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American Taxpayer Relief Act of 2012

TAX: Most extenders are through 2013, but a few provisions are made permanent.

By Tim Hilger, CPA
Editor

In the wee hours of New Year's morning, the Senate passed the American Taxpayer Relief Act of 2012. (HR 8) By early evening, the House had signed off on it. It was signed into law by the President on January 2, 2013.

The bill contains about 80 pages of tax law including extenders, many of which were needed just to complete 2012 returns.

Among the highlights:

- Tax rates remain the same, except for high earners, whose top rate increases from 35% to 39.6%;
- The AMT exemption amount is made permanent and indexed for inflation;
- Capital gains rates also rise from 15% to 20% for high earners;
- 50% bonus depreciation and \$500,000 IRC §179 are extended through 2013; and
- The 2% payroll tax holiday is not extended.

Individual provisions

The 2% cut in the Social Security tax for all earners will not be extended into 2013. For wages paid on or after January 1, 2013, the employee portion of Social Security tax will return to 6.2% (along with the Medicare tax, the total employee share of the tax will be 7.65%).

Beginning in 2013, the top tax rate of 39.6% (up from 35%) will be imposed on individuals with taxable income of more than \$400,000 a year, \$425,000 for head of household and \$450,000 for married filing joint. (Act §101(b)) These thresholds are indexed for inflation.

Countable assets

A California MediCal beneficiary is entitled to have no more than \$3,000 in countable assets. Countable assets include stocks, bonds, cash, long term care insurance, and other things.

Noncountable assets include:

- One car;
- Pensions or IRAs, as long as there are monthly payments being made over the life expectancy of the individual (those payments are considered income);
- Household goods;
- Principal residence;
- Certain prepaid burial contracts; and
- Personal property used in a trade or business.

COMMENT: Subject to certain limitations, the decedent's estate will be used to pay MediCal expenses at the death of the beneficiary. So, although the residence may be an exempt asset, if the individual dies and there is equity in the home, that equity will be used to pay expenses covered by MediCal.



65-day rule: Reducing tax on fiduciary returns?

ESTATES AND TRUSTS: Here's how to beat the Medicare surtax and high fiduciary tax rates.

**By Richard B. Malamud,
CPA, J.D., LL.M.**

Guest Contributor

Fiduciaries should consider making distributions from the trust to the beneficiaries because, not only are trust rates higher, but the Medicare surtax kicks in at only \$12,000 for trusts, \$200,000 for single individuals, and \$250,000 for joint returns. In making the decision, consider the rates, the terms of the trusts, and the beneficiaries themselves.

Trust rates

Trusts and estates are the highest taxed "individuals," with rates of 35% on income that exceeds \$11,650 in 2012. In 2013, that will be 39.6% on income above \$12,000. In addition, in 2013 the 3.8% Medicare surtax¹ will apply to the lesser of "net investment income" or income over \$12,000.²

The surtax does not apply to tax exempt charities or charitable remainder trusts, but distributions from a trust of net investment income will subject the beneficiary to the surtax if their adjusted gross income exceeds \$250,000 for married, \$125,000 for married filing separate, or \$200,000 for all others.³

Individual rates

However, the individual income tax does not reach its highest rate, 39.6%, until \$400,000 in 2013 for single returns, but it reaches that same rate at about \$12,000 for trusts and estates. Thus, if a trust earns \$100,000 of interest income and its (married) beneficiary earns less than \$150,000, a distribution from the trust will both lower the total income tax and eliminate the Medicare surtax when viewed as an aggregate tax between the beneficiary and the trust. This can be accomplished if the trust makes annual distributions of its investment income.

EXAMPLE 2-6: Bill is the trustee of his mother's living trust and he will share her estate with his twin brother, Will. They each have AGI of \$100,000. Their mother died August 1, 2013. Her net worth was \$6,000,000, and the taxable interest income from her trust was \$35,000 for 2013.

