater of (i) trust fiduciary accounting income for tax year election is made or (ii) DNI for that tax year.[86] The election governs the applicable tax year in which distributions within 65 days following such year are deemed to be made.[87] The election is effective only for tax year election is made.[88] The election becomes irrevocable after last day prescribed for making election.[89]

## Timing of Deductions

A fiduciary should always be looking for applicable deductions to reduce adjusted gross income. Some of the most common deductions related to ordinary and necessary expenses of a trust administration include costs attributed to:[90] (i) carrying on a trade or business;[91] (ii) the production of income and management/ conservation of income producing property;[92] (iii) the determination, collection or refund of tax;[93] (iv) reasonable expenses of administration (fiduciary, legal, accounting);[94] (v) investment advisory fees;[95] and, (vi) theft/casualty losses.[96]

The timing of applying the deductions is equally important. If deductions that exceed income are not otherwise used, they are wasted unless the excess deductions are generated in the final year of the trust administration.[97] Powerful tax planning can be achieved if trustees are cognizant of this critical timing. The tax rules allow a trustee to pass out excess deductions to beneficiaries as miscellaneous itemized deductions.[98] Excess deductions can only be passed out in the final year of the trust.[99] Because the beneficiaries of a trust may be able to use the deductions, it is important for a trustee to understand a beneficiary's personal tax situation and delay payment of expenses until the final year if the facts and circumstances allow.

Every beneficiary on Form 1041 receives a Schedule K-1 from the trust. Schedule K-1 allocates the beneficiary's financial information from Form 1041. Each beneficiary includes the numbers from Schedule K-1 on their Form 1040.[100] The excess deductions from Form 1041 that pass to the beneficiaries are reflected on Schedule K-1, Part III, Line 11 "Final Year Deductions."[101] The excess deductions are then picked up by the beneficiaries on their federal income tax return, Form 1040, at line 23 of Schedule A, as miscellaneous itemized deductions for that same tax year.[102]

## Choosing Where to Use Deductions

In addition to being cognizant on the timing of taking deductions, a fiduciary also has to assess the best place to utilize the deductions. If the deductions are going to be taken on the Form 1041, a critical election, known as a

"642(g) election," is required to be filed with the tax return, otherwise the deductions may be disallowed.[103] The rules governing the election require a statement to be filed providing that deductions on Form 1041 have not already been allowed as estate tax deduction.[104] The purpose of the election is so the fiduciary does not "double dip" on deductions for fiduciary income tax and estate tax filings. Since the election must be made with the Form 1041, the fiduciary must be mindful that it affirmatively waives any rights to take deductions on estate tax return.[105] As such, it is imperative that the fiduciary knows that no estate tax return will need to be filed or, if one is required, that taking the deductions on the Form 1041 will produce an overall better economic result. If the estate tax is repealed, the election statement would still need to be filed since it is affirmatively required to take deductions on the Form 1041.[106]

The election statement is designed to only require affirmative election for the Form 1041. Tax preparation software will typically generate an election statement. Otherwise, a statement outlining the requirements of the Treasury Regulation should be made.[107] The election statement should be filed in duplicate, with the Form 1041 for the applicable tax year the items are being claimed as deductions.[108] The election statement can also be filed with the IRS Service Center in Cincinnati.[109]

### Managing Capital Gains: Including in DNI

Generally, capital gains are excluded from DNI.[110] They also constitute principal under Michigan's Uniform Principal and Income Act.[111] Thus, regardless of whether a Trustee distributes income, capital gains are accumulated and taxed at the trust level, unless the Trustee can find a way to distribute them to the beneficiary.

