The Continuing Tax Benefits of Non-Grantor Trusts

Biography

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Among professional activities, which are too numerous to list, Mr. Blattmachr has served as an Advisor on The American Law Institute, Restatement of the Law, Trusts 3rd; and as a Fellow of The New York Bar Foundation and a member of the American Bar Foundation.

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Introduction

This article will discuss some of the potential income tax disadvantages of non-grantor trusts and how they might be avoided or mitigated.[1] In the first part, it will describe some of the advantages and disadvantages of using such trusts both under current law and under recent legislation that is part of One Big Beautiful Bill Act (OBBBA) legislation enacted earlier this year. In the second part, the use of the charitable deduction allowed to a trust is discussed and how OBBBA may have made it less valuable than before. In the third part, the potential use of a trust described in Section 678 is discussed. In the fourth part, having the beneficiaries of a trust include a so-called "S corporation" is explored. In the fifth part, a summary and conclusions are offered of whether the income tax burden on non-grantor trusts may be reduced.

Part 1: Advantages and Disadvantages of Non-Grantor Trusts

It seems appropriate before describing some of the advantages and disadvantages of non-grantor trust is to first discuss some of the consequences of trusts in general.

Some Benefits and Burdens of Trusts

Trusts serve many purposes including providing asset protection and avoiding unwise dissipation of wealth.[2] Trusts can provide succession planning, for example, by prudently designing and naming persons in various trust director capacities (e.g., a qualified person to be an insurance trustee, and a different person to have investment decision making over business assets, etc.). Trusts also provide a mechanism to create checks and balances which can be particularly useful in protecting aging or infirm clients.[3] Trusts may provide specialized applications to "safeguard" religious beliefs.[4] Trust may provide specialized applications to safeguard the interests of LGBTQ clients.[5] Trusts also may offer the most

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[1] A non-grantor trust is one that is not a deemed owner trust (commonly called "grantor trusts" under the provisions of subpart E of part 1 of subchapter J of Chapter 1 of the Internal Revenue Code of 1986 as amended ("Code"). Under Section 671, the income, deductions and credits against tax of the trust are attributed to the trust's grantor and, in one case, under Section 678, to a beneficiary who has the unilateral right to withdraw property from the trust. See, generally, J. Blattmachr, M. Gans & A. Lo, "A Beneficiary as Trust Owner: Decoding Section 678." 35 ACTEC J. 106 (2009). Throughout this article, "Section" is a reference to a section of the Code, and the term "trust" when not otherwise indicated means a non-grantor trust.

[2] See, generally, J. Blattmachr & D, Blattmachr, "Even Without Estate Tax the Right Answer Is Still the Same, Put It All in Trust," Leimberg Estate Planning Newsletter #2489.

[3] M. Shenkman, "Estate Planning for the Chronically Ill, Aging, and Otherwise Vulnerable or Isolated Client," 30 Probate &, Property 3 (May/June 2016), pg. 23.

[4] See, for example, Y. Ali & M. Shenkman, "Sharia Inheritance Estate Plans," 160 Trusts & Estates 50 (Sept. 2021)

[5] S, Kriz, M. Seyhun, V. Kanaga & M. Shenkman, "LGBTQ Planning Issues: Using a Special Trust Advisor," 159 Trusts & Estates 14 (July 2020).

efficient platform for income tax planning by their ability to shift income out of the trust to beneficiaries[6] and to do so within 65 days after the close of the trust's tax year,[7] to obtain an unlimited income tax charitable deduction,[8] and to avoid state income taxes.[9] The 65 day rule poses unique planning opportunities, and risks, for trustees, trust income tax return preparers, as discussed below, if the proposed surtaxes are enacted.

Some Benefits and Burdens of Grantor Trusts

In recent years, grantor trusts have been the primary platform upon which lifetime estate planning has occurred. Grantor retained annuity trusts (GRATs), described in Treas. Reg. 25.2702-3(b), almost always are grantor trusts which is advantageous because it not only allows the trust (and ultimately its beneficiaries, other than the grantor) to receive income and growth without income tax (because the income of a grantor trust is attributed to the grantor) which essentially allows growth and income for others to occur income tax free, but it also permits the trust to satisfy the required annuity payments with appreciated assets without gain recognition.[10] A sale of appreciated assets to a grantor trust by its grantor[11] does not result in gain recognition and if the trust pays for the property with a note, the interest need be only at the Applicable Federal Rate (determined monthly pursuant to Section 1274)[12] and will not be subject to income tax.[13]

Probably, the major wealth transfer benefit of a grantor trust is that, as indicated, it allows the trust to grow on an income tax free compounded basis as the grantor not the trust generally bears the burden of the income tax (unless the trust includes a tax reimbursement clause that the trustee acts upon[14]), one of the most powerful factors in financial planning, when it can be achieved.[15]

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[6] See Sections 651-652 and 661-662.

