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Estate Planning Bulletin

Trust Income Tax Election Just Became More Valuable

Higher income tax rates for 2013 and beyond have increased the value and utility of a long-existing income tax election with regard to the timing of trust distributions. This election, commonly referred to as the "65-day rule," applies only to non-grantor trusts. Grantor trusts are effectively disregarded entities for income tax purposes, with their items of income, expenses, credits and deductions flowing through to the grantor's personal income tax return. Non-grantor trusts are considered separate taxpayers and follow the income tax rules of Subchapter J of the Internal Revenue Code. The most important rule of Subchapter J is that distributions to beneficiaries are deemed to carry out the trust's taxable income to the beneficiaries. The trust treats such distributions as a deduction, reducing the trust's taxable income. This general rule applies regardless of whether the distribution is made from trust income or trust principal, and regardless of the timing of the distribution during the taxable year.

Non-grantor trusts may use the 65-day rule to treat distributions to beneficiaries made on or before the 65th day of the trust's tax year (March 6, 2013, for trusts with a calendar year as their tax year) as if they had been made in the prior tax year. The 65-day rule is useful in allowing a trust to manage its taxable income. A trust that is required under its terms to distribute all of its income realizes no benefit from the 65-day rule, as all of its income is deemed distributed to the beneficiary whether or not that income is, in fact, distributed in the calendar year. A trust that gives its trustee discretion on the timing and amount of distributions to beneficiaries particularly benefits from the 65-day rule, which gives the trustee an extra opportunity to shift taxable income from the trust to the beneficiaries.

March 6, 2013 is the deadline for making a trust distribution that would be eligible under the 65-day rule to be treated as a 2012 distribution. The deadline for the election itself is the due date (including extensions) for the trust's Form 1041 fiduciary income tax return.

The income tax brackets applicable to trusts are smaller than those for individuals, especially after the trust brackets were greatly compressed in 1993. This means that income retained within the trust (as compared to income that is distributed to beneficiaries) reaches the top tax rates at a much lower level of income, unless those beneficiaries are already at or very close to the top marginal tax rates. The first part of the chart below illustrates how a given amount of 2012 income would be subject to income tax if retained in a non-grantor trust or if distributed to a beneficiary. While a trustee may find sufficient justification for retaining rather than distributing trust income, the system of income taxation for non-grantor trusts effectively penalizes the retention of trust income that could be distributed to beneficiaries.

The new tax rates applicable for 2013—in particular, the new 39.6% top income tax rate, the new 20% top capital gains tax rate (for those items that previously qualified for the 15% rate) and the 3.8% Medicare investment income tax—further increase the effective penalty for retaining trust income. The second part of the chart on page 2 demonstrates how much greater this penalty is after these new rates go into effect for 2013.

The flexibility of the 65-day rule is important for early 2013 because it will allow distributions within the 65-day period to be treated as calendar-year 2012 distributions. Even though non-grantor trusts will not have to apply the new 2013 rates to their 2012 taxable income, use of the 65-day rule should result in lower taxes for trust beneficiaries who will be subject to the new top tax rates for 2013. The flexibility of the 65-day rule will become more important than ever in 2013 and beyond whenever there is an opportunity to shift a trust's taxable income to a beneficiary with a lower marginal tax rate.

If you would like to discuss how the 65-day rule affects your specific situation and existing estate plan, please contact a member of the Vedder Price Estate Planning group at +1 (312) 609 7500.

Hypothetical Income Tax Calculations, 2012 vs. 2013, Distributed vs. Retained in Trust (Federal Tax Only)

2012, Before New Top Rate and Medicare Surtax, All Ordinary Income

	Trust Income 100% Retained	Trust Income 50% Distributed	Trust Income 100% Distributed
Trust Taxable Income before Distribution	$250,000	$250,000	$250,000
Distribution Paid	$0	($125,000)	($250,000)
Trust Taxable Income after Distribution	$250,000	$125,000	$0
Trust Income Tax	$86,434	$42,684	$0
Effects of Distribution to Single Beneficiary:			
Beneficiary's Taxable Income before Distribution	$50,000	$50,000	$50,000
Distribution Received	$0	$125,000	$250,000
Beneficiary's Taxable Income after Distribution	$50,000	$175,000	$300,000
Resulting Beneficiary Income Tax	$8,530	$42,461	$83,528
Total Tax, Trust and Beneficiary Combined	$94,964	$85,145	$83,528
Net Tax Savings of Distribution	**0**	**$9,820**	**$11,436**

2013, After New Top Rate and Medicare Surtax, All Ordinary Income

	Trust Income 100% Retained	Trust Income 50% Distributed	Trust Income 100% Distributed
Trust Taxable Income before Distribution	$250,000	$250,000	$250,000
Distribution Paid	$0	($125,000)	($250,000)
Trust Taxable Income after Distribution	$250,000	$125,000	$0
Trust Income Tax	$97,358	$47,858	$0
Effects of Distribution to Single Beneficiary:			
Beneficiary's Taxable Income before Distribution	$50,000	$50,000	$50,000
Distribution Received	$0	$125,000	$250,000
Beneficiary's Taxable Income after Distribution	$50,000	$175,000	$300,000
Resulting Beneficiary Income Tax	$8,429	$42,293	$83,131
Total Tax, Trust and Beneficiary Combined	$105,787	$90,151	$83,131
Net Tax Savings of Distribution	**0**	**$15,636**	**$22,656**
Change in Net Tax Savings of Distribution, 2013 versus 2012:		**$5,816**	**$11,220**

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Estate Planning Group

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