JO Knows Trust Distributions

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With the end of the year fast approaching, we wanted to discuss a potential year-end tax planning idea that could provide income tax advantages – particularly for trustees and beneficiaries of irrevocable trusts – by distributing income out of the trust to the individual beneficiaries.

At the most fundamental level, distribution planning involves distributing income out of the trust such that the recipient of the income distribution (the beneficiary) pays tax on that income, rather than the trust itself paying the taxes. Irrevocable trusts provide rules for if, when and to whom you may distribute the assets and the income of the trust. Before engaging in any income tax planning, it is important that you understand the terms of the trust and what you are permitted, or not permitted, to do as a trustee.

For all the benefits of a trust, one primary disadvantage is trust tax rates. While a single individual pays the maximum tax rate on income above $539,900, a trust reaches the maximum rate at only $13,450 of income. If you have income that is accumulated inside a trust, it is almost guaranteed to be taxed at a higher rate than if it was reported on your personal return. So how do you avoid this? Unfortunately, the answer is every accountant's favorite. . . "it depends". Trust rules are "case by case" specific, but we'll try to cover some general ground rules.

First things first. While there are many different types of trusts, the main two groups are revocable and irrevocable trusts. For all revocable trusts (and for some irrevocable trusts) all the income related to the trust is already reportable on your personal 1040, and you won't have to do anything to avoid the trust rates.

On the other side, irrevocable trusts are where the complications can come in, as the rules are dependent on how your trust was set up and what language was included in your trust document. In general, when a trust makes distributions of trust income to a beneficiary, the beneficiary and not the trust pays the tax on that income. Conversely, if the trust accumulates income and does not distribute it, the trust will pay the income tax (often at higher marginal rates). If income is going to be distributed, the trustee should generally do so before year-end, but there is an election available to consider income that is distributed in the first 65 days after year-end as if was distributed in the prior year.

Income tax planning for a trust requires a careful look at the terms of the trust along with the assets and income of the trust to determine the best planning strategies, particularly around the distribution of income to beneficiaries. If you'd like to discuss the terms of a trust and income tax planning options, please reach out to the Johnson O'Connor Individual, Trusts & Estates group for more information.

To learn more, reach out to Johnson O'Connor's Individual, Trust and Estate Team.

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