[7] See Section 663(b).

[8] Section 642(c) and see, generally, J, Blattmachr, L. Boyle & R. Fox, "Planning for Charitable Contributions by Estates and Trusts", 44 Estate Planning 3 (Jan. 2017).

[9] See, generally, J. Blattmachr & M. Shenkman, "State Income Taxation of Trusts: Some Lessons of *Kaestner*," 46 Estate Planning 3 (Oct 2019). State income taxation also may be avoiding by using an electing small business trust described in Section 641(c). See, generally, L. Boyle, J. Blattmachr & M. Gans, "Planning Opportunities with ESBT's: Saving State and Local Income Taxes*,"* 129 J. of Tax'n 20 (July 2018).

[10] See Rev. Rul. 85-13, 1985-1 CB 184. Note that some proposals in Congress could change the result. On September 25, 2021, the House Budget Committee approved legislative language for the Build Back Better Act..

[11] See J. Blattmachr, "Adventures in Partial Interest Transfers: Avoiding the Legacy of Zero Valuation Under Section 2702," 45 Major Tax Planning – University of Southern California's Annual Institute of Federal Taxation ¶1300 (1993) at ¶1304.5[G].

[12] See Section 7872.

[13] See Rev. Rul. 85-13, 1985-1 CB 184..

[14] Cf. Rev, Rul. 2004-64, 2004-27 IRB 7.

[15] J. Glickman & J. Blattmachr, "High Returns and Tax-Free Compounding: Keys to Building Wealth"*,* 43 Estate Planning 11 (May 2016).

However, because the income of a grantor trust is attributed to the grantor for federal income tax purposes, opportunities to reduce the income tax burden by using a non-grantor trust generally are inhibited.

Some Benefits and Burdens of Non-Grantor Trusts

Income which is taxed to a non-grantor trust is much more will likely to face the highest federal income taxes, including having all taxable income essentially above $16,000[16] taxed at the highest federal rate (37% on ordinary income in 2021) and subject to the net investment income tax under Section 1411 of 3.8%. One of the major benefits of a non-grantor trust is that it can be used to avoid certain state income taxes even if the grantor and the beneficiary are subject to them.[17] There may be other income tax advantages of non-grantor trust, including the ability to shift the trust's income (to the extent of its distributable net income, known as DNI, defined in Section 643(a)), to a beneficiary of the trust,[18] maximize state and local tax (SALT) and charitable deductions,[19] etc.

The major federal income tax disadvantage is that the trust will reach the top federal tax rates at about $13,000 of income. Other than for a married person filing separately, an individual taxpayer does not reach the top bracket until well over $500,000 of taxable income. Moreover, an individual may use a standard deduction under Section 63 of between around $12,000 and $24,000. A trust (other than a qualified disability trust)) does not receive any standard deduction and is only afforded an exemption amount of $100 or $300.[20]

That means, except for the wealthiest of families, undistributed taxable income of a trust likely will face more income tax than if it were taxed to individual family members.

To some degree this higher federal tax burden may be offset by the avoidance of state income tax where the individual would face that tax but the trust does not. In general, and with careful planning, a

[16] See Section 1(e) and (j)(2)(E). The rates are inflation adjusted each year pursuant to Section 1(f). Proposals made in Congress would have decedent's estate and a non-grantor trust reach the top federal income tax bracket for both the regular federal income tax purposes and for purposes of the net invest income tax (NIIT) at $12,500.

[17] See Note 9, supra. and w. Lipkind, M. Shenkman & J. Blattmachr, "How ING Trusts Can Offset Adverse Effects of Tax Law: Part I," 144 Trusts & Estates 26,(Sept. 2018), and W. Lipkind, M. Shenkman & J. Blattmachr, "How ING Trusts Can Offset Adverse Effects of Tax Law: Part II," 144 Trusts & Estates 29 (Dec. 2018).

