

New Medicare tax creates trustee dilemma

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In brief

Trustees and beneficiaries have a new tax to contend with; the Net Investment Income Tax (also known as the Medicare Contribution Tax or Section 1411 tax). Trusts that own business interests have special reasons to be concerned about this new tax which will require trustees to know the income tax situation of each beneficiary. Therefore, beneficiaries should expect questions about their financial situation from their trustee.

The key is how best to position the trust for minimum overall tax on the combined trust and beneficiary group.

In detail

Starting January 1, 2013, trusts are subject to an additional 3.8% tax on net investment income in excess of \$11,950 (a relatively low threshold). Net investment income includes interest, dividends, investment gains, rental income and income from certain types of business activities. For trust accounting purposes, net investment income is treated like taxable income. If the trust distributes income to a beneficiary, net investment income will also be distributed. However, the 3.8% tax will not apply to a beneficiary with adjusted gross income (AGI) below \$200,000 for single individuals or \$250,000 for married couples (much higher thresholds than the threshold for trusts).

When assessing application of the 3.8% tax on trust income, trustees should consider the following:

- Does the trust have income from business interests in partnerships, limited liability companies, or S corporations? Trade or business income from 'passive' activities is subject to the 3.8% tax. However, trade or business income from 'active' operations (technically known as 'material participation') is not subject to the 3.8% tax. Categorizing income as 'passive' or 'active' requires an analysis of the passive activity loss rules as they apply to trusts. All Electing

Small Business Trusts (ESBTs) – which by definition must own a trade or business activity – will have to perform the 'passive' vs. 'active' determination.

- Next, should trust income be distributed to the beneficiary group or retained by the trust? Income retained by the trust will be taxed at the trust's income tax rate and may be subject to the 3.8% tax. Income distributed to a beneficiary will be subject to income tax and 3.8% tax on the beneficiary's personal tax return. The beneficiary may be in a lower income tax bracket and may not be subject to the 3.8% tax due to the AGI threshold.

- Finally, treatment of capital gains. State law trust accounting rules generally require that capital gains and losses be allocated only to the trust. The trustee's ability to plan around income usually does not extend to capital gains from asset sales. Such gains are effectively trapped at the trust and taxed at the trust's tax rates.

Passive activity rules

The passive activity rules, enacted in 1986, apply to individuals, trusts, and certain types of corporations. The Internal Revenue Service (IRS) produced lengthy regulations for individuals and corporations--but not trusts-- during the 1990s. Until now, trustees were ambivalent about the classification of an income producing business as active or passive.

Now the classification is extremely important to determine application of the 3.8% tax. Once income has been classified as 'passive' at the trust level, the recipient beneficiary will be bound by that classification for the current year (the beneficiary cannot reclassify the income based on the beneficiary's involvement in the business). Thus, the trust's annual classification of business income is critical.

The detailed material participation rules are beyond the scope of this summary. In general, the regulations provide seven possible ways to be a material participant. The most common is the so-called 500-hour requirement. The IRS historically has required individuals to keep meticulous records of business involvement on an hourly basis as well as the tasks performed. The IRS focus has been on day-to-day operational tasks rather than management and oversight tasks.

There are multiple parties involved in the operation of a trust. The issue

becomes: whose activities should be examined to determine 'material participation'? Should the trust look to the trustee, the beneficiaries, their employees, or some combination of them to determine material participation? The IRS's position is that the activities of the trustee, in his or her role as a trustee, should be the sole determining factor of whether the material participation requirements are met. However, in the only court case to address the application of the passive activity loss rules to trusts (Mattie Carter, 2003), the court decided that the activities of the trustee, the beneficiary, their agents and employees all should be aggregated to determine whether the trust was a material participant in the business.

Some trusts have multiple trustees or have special advisors associated with a business operation. The IRS's position is that special trustees or advisors should not be part of the material participation determination because they do not have full fiduciary responsibility.

Many trusts have an institutional trustee appointed in order to provide maximum trustee discretion. Such trusts may be forced to pay the 3.8% tax on income from business activities, absent major restructuring. Trusts with an institutional trustee should be especially sensitive to the material participation requirements. If there are co-trustees who share fiduciary responsibility, however, then the facts and circumstances will have to be considered to determine material participation.