Federal income tax brackets for trusts are much more compressed than those of individuals, exposing trusts to the highest federal tax rates more quickly than individuals.[112] Trusts' compressed tax brackets, coupled with the Net Investment Income Tax ("NIIT"),[113] increases the likelihood that there will be a significant income tax rate differential between trusts and beneficiaries. A trust with undistributed capital gain income may not only be exposed to the highest capital gain income tax rate, but also incur the NIIT on undistributed net investment income and Michigan state income tax. This triple threat tax exposure provides the Trustee with much incentive to distribute the capital gain as part of DNI, if possible. This method of managing capital gain has become an important part of fiduciary tax planning, but is far from straightforward or easy to apply. The Trustee will need to work through multiple layers of authority, including the governing instrument, the Michigan Principal and Income Act, the Michigan Trust Code, and federal tax law to determine whether the gain can be distributed to the beneficiaries as part of DNI, rather than paying tax on that taxable income at the trust level.[114]

The Regulations provide that these kinds of adjustments will be recognized and respected by the IRS if they are done pursuant to the terms of the trust and Michigan law (the "first prerequisite") or pursuant to the trustee's reasonable and impartial exercise of discretion (in accordance with Michigan law (such as a power to adjust) or by the governing instrument if not prohibited by Michigan law (the "second prerequisite").[115] The trustee's exercise of any such power must be reasonable and generally consistent.[116] Only after one of the above prerequisites is met can the Trustee then proceed to include capital gain in DNI under one of the three methods outlined under the Treasury Regulations.[117]

### Using a Partnership to Carry Out Income and Capital Gain

In the same vein of managing capital gains, if the Trustee is not comfortable relying on one of the two prerequisites and three methods under the Treasury Regulations for including capital gain in DNI or does not want to take a risk that the IRS will not respect deviations

from general rules of the Uniform Principal and Income Act,[118] the Trustee can utilize a Michigan partnership or LLC (taxed as a partnership) to pass out capital gain as part of DNI. This works because generally, Schedule K-1 income from a pass-through business entity will carry out any income (including capital gain) distributed to the trust and then to the trust's beneficiaries.[119] With some exceptions, capital gain earned through a partnership in the normal course of business (not through a liquidation) generally constitutes trust accounting income.[120] Therefore, the distribution from the trust to the beneficiaries would be includable in DNI and avoid being taxed at the trust level.[121]

### Distribution in Kind of Appreciated Property

A trust will recognize income when it distributes appreciated property in satisfaction of a pecuniary bequest to a trust beneficiary who is entitled to a specific dollar amount or to specific property other than what was distributed.[122] The trust is treated as if it sold the property to the beneficiary at its fair market value.[123] This principle is often called the Kenan rule, after an early case that held that an estate recognized a gain when it distributed property in kind to satisfy a fixed dollar legacy.[124]

Knowing this is the general rule, a Trustee can avoid income tax recognition by making specific devises of property pursuant to the governing document. This is because a specific bequest that is in satisfaction of a specific bequest or devise under the terms of a trust is not considered a taxable distribution.[125] The beneficiary in this case takes over the adjusted basis of the asset in the fiduciary's hands.[126] These distributions do not carry out income to the beneficiary and they generate no income distribution deduction to the estate or trust.[127]

### Income Tax Deduction for Estate Tax Attributed to IRD

Not all assets get a step-up in basis. A category of assets known as income in respect of a decedent (IRD)[128] does not.[129] Remember, items that would have been income to a decedent, but were not recognized before death, retain their character and are income when received by the estate or beneficiary of the item.[130] The beneficiary of such an asset or its income will "step into the shoes" of the decedent and report the income in the same way the decedent would have if he or she had lived to collect it.[131] Common examples include wages earned but not yet paid when death occurs, installment notes receivable, dividends declared before death but paid later, traditional IRA accounts, and investments in annuities.

Like other assets that a decedent controlled at death, IRD assets are no different, and their value is included in a decedent's gross estate for federal estate tax purposes.[132] If Federal estate tax is attributed to the IRD being included in the gross estate, the IRD is in essence double taxed when the money is collected and reported for income tax.