[18] See, generally, M. Lobb, J. Blattmachr & D. Zeydel, "When is a Non-Grantor Trust Preferable?", Peak Trust Company News Letter 2020, available at https://www.peaktrust.com/2021/11/08/when-is-a-non-grantor-trust-preferable/.

[19] Shenkman & Blattmachr, "Trust Planning After the New Tax Law," 144 Trusts & Estates 13, (Feb. 2018)..

[20] Section 642(b). A greater deduction is permitted for a qualified disability trust described in Section 642(b)(2)(C).

non-grantor trust may be able to avoid state income tax which neither its grantor nor beneficiary could avoid.[21]

Separate Trusts May or May Not Help Much

Creating separate trusts to reduce federal income tax may not help much. Under Section 643(f), two or more trusts will be treated as one trust for federal income tax purposes if they have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a principal purpose of the trusts was to avoid federal income tax. Hence, a trust created for child and another one for the child's spouse likely will be treated as one trust if income tax reduction was a purpose for creating two trusts.[22]

On the other hand, creating one trust primarily for each child (or possibly each descendant) of a taxpayer likely will not fall under the consolidation of trusts rules of Section 643(f) and the trusts for separate children (or separate descendants) would not presumably have substantially the same beneficiary or beneficiaries.

One potential disadvantage of creating a separate trust for each descendant is the limitation of distributing DNI in unequal shares, such as to a descendant who is in a lower overall income tax bracket than the trust or the other beneficiaries would face.

Practitioners should weigh the costs and administrative burdens of creating and administering multiple trusts versus the potential tax savings anticipated.

One Way to Reduce Federal Income Tax on Trust Income: Distributions to Beneficiaries

A way to avoid the higher tax that a trust, compared to an individual, may face is to distribute the trust income to a beneficiary, to the extent required or permitted under the terms of the trust.[23] To the extent that a trust distributes or is treated as distributing its income to a beneficiary, the income is not tax to the trust but to the individual. Although the taxable income of a non-grantor trust (or a decedent's estate) is generally computed in the same manner is that of an individual[24], there are exceptions, probably the most important of which is that a trust is entitled to a deduction for distributions of its distributable net income (DNI) defined in Section 643(a) to a beneficiary the amount

[21] See notes 9 and 17.

[22] See Prop. Reg. 1.643(f)-1 for the proposed regulations under the section including, essentially, presumptions of when the trusts will be treated as having a principal purpose of income tax avoidance. Proposed regulations, unlike final regulations, however, do not have the force of law.

[23] Historically, trusts required that their fiduciary accounting income (that is income as determined under the terms of the trust and applicable local law, typically referred to as FAI) be distributed currently. Typically, trusts that qualify for the gift or estate tax marital deduction require that all such income be distributed at least once a year. See Sections 2523 and 2056. Today, often other types of trusts do not require distributions but authorize the trustee to distribute as much income and corpus as the trustee determines although, not infrequently, the trustee may distribute only pursuant to a standard set forth in the instrument, such as health, education, maintenance and support. Many trusts created to hold life insurance policies (commonly called irrevocable life insurance trusts or ILITs) do not permit distributions until the death of the person whose life is insured under the policies die.

[24] Section 641(b).

of which the beneficiary is required to include in gross income.[25] That may result in lower over federal tax if the beneficiary or beneficiaries are in lower income tax brackets than the trust would be.

However, the beneficiary or beneficiaries may or may not be subject to state income tax on taxable income. If so, any reduction in federal income tax by taxing the DNI to the beneficiary rather than to the trust may be offset in whole or in part by the state income tax. In fact, the combination of state and federal taxes on a beneficiary may exceed what the trust would have paid in federal income tax if no distribution of DNI had been made to the beneficiary.

Other Consequences of Distributing DNI to the Beneficiary

Other consequences of distributing DNI to a beneficiary may arise. Normally, assets in a trust created by someone other than the trust beneficiary are not subject to attachment by the creditors of the beneficiary.[26]However, if trust assets are distributed to the beneficiary, they may be attached unless falling under an exception.[27]

A person may be denied government benefits (such as Medicaid) if the individual's "non-exempt" assets or income exceeds a certain threshold. [28]

Distributions to an individual may also mean subjecting his or her wealth at death to state or local death tax.

There are also the personal aspects of a distribution. The beneficiaries in federal lower income tax brackets or who are not subject state income may not be the beneficiaries that would otherwise be favored for distributions. The surtaxes may increase the pressure to make distributions that otherwise might not be advisable.