Although the estate cannot be settled until the estate tax is determined, which can not be finalized until after the alternative valuation date (May 1, 2014), Bill should consider making a distribution of \$17,500 to himself and his brother within 65 days of year end to avoid the highest fiduciary tax rate and the Medicare surtax, neither of which he or his brother will pay at their income levels.

Types of trusts and treatment of distributions

There are two types of trusts, simple and complex.

Simple trust

In a simple trust, all income is required to be distributed each year. In most cases, all of the investment income is therefore taxed to the beneficiary who receives it, rather than to the trust.⁴

Complex trust

Any other trust is a complex trust. In a complex trust or an estate, a deduction is available and the beneficiary is taxable for income required to be distributed and for any other amounts properly paid or credited to the beneficiary during the taxable year. Amounts not paid or credited to the beneficiary will be taxed to the trust or estate each year.

Annual distributions may not be possible for some estates or trusts due to the terms of the will, the trust, or state law.

Estates may prefer to wait until the estate's liabilities have been paid before making distributions, as the executor may be personally liable to creditors if distributions are made to beneficiaries and creditors do not get paid.

Many complex trusts may have to wait for the same reason or because distributions can not be made until the beneficiary turns 18 or 21. These entities may have effective federal tax rates on investment income of 43.4% (39.6% + 3.8%) and more than 50% including the California (or other) state tax on fiduciary taxable income above \$12,000 in 2013.

Trustee discretion

Other estates and complex trusts may provide the executor or trustee with the discretion to make annual distributions.⁵

If distributions are both permitted and advisable, discretionary distributions will be deductible and, like the simple trust, the income will pass to the beneficiary.

Lowering the overall tax may make tax sense, but it also has to work from a fiduciary and legal point of view. For example, should a trustee make a (tax savings) discretionary distribution to an 18-year-old who will spend the money wastefully, or instead pay the higher tax at the trust level and distribute what is left for the beneficiary at a later date?

In the case of a minor, under the terms of the trust, can anything be distributed prior to majority? What about a trust that allows for distributions to three children, but only upon majority, and two are still minors? If the trustee would have retained two thirds of the income each year, tax savings probably shouldn't cause the trustee to give all the income to the adult at the expense of the other two. These and other issues must be dealt with before making distributions that would lower the overall taxes.

Planning distributions

It is very difficult for a trustee with discretion to make the proper discretionary distribution each year. Year-end projections are usually wrong, because they can never know the exact amount of partnership income, or even income from some savings accounts, mutual funds, ETFs, or real estate investment trusts.

If the trustee estimates the trust will have \$100,000 of interest income for the year, how much should be distributed? If \$100,000 is distributed and it turns out there was actually \$116,500 of income, the trust would owe tax on \$4,500 at the highest possible rates in 2013, plus the Medicare surtax.

65-day rule

A more practical approach than estimating the proper amount is to make the distribution in the first 65 days of the next year. IRC §663(b) provides that the trustee of a complex trust and the executor of an estate⁶ can elect to treat distributions made within 65 days of the close of the tax year as having been made on the last day of the prior tax year. In 2013, Thursday, March 6, 2014, is the 65th day following a 2013 calendar year end return.

The maximum amount of the election is the greater of the accounting income or the Distributable Net Income (DNI) for the year.⁷ The election must be made by the due date of the fiduciary return, plus extensions, and it applies only to that year.⁸

How to make the election

There is a checkbox on Form 1041 to make the election.

The IRS allowed a late election where the amount was paid within 65 days and properly reported on a timely filed fiduciary and individual return where the election was not made.⁹

Since this is at the discretion of the IRS, it is better to follow the rules and make the timely election. This irrevocable election applies to the beneficiary and the income is included in the prior tax year, but it does not apply for estimated tax purposes.¹⁰

To qualify for the election, the distribution applies to “amounts paid [and] credited” to the beneficiary within the 65 days.¹¹ If it is timely paid, there is no problem, and that should be done. The IRS may deny any credited amounts, although there is case law that allows deduction if there was a credit to the beneficiary’s account and the amount was available on demand.¹²

Early preparation

The easiest way to make sure all goes well is to prepare the fiduciary tax return by late February, make the desired distribution within the 65 days, and file the election with the return.

