Estate & Succession Planning Corner

The Ties that Bind: Administering the Trust

By Louis S. Harrison

Administration: A Bridge Too Far?

As estate planners, we often focus on our role as strategists, planners that set up a workable estate plan. Examples include establishing a family limited partnership to achieve estate tax discounts, or creation of one or more trusts for estate tax reduction, or establishment of a trust for creditor or spousal protection.

Once techniques are implemented, both planners and clients often experience a certain *laissez faire* towards the steps post signing, the actual administration of these strategies. In past articles, we have discussed the importance of correct administration of partnerships, including a focus on income tax planning. This month's planning column focuses on the parallel importance of proper trust administration.

What Kind of Tax Animal Is This Trust?

Step one then is to revisit to what type of income taxation the trust is subject, and to coordinate filings accordingly. For example, all qualified personal residence trusts (QPRTs) and grantor retained annuity trusts (GRATs), are grantor trusts during the retained term. Further, in sales to trusts, typically the trust is a (defective or effective, depending on your bent) grantor trust. At the end of retained terms in QPRTs and GRATs, the successor trusts may be structured as grantor trusts; and gifting trusts may also be grantor trusts.

Revocable living trusts are grantor trusts during the lifetime of the grantor, and post mortem, are usually simple or complex (nongrantor in either variety) trusts.

If the practitioner determines a lifetime trust is a grantor trust, the next step is to make sure the accounts are set up with the grantor's social security number[1] and that the grantor's tax compliance professional, typically the accountant, is notified of the trust and that income of the trust will flow to the grantor's 1040. The accountant should also be ready to file a grantor trust information return for the trust.[2]

No other tax scheduling is required for the trust, other than focus on when to recognize taxable gains, and whether to do substitution. [See discussion below on "Adding Value through Tax Planning."]

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If the trust is a nongrantor trust, then compliance needs to be done immediately.[3] These include lifetime gifting trusts that are nongrantor trusts, and typically testamentary trusts, trusts created under estate planning documents that come into play at a grantor's passing.

These trusts require the following steps for administration: step one, apply for an EIN, and make sure the accounts are registered accordingly. Step two, determine who will file the income tax returns on an annual basis. Step 3: consider immediately the need for estimated tax payments. Some trusts may not; grantor trusts that become nongrantor trusts at death have a two-year window before estimated taxes are required. Step 4: docket December 1 each year for income tax planning, and determining whether the trust or the beneficiaries should pay the tax (see discussion, below).

In order to have a successful planning strategy, administration of the trust post signing, in a compliant and thoughtful way, must be done.

In addition to being income tax compliant, the trust needs to have "i's" dotted and "t's" crossed, as with asset titling.

Details are Painful: Compliance with Titling

One of the least favorite actions of any professional is completing administrative forms on titling of assets. Different financial institutions have different requirements, the forms are tedious, and forms often get stuck somewhere in the process before completion.

Transferring title of assets transferred to an irrevocable or revocable trust is of critical importance. For example, with GRATs, the Code and regulations contemplate that title of assets will be transferred concurrently with the establishment of the GRAT.

Gifting trusts may become incomplete for gift tax purposes—a no-no—if the intended asset is not actually transferred to the trust.

Even the straightforward funding of revocable trusts can become more sophisticated than it appears. For example, a quitclaim deed transferring a residence, itself easy to complete, can invoke other needed documents. For example, consider the need to assign over the title insurance when real property is transferred into a living trust (many recent title insurance policies, like the ALTA form, do not require an assignment any more); and perhaps to notify the home insurer. If there is a mortgage on the property, ponder whether the lender needs to be notified. Under federal statutes,[4] the transfer of property from an individual to that individual's living trust will not accelerate a loan secured by that property. However, as a matter of protocol, practitioners will often notify lenders and get that consent.

Beneficiary designations are often overlooked in the titling process, but are of equal importance. For example, we often field the question, "How can I transfer my IRA to my living trust; the IRA custodian says it has to be the owner, and no transfer is permitted?" The statement by the IRA custodian is correct, and instead of focusing on ownership at the trust level, the practitioner should consider the beneficiary designation being at the trust level (or to the surviving spouse, for rollover planning, for income tax purposes). Similarly, insurance and other beneficiary designation accounts should have the living trust as the primary (and only) designation, assuming there is no other reason to name an individual.

In terms of compliance with titling, we usually construct an excel spreadsheet with columns as to assets, suggested title, and status. On the status item, we either add to the calendar each month, or the task bar, a status question to follow up on titling until a client's full funding for the living trust is completed.

A Taxing Matter: Income Tax Compliance

Whether we are dealing with grantor or non-grantor trusts, we need to calendar tax compliance dates. These should be the following: tax filing timeline (April 15 and extensions), estimated tax payment dates (same as for individuals), determinations whether to carry out income to the beneficiaries through distributions (see below), to be done December 1 and January 30 each year, and communications in January/February to the beneficiaries about possible taxable income a beneficiary may receive for the prior year.

Who's calling? Beneficiary Communications

Not in the last 30 years has communication with beneficiaries been easier than it is today. We have the phone,

Continued on page 53

Estate & Succession

Continued from page 14

and correspondence, but these were there 30 years ago. In addition, there is email, there is text, and there is FaceTime and other video conferencing. We have the tools to ensure proper beneficiary happiness.

Communication with beneficiaries should include the basics—that they are a beneficiary, that A and B are trustees, and that they may be receiving distributions based on [here you

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want to insert both the standards of the trust and the expectations of the grantor and the trustee as to when distributions will be made].

