

**NEW JERSEY INSTITUTE FOR
CONTINUING LEGAL EDUCATION**

HOT TIPS IN TAXATION

JANUARY 29, 2015

**TRUST AND ESTATE
PLANNING CONSIDERATIONS
FOR THE 3.8% TAX ON
NET INVESTMENT INCOME**

Presented by:

Brian D. Reynolds, Esq.

**MANTELL, PRINCE & REYNOLDS, P.C.
Mountain Heights Center at Berkeley Heights
430 Mountain Avenue
Murray Hill, New Jersey 07974
908-464-5900
FAX: 908-464-5901
breynolds@mantell-prince.com
www.mantell-prince.com**

TRUST AND ESTATE PLANNING CONSIDERATIONS FOR THE 3.8% TAX ON NET INVESTMENT INCOME

I. Basic Statutory Structure; Regulations.

- A. The tax on “net investment income” was technically part of the Health Care and Education Reconciliation Act of 2010, which was passed one week after the Patient Protection and Affordable Care Act, but the two statutes are collectively called the Affordable Care Act.
- B. Section 1411 imposes a surtax (in addition to federal income taxes) of 3.8% on the unearned income of individuals, estates, and trusts for taxable years beginning after December 31, 2012 (which is commonly referred to as the “Medicare tax”).
- C. For estates and trusts, §1411(a)(2) imposes a tax equal to 3.8% times the lesser of —
 - a. the estate’s or trust’s adjusted gross income (as defined in §67(e)) in excess of the highest income tax bracket threshold (\$12,150 for 2014 and \$12,300 for 2015), or
 - b. the estate’s or trust’s undistributed net investment income.
- D. The threshold for estates and trusts is the dollar value for the highest income tax bracket for estates and trusts, which is indexed, but which is a very low number (\$12,150 for 2014 and \$12,300 for 2015).

II. AGI of Estate or Trust.

- A. The AGI of an estate or trust is determined under §67(e). AGI is computed the same as for an individual except that deductions are allowed for charitable contributions, the personal deduction, distributions to beneficiaries, and costs “which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if property were not held in such estate or trust.”
- B. As a general rule, most of the income of estates and trusts will be net investment income.

III. Capital Gains.

- A. Capital gains are an item of net investment income. While distributions reduce both AGI and net investment income, capital gains cannot be distributed without authority in the trust instrument or state law for doing so. Trust instruments can either mandate how distributions are allocated against various types of taxable income, or can give the trustee discretion to allocate capital gains to income that is distributed.
- B. Capital gains ordinarily are excluded from DNI. Reg. §1.643(a)-3(a). However, the regulations provide the capital gains will be included in DNI if they are, (1) "pursuant to the terms of the governing instrument and applicable law" or (2) "pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law).

IV. Distributions.

- A. Distributions from an estate or trust may reduce the income subject to the top 39.6%/20% rates on ordinary and capital gains income, respectively, as well as reducing the income subject to the 3.8% tax on net investment income. Thus, distributions to beneficiaries can save tax, if the individual beneficiary is not in the top tax bracket. In addition, distributions can save the 3.8% tax on net investment income if the beneficiary does not have AGI exceeding the \$250,000/\$200,000 threshold for individuals.
- B. This may present additional pressure on fiduciaries to make distributions. Of course, the fiduciary must look to the distribution standards in the trust agreement to determine the extent to which these tax considerations come into play. If the distribution is based solely on the health, education, support, and maintenance of the beneficiary, the trustee may not have the authority to take into consideration tax effects of distributions.
- C. **65 Day Rule**. Under IRC Section 663(b), the fiduciary may elect to treat distributions made during the first 65 days following the close of the taxable year as if they had been made on the last day of the prior year. An estate's or trust's taxable income may not be determined by the end of the taxable year, and the 65 day rule can be helpful in planning distributions to carry out income to multiple beneficiaries, each of whom have higher thresholds, than subjecting income to taxation at the trust or estate level.