To help allay double taxation, there is relief under IRC 691 that is often overlooked. This section provides that a taxpayer who includes in gross income any amount of IRD may deduct for the same taxable year that portion of the federal estate tax imposed on the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive that amount.[133]

If a trust is the recipient of IRD and makes no distribution of the income in respect of the decedent in the year in which it is received, the estate tax deduction belongs entirely to the trust.[134] If the trust distributes all or part of the income in respect of a decedent in the same year that it is received, an allocable portion of the estate tax deduction is passed through to the beneficiary receiving the distribution.[135] The IRD deduction for estate tax attributable to income in respect of a decedent available to a trust is computed by excluding from gross income of the trust so much of the decedent's post-mortem income as is properly paid, credited, or to be

distributed to the beneficiaries during the tax year, and such income shall be considered IRD to such beneficiary for purposes of allowing the deduction.[136]

### Unlimited Charitable Deduction

Just like individuals, trusts are eligible for an income tax deduction for certain payments made to or for the benefit of charitable organizations.[137] Unlike individual taxpayers, however, a trust is allowed to deduct any amount of gross income, without limitation, which, pursuant to the terms of the governing instrument is, during the taxable year in question, paid for a charitable purpose specified in IRC 170(c).[138]

The charitable deduction rules are more favorable to trusts than individuals for several reasons. First, the deduction for trusts is unlimited, whereas an individual's deduction is subject to a 50% of AGI ceiling.[139] Second, an election can be made to treat charitable contributions made in a subsequent tax year as being paid in previous taxable year.[140] This flexibility allows a trustee to conduct the necessary due diligence and determine whether a charitable deduction will provide the most economic impact to the trust and beneficiaries if claimed in the year it is actually paid or in the preceding year. Finally, trusts are permitted to make charitable contributions for a charitable purpose specified in IRC 170(c)(2) even if such contribution is to a foreign organization.[141]

This flexible charitable deduction rule is not without complication, however. For a charitable contribution by a trust to qualify for the income tax charitable deduction, the payment must be made "pursuant to the terms of the governing instrument."[142] Flexibility in the trust agreement may also help achieve the charitable deduction. The Supreme Court has held that it is not necessary that a trust instrument direct the charitable contribution claimed as a deduction; rather, it is sufficient that the charitable use is authorized in the trust instrument, and that the amount is actually distributed.[143] There are many favorable PLRs cited on this subject. One in particular ruled that a trust was entitled to an income tax charitable deduction for a charitable contribution where the trust agreement gave the beneficiary a lifetime limited power of appointment that could be exercised only in favor of charitable organizations, and the beneficiary exercised the power to cause the Trustee of the trust to distribute income to the charities.[144]

### Manage State Income Tax

A nongrantor trust that accumulates ordinary income and capital gains is taxed at the entity level. Just like individual taxpayers, the trust is subject to federal income tax and, potentially, but certainly not always, income tax in one or more states. Michigan's income tax is a direct flat-rate tax that applies to all taxpayers regardless of level of income. The tax rate in Michigan is 4.25% for 2016.[145]

The multiple layers of taxation warrant carefully analyzing the applicability of the income tax laws of Michigan and other states that have or could have a connection or nexus to the trust. Logically, virtually every state that imposes income tax will tax income sourced within the state.[146] Notably, however, many state legislatures have enacted one or more additional bases of state income taxation, which serve as "triggers" for imposing income tax on the trust. Some examples of states to which the authors have dealt with in practice on analyzing nexus tests include California, the District of Columbia, Maryland, Missouri, New Jersey, New York, Pennsylvania, Virginia, and Wisconsin, and impose state-level income tax under the following nexus tests:

(i) The trust is a testamentary trust and the testator of the trust was living in the state at his or her death;[147]

(ii) The trust is an inter vivos trust and the settlor is living in the state as a resident as of the date of creation of the trust, date of funding of the trust, during the current taxable year in question and/or the date on which the trust became irrevocable;[148]

(iii) The trust has at least one trustee or beneficiary who is a resident of the state;[149] and,
(iv) The trust is considered to be administered in the state (which may be determined by facts and circumstances or by a statute that, if a certain set of circumstances exists, finds the trust to be a resident of such state for state income tax purposes).[150]

Although trusts typically contain a provision that designates which state's laws govern administration, such a provision is not necessarily dispositive in the determination of the trust's state tax residency. Sometimes, courts are called upon to decide whether a state taxing authority has pushed the constitutional limits too far in asserting its ability to tax a trust based on the contacts existing between the subject trust and the state.[151]