On distributions, and what to expect annually, the best communication is a meeting between trustee and beneficiary, in person or by phone. At the meeting, the trustee can forewarn the beneficiary as to information the trustee may need in making annual decisions, such as a beneficiary tax bracket.

Beneficiaries should also receive trust financial reports each year. This is critical to a trustee on two fronts. First, it avoids surprises, irritation, and beneficiary unhappiness with investments. Second, pursuant to the terms of the trust or state trust statute, it starts a statute of limitation period during which the beneficiaries have to object or be barred from thereafter questioning the trustee's actions during that reporting period.

Beneficiaries also should not be surprised about taxable income allocations. If the trustee is making a distribution that will carry out income, the trustee needs to notify the beneficiaries well in advance, even if it is just an estimate.

Adding Value with Tax Planning: Grantor Trusts

Assuming all else has been taken care of, one of the luxuries—what we can call "value added"—to engage in is tax planning. We had initially discussed the predicate determination of whether the trust is a grantor or nongrantor trust. The planning opportunities are different based on which kind of trust is involved.

If a grantor trust, we need to be focused on two categories of items, the income tax effects of the trust on the grantor, and eliminating inherent capital gain with the beneficiaries.

On the income tax effects to the grantor, we need to advise the grantor that items of income or deduction will flow through to the grantor and be included in the grantor's income tax return for compliance purposes. The grantor's accountant should be notified (and should, along with the grantor's 1040, file an information return, Form 1041, for the trust, so that all items can be more easily coordinated and demonstrated to be so).

Also, assets in the trust should be considered when focusing on the grantor's income tax planning. For example, early recognition of losses, what has become known as the "harvesting of capital losses," should be considered even at the trust level, so that the grantor can use those losses on the grantor's return.

The effect of incurring capital gain at the grantor level should be considered before any asset is sold by the trust. However, this negative effect to the grantor may be overridden by a positive effect to the trust beneficiaries.

That positive effect gets into the second category of planning, eliminating inherent capital gain to the trust. One of the detriments of a grantor trust is that often low basis assets will find themselves as capital of the trust. For example, in a "sale to a grantor trust" strategy, because the sale is not recognized for taxable income purposes, low-basis assets can (and often will) be used as the asset sold to the grantor trust. And these low-basis assets will retain their basis at the trust level. The value of what the beneficiaries will have then becomes gross fair market value less inherent capital gains tax, which is less than gross fair market value less no tax.

The tax can be eliminated by having the trust sell a low-basis capital gain asset, thereby returning the face (and new high basis) value to the trust, and jamming the grantor with the capital gain. Alternatively, assets can be substituted into the trust by the grantor, either pursuant to an express substitution power, or a nontaxable sale and purchase between the grantor and the trust.

For example, assume the grantor trust has Berkshire Hathaway stock worth $1 million with a basis of $10,000. The grantor could exchange—and this would be a nontaxable exchange—the stock for $1 million of bonds. The trust would then have $1 million of essentially high basis assets—bonds—and the grantor would have the low-basis Berkshire Hathaway stock. That low-basis stock could receive a step up in basis at the grantor's passing.

The income tax basis planning for a grantor trust becomes an important add-on strategy to the overall administration.

Income Tax Planning and Nongrantor Trusts

Income tax planning is important for nongrantor trusts, too. Here the basis issue is much more difficult to resolve. Investing at the trust level becomes more critical for nongrantor trusts in the sense that the trust's after-tax return can be much different than its before income-tax return.

Income tax planning by the trustee and practitioner is valuable each year. For the trust, the planning is focused on whether the trust, or its beneficiaries, should receive taxable income in a given year. Subchapter J of the Code, the income tax provisions applying to trusts, essentially allocates income earned by a trust as between the trust or the beneficiaries, based on what has been distributed, or not, each year. And the trustees have 65 days after the first of each year, to decide whether to make a distribution and elect to

have that distribution apply to the prior year.

For tax planning purposes, the trustee may want to make a distribution to carry out taxable income, if that distribution will shift income in a meaningful way to the beneficiaries who are in a lower income-tax bracket (subject, of course, to a review of any generation skipping tax planning, a subject for another day). Ordinary income generated in a year can be shifted to the beneficiaries in that year if there is a distribution equal to or greater than that income. Capital gain is a bit more difficult to shift to beneficiaries, but under Code Sec. 643, the trustee can arguably shift capital gains to the beneficiaries, as well. Since capital gain rates are generally the same between beneficiaries and trusts, this shifting will occur under unusual circumstances; for example, a beneficiary may have unused capital losses or capital loss carryovers; or estimated taxes have not been taken care of by the trust, but have been by the beneficiaries.

Other planning at the trust level is similar to what is done for individuals, including harvesting tax losses, moving deductible losses into different years (primarily the payment of trust and attorneys' fees), arguing that fees are not subject to the two-percent floor on miscellaneous itemized deductions because they are necessarily incurred for proper trust administration, and making sure estimated tax payments are safe harbored.

Conclusion

Taking a deep breath after doing the planning and implementing a trust is a good idea. But the planning race is far from over at that stage. In order to see the planning strategy to the finish line, administration of the trust post signing, in a compliant and thoughtful way, must be done. The above areas provide an outline of the steps that a practitioner should consider post trust signing.

ENDNOTES

[1] This is not necessarily required, but practice in 2014 is to use a grantor's social security number for grantor trusts.

[2] This result is also not necessarily required, but is considered and should be considered a Best Practice.

[3] Trusts could also be grantor trusts as to a beneficiary, when the beneficiary has a withdrawal power, including an annual exclusion *Crummey* right, under Code Sec. 678.

[4] 12 U.S. Code § 1701j–3 (d)(8)