Even in the absence of an early tax return, the trustee can make a distribution within the 65 days and elect how much of that is to be treated as a prior year distribution when the return is completed. If the distribution exceeded the election amount, the excess would be treated as distributed in the year it was actually paid out.

EXAMPLE 2-7: The Smith Child’s Trust of 2011 expects income to be \$100,000 in 2013, but the tax return is not complete within 65 days of year end. During the tax year, \$90,000 was properly paid to the beneficiary. To be safe, the trustee can distribute \$30,000 within 65 days of year end. When the return is prepared, DNI is \$105,500. An election can be made for \$15,500 (\$105,500 - \$90,000), the taxable income of the trust will be \$0, and the beneficiary will pay tax on \$105,500. The remaining \$14,500 will be treated as a 2014 distribution.

More planning for 2013

Given the high income tax rates applicable to trusts and estates, plus the new Medicare surtax applicable in 2013, fiduciaries and their advisors should pay more attention to the trust or estate's taxes as compared to the beneficiary's.

If it appears that the trust will have income that can be paid or credited to the beneficiary, distributions within 65 days of year end should be considered. That will be more difficult for estates and living trusts that function as estates, where discretion or legal issues such as paying off debts may preclude distributions each year.

About the author

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- ¹ IRC §1411(a)
- ² IRC §1411(a)(2)(B)(ii). See also Robert S. Keebler, Estates and Trusts with 3.8% Medicare Surtax, (July 30, 2012) at <http://blog.aicpa.org/2012/07/estates-and-trusts-with-38-medicare-surtax.html#sthash.Y57ywg9Y.dpbs> and Wealth Strategy Report, The 3.8% Medicare Surtax on Investment Income (U.S. Trust) at www.ustrust.com/Publish/Content/application/pdf/GWMOL/3.8-Medicare-Surtax.pdf
- ³ IRC §1411(b)
- ⁴ A complete understanding of fiduciary taxes is beyond the scope of this article. Information can be found, for example, in Spidell's self-study course, Basic Trust Preparation
- ⁵ This will take a careful reading of the will or trust, which often exceeds 50 pages and is very complex. It may require advice of the estate or trust's attorney to properly interpret the instrument
- ⁶ For estates, this applies to tax years after beginning after August 5, 1997
- ⁷ Income passed to the beneficiary can not exceed DNI even if the election exceeds that amount, but doing so might lower the amount of the next year's distribution. So, generally, DNI should be used if it is lower than accounting income
- ⁸ Treas. Regs. §1.663(b)-2(a)(1); if no return is required, a statement can be filed at the IRS Service Center where the fiduciary return would have been filed
- ⁹ PLR 201129026
- ¹⁰ Rev. Rul. 78-158
- ¹¹ Treas. Regs. §1.663(b)-1(b)
- ¹² *Estate of Andrew J. Igoe* (1946) 6 TC 639, acq. 1946-2 C.B. 1 and *Estate of John Fossett* (1954) 21 TC 874; cf. *Hay v. U.S.* (1967) U.S. District Court N.D. Texas, Fort Worth Division, Civ. A. No. 4-401, stating that to be deductible amounts must be "irrevocably and unconditionally placed at the disposal of the beneficiary"

News Briefs

Taxpayer bound by reporting of SE income on partnership Schedule K-1 — A husband and wife formed an LLC with another partner for the purpose of providing software and hardware to hospitals.¹

Although the wife lacked any background in computer technology, she was given membership in the LLC, rather than her husband, because her credit rating was better and it needed to be used in order to obtain loans for the business.

The LLC reported payments made to both of the partners during the years in question as "guaranteed payments." But, on the couple's personal returns, the wife reported the amounts she received as "partnership distributions" that would not be subject to self-employment tax because of her limited involvement in the LLC's operations.

The Tax Court held that the taxpayers "may not disavow the form of the transaction as reported on the LLC returns."