States that tax trusts based on the tax residence of the trustee, tax residence of the beneficiary or any other factor besides the tax residence of the individual who created the trust, provide much more flexibility in managing the tax residence of the trust.[152] Specifically, Michigan taxes trusts created by the Will of a resident decedent (a testamentary trust) and inter vivos trusts created by an individual who was a Michigan resident at the time the trust became irrevocable.[153] Michigan may not, however, tax an inter vivos trust created by a Michigan resident if trustees, beneficiaries and the administration of the trust are all outside of Michigan, even if the trust holds Michigan real property (non-income producing).[154]

Knowing Michigan's general stance on what constitutes sufficient nexus is a good starting point to better understand potential strategies for managing (and perhaps shifting) state income tax residency. But state income tax management is not without complexity. Before a trustee can effectively shift a trust's state tax residency, the trustee must first identify the aspects of the trust which expose it to state tax liability currently and which create nexus in the prospective jurisdiction of residency. This requires a thorough analysis of the rules and procedures regarding trust tax residency in each jurisdiction, the terms of the trust instrument and the characteristics, including the location of the trustee, the trust assets and the beneficiaries. This due diligence process can be involved and as a practical matter, the trustee needs to consider whether the desired benefits are significant enough to justify the costs and risks that will be incurred in connection with a change of tax residency.

After preliminary due diligence is conducted, below are some strategies for the practitioner and trustee to consider when trying to manage state income tax liability:[155]

(i) Drafting flexibility in the trust for the appointment and resignation/removal of successor Trustees, initial place of administration and change of administration, and selection and change of governing law;[156]
(ii) Paying careful attention to Trustee distribution standards and ability of the Trustee to "bifurcate" the trust assets by asset class for more flexibility in management;
(iii) Creating sub trusts so that separate shares of beneficiaries who are nonresidents of Michigan can be administered as a separate trust and possibly be subject to a more favorable income tax state;
(iv) Given the mobility of beneficiaries and accounts, using financial institutions as custodian of marketable securities and liquid accounts that have places of business in multiple states with favorable income tax rates and close to where beneficiaries are located;
(v) Creating entities in income tax favorable states to hold trust assets; and
(vi) If permitted under the terms of the trust and Michigan law, decanting the trust or sub trusts to a new trust with more favorable provisions that allow for better state income tax management.

Finally, keep in mind that when a trust is subject to income tax in multiple states, it is necessary to conduct an analysis of the applicable state laws and sources of trust income to determine if a bifurcation of income is appropriate and if

some income items are subject to income tax in multiple states. Due to the lack of uniformity among the states, any state income tax credits may not offset in whole or in part, the income tax paid to the other state.

## Conclusion

Income tax planning during the administration of an irrevocable non-grantor trust is, and will continue to be, an important component of the Trusts & Estates practice. Some of the planning strategies outlined above are routine while others can be more complicated to implement. But all are worthconsidering under the right circumstances to help minimize taxes and preserve more value for trust beneficiaries.