- D. **PRACTICE POINT:** You should meet with every client for whom you established a non-grantor trust, every executor you represent and/or every fiduciary for whom you prepare a Trust or Estate's Form 1041 at or near the end of the year to determine if there are benefits to making distributions. Of course, with respect to trusts, the distributions must be within the trustee's authority.

V. **Material Participation by Estates and Trusts.**

- A. The combination of the new top rate bracket that applies to trusts with taxable income of only \$12,150 for 2014 (\$12,300 for 2015) and the 3.8% tax on undistributed net investment income of trusts results in a dramatic percentage increase in the federal income tax rate that applies to trusts.
- B. Passive income is included in both AGI and net investment income. The **material participation requirements** under the §469 passive loss rules are used for this purpose. Section 469(h)(1) defines material participation as an activity in which the taxpayer participates on a "regular, continuous, and substantial basis."
- C. Individuals can use one of seven tests to establish material participation to avoid passive income treatment.
- D. The rules are not as clear regarding material participation by trusts or estates.
- a. **Grantor Trusts** – the Grantor's material participation controls
- b. **Non-Grantor Trusts** – The Trustee has to materially participate (See TAM 201317010 and *Frank Aragona Trust v. Commissioner*)
- E. Technical Advice Memorandum 201317010.
- a. IRS Position on material participation by trusts
- b. IRS refuses to recognize the activities of a co-trustee who was also the president of a subsidiary of an S Corporation in which the trust owned an interest reasoning that the activities were largely in the individual's capacity as an employee and not as a trustee.

- F. *Frank Aragona Trust v. Commissioner* (142 T.C. No. 9)
- a. Facts: The Trust was the sole owner of an LLC that managed real estate. 3 of 6 Co-Trustees (not a majority) were active in the business.
 - b. Issue: The issue in the case was whether the Trust could deduct rental losses or whether they were passive losses and therefore not currently deductible.
 - c. Holding: The Trust materially participated in the real estate rental business which is one of the requirements of the "real estate professional exception" under IRC Section 469(c)(7).
 - d. Whether a trust materially participates in a business is increasingly important because non-passive business income is NOT subject to the 3.8% tax on net investment income.
- G. See also *Mattie K. Carter Trust v. U.S.*, 256 F. Supp.2d 536 (N.D. Tex. 2003); Letter Ruling 200733023; Letter Ruling 201029014; and Technical Advice Memorandum 201317010.
- H. **PRACTICE POINT.** If a non-grantor trust owns an interest in an active trade or business operation, a planning consideration will be whether to name some individual who is actively involved in the business as a co-trustee.
- I. A leading practitioner has suggested that pursuant to the Regulation under IRC Section 1411, Character is Determined at the Trust Level
- a. If it's Net Investment Income at the trust level, it stays Net Investment Income at the beneficiary level even if the beneficiary materially participates.
 - b. Presumably, the reverse is true.
- J. Consider the following **EXAMPLE:**
- A&B own 80% of successful and profitable LLC. They are brothers. Trust set up by father owns 20% of LLC. Trust is complex trust. Bank and lawyer are trustees.
 - Trust share of 2014 LLC profits is \$200,000. Trust is passive owner of LLC for sure. Beneficiaries of Trust are 4 children of

father, including A&B. Trustees make discretionary decision to distribute all profits of LLC equally to 4 children, \$50,000 per child. If Trust retained profits the 3.8% surtax would be imposed on the income.

- Assume all four children have well over \$250,000 in taxable income before distribution from Trust. Children C&D have no involvement in LLC. C&D will be subject to the 3.8% surtax on the \$50,000.
- Are A&B subject to the 3.8% surtax on the Trust distribution to them. We know they are not subject to the 3.8% surtax on their share of the LLC profit since they are active in the business of the LLC and materially participate pursuant to IRC Section 469. But the Trust passes out passive income since it is clearly not active. Does the character of the income morph to active when it is reported by A&B?