Part 2: Making Distributions of Gross Income to or for Charity

The income of a non-grantor trust is determined as it would be of an individual subject to special rules. As mentioned, the deduction for a distribution of DNI allowed under Section 651 or 661 is one of the more important special rules. Another is the charitable deduction, which for a non-grantor trust is allowed, in general, under Section 642(c) for its gross income paid for a charitable purpose.[29]The charitable deduction allowed under Section 642(c) not only reduces the trust's taxable income but also

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[25] See Sections 651, 652, 661, 662. See, generally, F. Boyle & J. Blattmachr, Blattmachr on the Income Taxation of Estates and Trusts (17th ed., PLI, 2021), at ¶ 3.1.

[26] See Article 5 of the Uniform Trust Code, available at https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=3d7d5428-dfc6-ac33-0a32-d5b65463c6e3&forceDialog=0.

[27] Exemptions may arise under federal or applicable state law. See, e.g., https://upsolve.org/learn/federal-nonbankruptcy-exemptions/ and https://www.nolo.com/legal-encyclopedia/using-exemptions-protect-property-from-judgment-creditors.html.

[28] The income and asset value levels in some cases are relatively low, subject to exceptions and special rules. See, generally, Feke, "Medicaid Eligibility: MAGI and Your Assets," available at https://www.verywellhealth.com/your-assets-magi-and-medicaid-eligibility-4144975.

[29] For a somewhat detailed discussion of Section 642(c), see J. Blattmachr, F. Boyle, & R. Fox "Planning for Charitable Contributions by Estates and Trusts", 44 Estate Planning 3 (Jan. 2017).

may reduce its DNI and would reduce the threshold upon which the surcharge discussed above would apply.

A distribution of DNI might also be made to a charitable remainder trust (CRT) described in Section 664. The DNI distributed to a CRT will not be subject to income tax in the hands of the trust as the trust is exempt from income tax, although distributions to a beneficiary of the CRT may be included in the gross income of the beneficiary.[30] Using a so-called "net income with make-up" CRT may allow for postponement of tax.[31]

DNI distributed to a charitable lead trust (CLT), as described in Section 170(f)(2)(B), may not avoid income tax as a lead trust, unlike a CRT, is not exempt from income tax.[32] Yet, it seems a distributions deduction should be allowed under Section 661 for a distribution of DNI to a CLT. However, a CLT may be subject to income tax and to the proposed surcharge tax, discussed above, although a deduction allowed to the trust under Section 642(c) will reduce the trust's taxable income and the threshold for purposes of imposing the surcharge tax.

OBBBA may have thwarted, to some degree, having a trust (or a decedent's estate) make distributions of its income to charity to avoid all tax. Before OBBBA, a trust or estate was entitled to an unlimited deduction for its gross income paid pursuant to the terms of its governing instrument for a charitable purpose (except to the extent such income was unrelated business income in which case the deduction is limited essentially under 170 to the deduction limitations applicable to individuals). Although the tax law has long limited the benefit of deductions of individuals (see Section 68), Section 68(e) essentially exempted decedents' estates and non-grantor trusts from such cutbacks. However, that specific portion of Section 68 is eliminated under OBBBA which may indicate that all decedents' estates and all non-grantor trusts are subject to the cutback (which is 2/37th or about 5.4% of the itemized deductions or that amount of the entity's income to which the top 37% bracket applies which for 2025 is about $16,000). That would mean that a trust, including a charitable lead trust described in Section 170(f)(2)(B), may be subject to income tax even if all of its gross income is paid to charity. So if the trust or the estate had $1,000,000 of income for the year which it paid to charity and received a Section 642(c) deduction for the payment, it would owe income tax of nearly $20,000. Some have contended that because Section 642(c) says an estate or a non-grantor trust gets the deduction "without limitation", the cutback under Section 68 would be a cutback and, therefore, should not apply.

Although not certain, it is possible that a Section 678 trust for charity might avoid that result in any case. (This idea was pioneered in large measure by Edwin P. Morrow, Esq.). By granting charity the right to withdraw the income from the trust, it seems that such income would be attributed to the charity and never be income of the trust itself. The charity would not be subject to the cutback of Section 68.

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[30] Section 664(c).

[31] See discussion in M. Blattmachr, J. Blattmachr & R. Fox, "Using a Charitable Remainder Trust as the Recipient of Qualified Plan and IRA Interests", 47 Estate Planning 3 (July 2020).