### Notes

1. All references and citations to the Internal Revenue Code throughout this article shall be to the "Code" or "IRC."
2. IRC 651 and 661.
3. The planning considerations discussed in this article apply to non-grantor trusts taxed under IRC 641 et. seq. This article will not address planning involved with the special rules in subchapter J (known as the "grantor trust rules") that provide that if a grantor (or another person) of a trust holds an interest or a power described in IRC 671 through 679, then such grantor (or other person) is deemed to be the owner of the trust for federal income tax purposes.
4. IRC 6072(a).
5. *See* Treas. Reg. 1.671-4(b).
6. IRC 643(b). Estates and trusts are also subject to the same alternative minimum tax liability as individuals. IRC 55.
7. IRC 641(a).
8. IRC 651 and 661.
9. Treas. Reg. 1.661(a)-1.
10. *Id.*
11. *Id.*
12. *Id.*
13. MCL 555.501, et. seq.
14. IRC 643(b).
15. IRC 641 and Treas. Reg. 1.641(b)-1.
16. IRC 652(a) and 662(a); *see also* IRC 61(a)(15).
17. Treas. Reg. 1.641(b)-1.
18. IRC 643(a).
19. IRC 651(b) and 661(a) (limiting distribution deduction); IRC 662(a)(1) and (2) (limiting the taxable amount of a distribution).
20. Rev. Proc. 2015-53.
21. As will be discussed later in this article, under President-elect Donald Trump's tax plan, the capital gains rate may be reduced and the Net Investment Income Tax may be repealed. See https://www.donaldjtrump.com/policies/taxplan (last retrieved Dec 2, 2016); See also *e.g.*, Robert W. Wood, *Trump Tax Plan Could Impact 2016 Year-End Planning*, Forbes, November 14, 2016 (retrieved December 2, 2016 from http://www.forbes.com/sites/robertwood/2016/11/14/trump-tax-plan-could-impact-2016-year-end-planning/#69bd3949530d).
22. *E.g.*, *compare* IRC 651 *with* IRC 661 (specifying different deductions available to simple trusts and complex trusts).
23. MCL 555.503(1).
24. See Michigan Uniform Principal and Income Act, MCL 555.501 et. seq.
25. MCL 555.502(d) (income); MCL 555.804 (principal).
26. MCL 555.901(c)-(d) and MCL 555.902(1)(b)-(g) and (2).
27. MCL 555.901(a)-(b) and MCL 555.902(1)(a).
28. MCL 555.902(f) and MCL 555.901(c).
29. MCL 555.502(i).
30. MCL 555.502(g).
31. IRC 2056(b)(7)(B)(i)-(ii).
32. MCL 700.7103(d).
33. Treas. Reg. 1.661(a)-1.
34. MCL 555.502(g) and (h).
35. Treas. Reg. 1.661(a)-1.
36. IRC 641(b).
37. IRC 642(b).
38. IRC 642(b)(1).
39. IRC 642(b)(1)(B).
40. IRC 642(b)(1)(A).
41. *Id.*
42. IRC 651(b) and 661(a).
43. IRC 643(a)(1)-(6).
44. IRC 643(a)(6).
45. IRC 643(a)(4).
46. Treas. Reg. 1.643(a)-5(a).
47. *Id.*
48. IRC 643(a)(3). There are exceptions to this rule, which are mentioned later in this article. Also, the fiduciary income tax rules governing non-domestic (foreign) trusts generally include capital gains in DNI. This article only addresses domestic trusts.
49. Treas. Reg. 1.643(a)-3(b).
50. The three methods are outlined at Treas. Reg. 1.643(a)-3(b)(1) (the "first method"), Treas. Reg. 1.643(a)-3(b)(2) (the "second method"), and Treas. Reg. 1.643(a)-3(b)(3) (the "third method"). For an in depth discussion of

capital gain management and planning in connection with non-grantor trusts, see Malviya, Raj, (2014, June). "Fiduciary Income Tax Planning: Including Capital Gains in Distributable Net Income (DNI)." The Michigan Tax Lawyer, Vol. XL; *See also* Nicholas E. Christin & William A. Snyder, Minimize Capital Gains Tax of Estate, Trusts, and Beneficiaries, 41(4) Est. Plan. J. (WG&L), 11-17, Apr, 2014. Issue 2, Summer 2014); *See also* Frederick M. Sembler, Including Capital Gains in Trust or Estate Distributions After ATRA, March 2013 Trusts & Estates 23-29 (Mar 7, 2013). ); *See also* Jonathan G. Blattmachr & Mitchel M. Gans, The Final "Income" Regulations: Their Meaning and Importance, 2004 Tax Notes Today 96-35 (May 17, 2004); *See also* John Goldsbury, Practical Issues in Planning for the 3.8% Tax on Trusts/Estates (Focus Series), 48th Annual Philip E. Heckerling Institute on Estate Planning, Special Session III-C-1-32 (Jan 16, 2014).

