2014 Trust and Estate Planning - PART 2: 65 Day Rule for Trust Distributions

This is the second article of a series regarding 2014 Trust and Estate Planning
For the prior article, see:

[Link to PART 1: Introduction]

Trusts that are not treated as grantor trusts are now subject to income tax at much higher rates. Trusts are taxed at the maximum individual income tax rates on all income beyond $11,950 for 2013 and $12,150 for 2014. As a general rule, non-grantor trusts are taxed as follows: to the extent income is distributed to the beneficiaries, the beneficiaries are taxed; the portion of the income retained in the trust is taxed to the trust. There is a special rule for capital gains, which generally makes capital gains taxable to the trust whether or not the proceeds are distributed to the beneficiary.

When the beneficiary of the trust is not in the top income tax bracket, it is often possible to reduce overall income taxes by making distributions to the beneficiary. This assumes that circumstances are appropriate for making distributions. First, the trust must authorize the trustee to make the distributions. Second, the beneficiary must not waste the distribution. It is better to pay a high tax within the trust and keep the after-tax proceeds than to make a distribution and have it wasted by the beneficiary.

There is a special election that allows the trust to treat distributions made within the first 65 days of the following calendar year as having been made in the previous calendar year. Thus, if there is a beneficiary who is in a lower tax bracket and circumstances are appropriate for making a distribution to the beneficiary, the trust may be able to reduce its taxes for 2013 by making a distribution on or before March 5, 2014.

Due to certain rules that apply to individuals but not to trusts, the maximum tax bracket for individuals is slightly higher than the maximum tax bracket for trusts. When the beneficiary is in the top bracket, it may work out better for the trust to pay tax on the income than for the beneficiary. If circumstances warrant, consideration should be given to accumulating income within the trust. If income is distributed within the 65-day period, the trust is not required to treat it as having been made in the prior year.

In addition to the federal income tax consequences, state income taxes may also be relevant. When the beneficiary lives in Tennessee, the Hall income tax will be paid whether or not a distribution is made. However, if the beneficiary lives in another state, Tennessee taxes will not be payable. Whether or not taxes are paid to the beneficiary’s state of residence may depend on whether or not distributions are made from the trust.

As you can see, the timing and amounts of trust distributions can affect the amount of federal and state income taxes that are paid. You should analyze these opportunities now in case distributions need to be made prior to March 6, 2014.

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