[32] In order to be described in Section 664, a CRT may not be a grantor trust. A CLT, however, may or may not be a grantor trust. See Section 170(f)(2)(B). If it is a grantor trust, the income will be attributed to the grantor under Section 671.

Part 3: Potential Use of a Section 678 Trust

As mentioned above, the income, deductions and credits against tax of a grantor trust are attributed for federal income tax purposes to the grantor generally whether or not any distribution is made to the grantor. Under Section 678, a person other than the grantor is treated as the owner (and essentially taxed under the grantor trust rules as though the person were the grantor) of any portion of a trust with respect to which the person has a power exercisable alone to vest the income or corpus in that person.[33] It appears that a trust may be one described in Section 678 as to only part, such as where the beneficiary has the right only to withdraw income, either in a fiduciary accounting sense or a tax sense.[34] Hence, the beneficiary could be given the unilateral right to withdraw all or a portion of the trust's tax income. Perhaps, the beneficiary could be given the right to withdraw only so much of the income that the income tax the beneficiary pays on the income is not greater than what the trust would pay.[35]

Because the beneficiary of a Section 678 Trust must have a unilateral right to withdraw from the trust, creditor protection almost certainly will be lost to that extent, at least in many states.[36] Also, if the beneficiary is disabled and entitled to government benefits, allowing the power of withdraw lapse (or releasing it) will cause a period of ineligibility for the beneficiary of those benefits, in most cases.[37] It the power to withdraw is partially released or otherwise modified and does not entirely disappear, it remains a Section 678 Trust.[38] Hence, if the beneficiary is permitted to and does modify the power (perhaps, so it can only be exercised with the consent of the trustee only for supplemental needs), it

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[33] See J. Blattmachr, M. Gans & A. Lo, supra.

[34] See, generally, E. Morrow, J. Blattmachr & M. Shenkman, "Using Decanting and BDOT Provisions to Avoid a Peppercorn of Income Potentially Triggering State Income Tax on a Trust's Entire Income," Leimberg Income Tax Planning Email Newsletter Archive Message #205 (September 15, 2020). Even if the beneficiary holds the right to withdraw all tax income, that may be impossible for the beneficiary to withdraw income that is merely imputed to the trust as may be the case where the trust is a partner in a partnership. Cf. Sid Richardson Foundation v. US, 306 F. Supp. 755 (N.D. Tex. 1969), aff'd, 430 F. 2d 720 (5th Cir. 1970), cert. denied, 401 US 1009 (1971).

[35] This might help to avoid state income tax in some cases. For example, the undistributed income of a trust created by a New York tax resident is not subject to New York income tax if the trust has no New York trustee, has no asset sited in the state and has no New York source income. New York Tax Law 605(c)(2)(D). It is understood that the state has taken the position that any amount of New York source income, no matter how small, subjects all of its undistributed income to the state's income tax. However, if a beneficiary of a New York trust has the unilateral right to withdraw all New York source income, that income is not income of the trust but only of the beneficiary meaning, presumably, the trust has no New York source income avoiding the position of the state.

[36] Under Alaska law, however, property subject to a presently exercisable general power of appointment is not subject to the claims of the creditors of the power holder except to the extent the funds are withdrawn. Alas. Stat. 34.40.115.

[37] First party special needs trusts are ones created by the beneficiaries for themselves. Third party special needs trusts do not have a specific statutory exemption but POMS SI 01120.200(D)(2) provides that, if the beneficiary does not have the legal authority to revoke or terminate the trustor to direct the use of the trust assets for his or her own support and maintenance, the trust principal is not the individual's resource for social security benefit purposes.

[38] See Section 678(a)(2) and PLR 200944002 (not precedent).

should mean it is still a Section 678 Trust so the income will continue to be attributed to the beneficiary but may still provide asset protection under the law of at least some states.

However, this means that the income will be taxed to the beneficiary to the extent of the beneficiary's unilateral power to withdraw.