51. MCL 555.504; Treas. Reg. 1.643(a)-3(b)(2).

*52. See* Reg. 1.643(a)-3(b)(1). While conversion to a unitrust income interest may be possible by petition to exercise the discretionary power to adjust under MCL 555.505(4), Michigan lacks a statute specifically permitting conversion to a unitrust as has been adopted in several states.

53. IRC 663(a)(1).

54. IRC 651 (a) and (b).

55. IRC 661(a). As explained above, this deduction is limited to distributable net income.

56. IRC 651(b) and 661(c).

57. IRC 644(a); IRC 645. In practice, the IRS automatically puts an Estate on a fiscal year (in determining the 1041 due date). An estate can essentially file on a calendar year end by filing a short year return.

58. IRC 652(b) and 662(b).

59. IRC 652(a).

*60. Id.*

61. MCL 555.602(2).

62. IRC 662(c).

*63. See* IRC 662(a)(1)-(2) and Treas. Reg. 1.661(a)-2 and 1.661(a)-3.

64. Treas. Reg. 1.661(a)-3.

65. IRC 663(c).

66. Treas. Reg. 1.663(c)-1(a).

67. Treas. Reg. 1.663(c)-3(a). The separate share rule does not apply, where, under applicable state law, separate trusts are created pursuant to the terms of the will or trust. *Id.*

68. Many of the planning considerations in this article apply to both estate and trusts. For ease in reference, the authors will generally refer only to trusts and trustees throughout the discussion, unless specifically stated otherwise.

69. IRC 645(a); Treas. Reg. 1.645-1.

70. IRC 645.

71. IRC 645(b)(1); 676.

72. IRC 645(b)(2)(A);Treas. Reg. 1.645-1(f)(2)(i).

73. IRC 645(b)(2)(B); Treas. Reg. 1.645-1(f)(2)(ii).

74. Additional benefits of 645 election include: (i) Material participation requirement as to threshold of real estate passive activity losses waived for 2 years following decedent's death (i.e. participation is treated as active) See IRC 469(i)(4); Treas. Reg. 1.645-1(e)(2)(i) and (3)(i); (ii) Ability to expense reforestation expenditures vs. only amortization. IRC 194; (iii) Charitable set-aside deduction allowed. IRC 642(c).

75. IRC 662(c).

76. Treas. Reg. 1.645-1(c)(2)(i).

*77. Id.*

*78. Id.*

*79. Id.*

80. Treas. Reg. 1.645-1(c)(2)(ii).

81. Treas. Reg. 1.645-1(c)(2)(i); IRC 6072.

82. IRC 663(b)(2).

*83. Id.*

*84. See* Form 1041 (last revised 2015).

85. IRC 663(b).

86. Treas. Reg. 1.663(b)-1(a)(2)(i).

87. IRC 663(b); Treas. Reg. 1.663(b)-1(a)(1).

88. IRC 663(b)(2);Treas. Reg. 1.663(b)-1(a)(1).

89. Treas. Reg. 1.663(b)-2(a).

90. These are expenses that are generally not subject to the 2% of AGI floor since they are costs that are not "commonly or customarily" incurred by individuals. See *Knight v Commissioner,* 552 US 181 (2008).

91. IRC 162; Treas. Reg. 1.162-1.

92. IRC 212; Treas. Reg. 1.212-1(d).

93. IRC 212(3).

94. IRC 212; Treas. Reg. 1.212-1(i).

95. Treas. Reg. 1.212-1(i); IRC 67(e); Treas. Reg. 1.67-4(b). These expenses are deductible to the extent they exceed 2% of the taxpayer's adjusted gross income. See *Knight v Commissioner,* 552 US 181 (2008).

96. IRC 165(c)(3).

97. IRC 642(h).

*98. Id.* These expenses are deductible to the extent they exceed 2% of the taxpayer's adjusted gross income.

99. IRC 642(h)(2).

100. IRC 652(a) and 662(a).

*101. See* IRS 2016 Form 1041 (Schedule K-1).