Part 4: Potential Use of a Qualified Subchapter S Trust May Help Even More

Using a QSST as the Beneficiary

Only US individual taxpayers, their estates and certain trusts may hold shares in an S corporation[39], the income of which is taxed directly to its shareholders.[40] A Qualified Subchapter S Trust, described in Section 1361(d)(3), commonly known as a QSST, is a permitted S corporation shareholder. To be a QSST, the trust must have only one beneficiary who is a US individual taxpayer, must be required to or does, in fact, distribute all of its fiduciary accounting income (FAI), within the meaning of Section 643(b), each year to that beneficiary, and the beneficiary must elect to be treated as the income tax owner under Section 678 (essentially as though it were a grantor trust as to the beneficiary) of the portion of the trust that consists of the qualifying S stock and, thereby, be treated as the shareholder. One of the effects of a QSST election is that the income of the S corporation is treated as being that of the shareholder (in this case, the beneficiary of the QSST), although it does not apply to the treatment of a sale of the S corporation stock.

Hence, if a QSST is used, as opposed to another type of trust, the income of the S corporation will be taxed to the trust beneficiary rather than to the trust as a separate taxpayer even if no distribution is made to the beneficiary. The more onerous income tax rules with respect to trusts in some cases, as discussed above, will not apply. And unlike a Section 678 trust, the QSST may provide more asset protection, and may also avoid disallowance to government benefits.[41]

Of course, that means, as a practical matter, that the direct beneficiary of a client's wealth will be an S corporation. It is beyond the scope of this article to discuss the matter in significant detail but S corporations have certain drawbacks including potential adverse effects upon liquidation. Moreover, the QSST, as stated, will have only one individual beneficiary curbing the ability to make distributions in a more favorable manner among several beneficiaries such as by shifting tax income to someone in the lowest tax bracket or one who is not subject to state income tax.

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[39] Section 1361. It does not seem that an S corporation, to be respected as such, need be formed for a business purpose. See Rev. Rul. 75-188, 1975-1 C.B. 276

[40] See, generally, Blattmachr & Boyle, supra, Chapter 8.

[41] Nonetheless, it is understood that some "divorce" courts in determining alimony (maintenance in some jurisdictions) and child support, simply look at the income as reported for federal income tax purposes of the former spouse or parent (which will include the income of the S corporation to the extent he or she is a trust beneficiary) even though the former spouse or parent may not receive and may not be entitled to receive payments from the QSST.

Using a Discretionary Trust with S Corporations and Others as Beneficiaries

Perhaps, a better plan is to use a so-called discretionary trust such as one where the trustee may choose among a class of beneficiaries as to which one or ones of which distributions of DNI should be made. Such a trust is commonly used in planning and the disposition of wealth and may include all of the property owner's descendants, their spouses, charities and split-interest trusts (such as charitable remainder trusts described in Section 644 and charitable lead trusts described in Section 170(f)(2)(B)). It may include corporations but may not effectively include a transferee who acquired an interest in the trust for value.[42]

To the extent the trust is permitted to and does distribute its DNI to an S corporation, the shareholder of the S corporation will include it in gross income, whether or not the corporation makes any distribution. Where the shareholder is a QSST, the beneficiary of the QSST will include the distribution in gross income whether or not the trust makes any distribution other than FAI which a QSST must distribute to its beneficiary. This income will be taxed to the beneficiary whether or not the beneficiary receives anything other than trust FAI and the S corporation's income will not be in FAI unless the S corporation makes a distribution that constitutes FAI (as most dividends would[43]). That means the S corporation's income will be taxed at the beneficiary's rates.

One of the advantages of using a QSST is that it will not necessarily cause the trust to be included in the gross estate of a beneficiary as distributions to the beneficiary would. Although FAI must be distributed to the beneficiary of a QSST, FAI generally can be kept at a minimum.[44]

Using the 65 Day Option

Under Section 663(b), any amount or all trust or estate distributions properly paid or credited within the first sixty-five days of a taxable year may be consider paid or credited on the last day of the preceding taxable year, provided the fiduciary makes an election, pursuant to regulations. The amount to which the election applies cannot exceed FAI of the year or DNI, if greater, reduced by any amounts, paid, credit or required to be distributed in such taxable year.

Hence, with several beneficiaries, including individuals, S corporations and charitable remainder trusts, the trustee of a discretionary trust will have slightly more than two months following the close of the trust's tax year to determine where to tax the trust's DNI. A broad array of beneficiaries may provide a significant option in reducing the tax on the trust's income.

If the surtaxes are enacted, monitoring trust income before or shortly after year end to determine the extent to which the Section 663(b) election should be made may have more importance for many trust clients.