102. IRC 662.

103. IRC 642(g); Treas. Reg. 1.642(g)-1.

*104. Id.*

105. Treas. Reg. 1.642(g)-1.

*106. Id.*

*107. Id.*

108. Treas. Reg. 1.642(g)-1.

109. IRS Notice 2010-53.

110. IRC 643.

111. MCL 555.804(b).

*112.* *See* Rev. Proc. 2015-53 (providing inflation-adjusted tax rates). The 2016 highest income tax rate applies to married couples filing jointly on earnings over $466,950, while the highest income tax rate applies to trusts on all earnings which exceed $12,400.

113. Note that one of President-elect Trump's tax proposals is to repeal the NIIT. See FN No. 22, supra.

114. For a detailed discussion of capital gain management and avoiding the NIIT in connection with non-grantor trusts, see Malviya, Raj, (June 2014). "Fiduciary Income Tax Planning: Including Capital Gains in Distributable Net Income (DNI)." The Michigan Tax Lawyer, Vol. XL. See also Malviya, Raj and Gregory, George, (Jan 2015). *Drafting Trusts for the Net Investment Income Tax.* Presented for Michigan Institute of Continuing Legal Education Annual Estate Planning Drafting Seminar. See also Gadarian, Gregory V., Harris, T. Randolph H, Willms, Melissa J. "Treating Capital Gains as Trust Accounting Income: Essential Updates for Estate Planners." Sponsored by the American College of Trust and Estate Counsel (ACTEC).

115. Treas. Reg. 1.643(a)-3(b).

*116.* *Id.*

117. Treas. Reg. 1.643(a)-3(b)(1) – (3).

*118.* *See* Treas. Reg. 1.643(b)-1 (If it is determined that the provisions of the trust "depart fundamentally from traditional principles of income and principal", applicable state law will control). *See also* MCL 555.503(3) (requiring a fiduciary to use discretion impartially so that the result is fair and reasonable for all beneficiaries). This creates an opportunity for the IRS to take the position in audit that capital gains could not lawfully be re-allocated.

119. This strategy also works for S corporations; however, this article only focuses on partnerships because non-grantor trusts that hold S corporation stock will have other planning considerations that need to be addressed in order to be a qualified S shareholder.

120. MCL 555.801(2). Exemptions to this treatment are: 1) if the gains received are in a total or partial liquidation of the entity, 2) if the entity is a regulated investment company, real estate investment trust, or 3) if the funds distributed constitute a capital gain dividend. Some exceptions are liquidation of entity or partial liquidation. MCL 555.801(3). The Court of Claims has held that capital gain distributed in the ordinary course of a partnership's operations is includible in DNI. *Crisp v United States*, 34 Fed Cl 112 (1995). However, the facts of that case might not cause one to find comfort in all partnership situations, as the partnership was a relatively small investment relative to the trust's other assets.

*121.* *See* IRC 643(a) (definition of DNI).

122. Treas. Reg. 1.661(a)-2(f).

123. IRC 643(e)(2).

*124.* *Kenan v Commissioner*, 114 F2d 217 (2d Cir 1940).

125. IRC 643(e)(4). Treas. Reg. 1.651(a)-2(d) and Treas. Reg. 1.661(a)-2(f).

126. IRC 643(e)(1).

127. Treas. Reg. 1.661(a)-2(f); IRC 663(a).

128. Treas. Reg. 1.691(a)-1.

129. IRC 1014(c).

130. Treas. Reg. 1.691(a-b); IRC 691(a)(3); Treas. Reg. 1.691(a)-3(a).

131. IRC 691(a)(2).

132. For example, *see* IRC 2033, 2039.

133. IRC 691(c)(1)(A); Treas. Reg. 1.691(c)-1(a).

134. IRC 691(c)(1); Treas. Reg. 1.691(c)-2(a)(1).

*135.* *Id.*

136. Treas. Reg. 1.691(c)-2.

137. Under IRC 642(c), certain trusts (specifically, trusts established before October 8, 1969 that meet certain requirements outlined in that Code section) may deduct gross income "permanently set aside" for the benefit of a charitable organization, as well as income currently paid to such organizations.

138. IRC 642(c)(1).

139. IRC 642(c); 170(b)(1)(A). In some cases, an individual's charitable deductions are limited to 30% of AGI. *See* IRC 170(b)(1)(B).

140. IRC 642(c)(1) (permitting a trust to elect to treat a charitable contribution paid after the close of a taxable year (but before the last day of the following taxable year) as having been paid during such taxable year).

141. IRC 642(c)(1). Compare this rule to U.S. individual taxpayers, who are limited to making charitable contributions only to those charitable organizations created or organized within or under the laws of a state, the U.S., a U.S. possession or the District of Columbia. IRC 170(c)(2)(A).

142. IRC 642(c)(1).

*143.* *Old Colony Trust Co v Commissioner*, 301 US 379 (1937).

144. PLR 200906008.

145. MCL 206.51(1)(g).

146. The constitutionality of taxing income at its source was established almost 100 years ago. *Shaffer v Carter*, 252 US 37 (1920).

*147.* *E.g.* New Jersey, NJSA § 54A: 1-2(o); Pennsylvania, Pa Code 61 101.1 (trusts which are partially funded by a resident transferor are also taxable under this provision; *but see* FN 155 and associated text); District of Columbia, D.C. Code 47-1809.01; Illinois, 35 Ill. Comp. Stat. 5/1501(a)(20)(C)-(D); New York, N.Y. Tax law 605(b)(3)-(4) (Note: New York City also taxes trusts under the same regime. *See* Admin. Code City of N.Y. 11-1704.1.).

*148.* *E.g.* Missouri, Mo. Rev. Stat. 143.331.1.

*149.* *E.g.* California, Cal. Rev. & Tax Code 17041(a), (e), (h).

*150.* *E.g.*, Wisconsin, Wis. Stat. 71.14(3); Virginia, Va. Code Ann. 58.1-302 (Virginia and Wisconsin also tax trusts which are created by the Will of a resident decedent or an inter vivos trust created by a resident settlor. *Id.* and Wis. Stat. 71.14(2). Virginia also taxes trusts which are at least partially funded by a resident transferor under the same provision; *but see* FN 155 and associated text.).

151. For an in depth discussion of the constitutionality of state income taxation of trusts, *see* Gutierrez and Keydel, State Taxation of Trusts with Multi-State Contacts, ACTEC Studies, Study 6, 6-5 – 6-8 (September 2001).

152. See Michaels & Twomey, State Income Tax Issues With Trusts, 2011 Cannon Financial Institute, Inc. 7-

153. MCL 206.18(1)(c).

*154.* *Blue v Department of Treasury*, 185 Mich App 406, 462 NW2d 762 (1990).

155. This article does not address DINGs, but they should be considered for managing state income tax liability. The IRS recently issued a series of taxpayer-favorable private letter rulings regarding a trust structure referred to by practitioners as "Delaware Incomplete Gift Non-Grantor Trusts", or "DING trusts." By structuring a trust as a DING trust, a trust settlor may be able to mitigate overall income tax exposure by shifting assets and, potentially, state income tax liability from a high-income tax state to a state with more favorable income tax laws (or perhaps to a state that does not impose state-level income tax on trusts). PLR 201310002; PLR 201310003; PLR 201310004; PLR 201310005; and PLR 201310006.

156. Michaels & Twomey, supra. Be mindful of MCL 700.7108(1), which outlines the principal place of administration of a trust and effectively warns that the terms of a trust designating a principal place of administration do not necessarily control if the Trustee's place of business or place of the ongoing administration deviate too much from the place designated in the trust. See also MCL 700.7108(2), which provides the Trustee has a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the qualified trust beneficiaries. But then see MCL 700.7108(3), which gives the Trustee flexibility to change the place of administration if it will correlate with the objectives in (2) Finally, *see also* MCL. 700.7401 et. seq. (Part 4 of the Michigan Trust Code, Creation, Validity, Modification, and Termination of Trust, does not require a court proceeding to replace a trustee, even if the effect of the trustee's resignation and replacement affects the trust's Michigan income tax liability).

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