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[42] See Nemser v. Commissioner, 66 TC 780 (1966), aff'd. 556 F/2d 558 (2d Cir. 1977), cert. denied 434 US 855 (1979). Making an S corporation the beneficiary of a trust may have other ramifications, such as where IRA or qualified plans proceeds are payable to it. That is discussed in detail in J. Blattmachr, F. Boyle, M. Gans and D. Zeydel, "The SECURE Act, Trusts, Corporations and CRTs", 47 Estate Planning 24 (July 2020).

[43] See, e.g., section 409(b) of the Uniform Fiduciary Income and Principal Act.

[44] See discussion in M. Blattmachr, J. Blattmachr & R. Fox, supra.

Funding the QSST Beneficiary's Income Tax Liability

If the S corporation's income is attributed to the QSST beneficiary, he or she presumably will need cash to pay the income taxes on the S corporation income attributed to him or her pursuant to the QSST election.[45] Having the S corporation pay a dividend to the QSST which, in turn, is paid to the beneficiary (as it must be if it is FAI as it probably would be[46]) means the beneficiary may have more income and resources so as to cause disqualification for government benefits. However, the trustee of the QSST, rather than distributing the S corporation distribution to the beneficiary, could instead apply it in satisfaction of the beneficiary's income tax obligation. According to PLR 8907010 (not precedent) that should be treated as being a payment to the beneficiary, as a QSST is required to do. However, that discretionary payment by the QSST of the beneficiary's income tax liability will not count as income or as a resource for at least most governmental benefit programs.[47]

Therefore, the S corporation can pay a dividend to the QSST in the amount of the beneficiary's income tax liability (which will be based at least on the S corporation's income imputed to the QSST beneficiary) and the trust can pay the income tax liability of the beneficiary and will be treated as distributing that amount (which may be FAI) to the beneficiary so the status as a QSST will not be lost and the risk of causing the beneficiary to lose governmental benefits will not arise.[48]

For wealthy QSST beneficiaries, paying income tax on trust income not received may provide an estate tax "burn" similar to that in traditional grantor trusts (that is, the QSST will grow on an income tax free compounded basis because the income received by the trust will be paid by the beneficiary and not the trust). That may prove an advantageous wealth transfer step, in addition to avoiding higher trust income tax rates.

Part 5: Summary and Conclusions

Trusts serve many purposes including protection against claims of creditors of beneficiaries and the unwise dissipation of wealth. Although the federal tax law has become somewhat hostile to non-grantor trusts and would be made even more so if the surtax on income above $200,000 is enacted, careful planning in the structure of trusts and their thoughtful administration, may go far in avoiding the harshest income tax rules for trusts, while preserving many of the benefits they offer.

Creating one trust for each descendant of the property owner may provide some relief from the harsh trust income tax rules. Distributions of DNI to the beneficiary may reduce overall taxation of the trust's income although, once received by the beneficiary, creditor protection and estate tax exclusion benefits that a trust may offer will be gone. Having a so-called "sprinkle" or "spray" trust (that is one that authorizes the trustee to make or not make any distribution to one or more beneficiaries) with a large

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[45] The beneficiary must affirmatively elect for the trust to be a QSST and may revoke the election only with the consent of the Commissioner of Internal Revenue. Reg. 1.1361-1(j)(11).
[46] Section 409(b) of the Uniform Fiduciary Income and Principal Act.
[47] SSA – POMS: SI 00815,400 available at .https://secure.ssa.gov/apps10/poms.nsf/lnx/0500815400
[48] An alternative to using a QSST is to use an electing small business trust defined in Section 641(c) which is an eligible S shareholder, under which all of the S corporation's income is taxed to the trust at the highest federal income tax rate and without the ability to shift the income to a trust beneficiary. However, that may provide a way to avoid state income tax.

class of beneficiaries may provide the trustee flexibility to shift income out of the trust to a lower tax beneficiary and assess the beneficiaries state and federal income tax and asset protection concerns before making a distribution. A trust described in Section 678 from which a beneficiary may withdraw tax income may provide some opportunity for income tax reduction without full loss of asset protection and estate tax exclusion benefits. Using a QSST may also avoid the harsh income tax rules applicable to individuals but are somewhat inflexible. A discretionary trust for several beneficiaries, including an S corporation of which a QSST for a descendant is the shareholder, along with other potential beneficiaries, such as a CRT, may provide the best opportunity for income tax reduction on the earnings of the trust. The 65-day rule of Section 663(b) will give the trustee over two months to plan as to whom distributions of DNI should be made.