A practical issue arises when an individual associated with the business operations is also a trustee. The lines between owner tasks, employee tasks, and trustee tasks can be blurred. The IRS could argue that the trustee must perform and record a

discrete set of tasks in his or her capacity as trustee to meet the material participation requirements. Documentation of trustee meetings, minutes, and records of fiduciary factors and decisions are likely to become important.

The following hypothetical fact patterns illustrate the issues.

Case 1-- Bob Jones is the trustee of the Jones Family Trust created by his grandfather. The trust owns 65% of an operating business. Bob owns 5% of the business and Bob's siblings and cousins own the other 30%. Bob is the president and a full-time employee of the business. Since Bob is a full-time employee it is likely that he would be classified as a material participant for his 5% business interest. However, his owner and employee tasks do not guarantee that the Jones Family Trust materially participates in the business. Does Bob record his trustee tasks thinking about the various trust beneficiary groups and what might be best for the trust? Does the trust's majority ownership of the business influence Bob's day-to-day business management decisions? Should Bob have a trustee binder with time records and trust goals/objectives relative to day-to-day business operations?

Case 2--Some of Bob's siblings and cousins (trust beneficiaries) also work for the business. Does this improve the potential for material participation by the trust?

Case 3--Bob Jones is the trustee of the Jones Family Trust and works in the business on a full-time basis. The Jones Family Trust owns 5% of the business and Bob owns 60%. Does the minority ownership of the trust have an impact on material participation? Is Bob less likely to be thinking about the trust's ownership

interests when making business decisions?

Case 4-- Bob Jones is the trustee of the Jones Family Trust and works in the business. He documents and records that half of his time relates to his personal interests and the other half of his time he is thinking about trust related considerations. He has two different offices and receives two different pay-checks. Does this help with demonstrating material participation by the trust?

Case 5--The Jones Family Trust owns 66% of the business. The trust is divided into six separate trusts (one trust for each grandchild). Bob is the trustee of each trust and works in the business. Does Bob have to satisfy a 500-hour requirement for each separate trust? Does he need separate records for each trust? Should he have different offices?

As these fact patterns demonstrate, creating a workable set of guidelines for trustee material participation can be a challenge.

Trustee actions to consider

Any trust owner of a business operation should construct a plan to address the 3.8% tax and material participation. This is a fact specific determination. At a minimum, the plan should consider the following:

- How might the material participation rules be applied to the specific facts of the trust and the business (based on trust ownership of the business and current trustee involvement)?
- What trustee involvement is there in the business?
- How should time and functions be documented to support material participation?

- Should trustees be changed or hired as employees of the business?
- Can beneficiaries be involved in the business?
- Should the business be distributed or sold to select beneficiaries?
- Should trust modification via the so-called decanting process be employed to change trust features?
- Should an Electing Small Business Trust (ESBT) election be replaced by a Qualifying Subchapter S Trust (QSST) election (or vice versa)?

Trust beneficiaries need to be aware of these issues. Beneficiaries who haven't been contacted by their trustee should make it a point to inquire about the 3.8% tax and the trustee's plans to address the possible impact of the tax. Without assistance, trustees may pay the 3.8% tax without investigating alternatives.

Specific rules for certain trusts

Certain types of trusts are subject to special income tax rules. These same trusts have special rules for the 3.8% tax and the material participation focus.

A **Grantor Trust** is essentially a disregarded entity for income tax purposes. Trust income is reported on the grantor's personal income tax return. The 3.8% tax also applies to the grantor's individual income tax return. Application of the passive activity loss rules is determined at the individual level. The material participation focus is on the individual and not the trustee.

Because the grantor trust is ignored for income tax purposes, trust distributions do not carry any income tax or 3.8% tax consequences to the beneficiary.

A **Qualifying Subchapter S Trust** (QSST) is a trust that has elected to be treated as a grantor trust with respect to the income beneficiary for income tax purposes because it owns shares in an S corporation. All items of income or expense associated with the business are reported on the beneficiary's personal tax return. The material participation focus is on the individual and not the trustee.

An **Electing Small Business Trust** (ESBT) is a trust that owns shares in an S corporation. All trade or business income is reported on the trust tax return each year. The business income will be subject to the 3.8% tax if the trust is not a material participant in the business. The material participation focus will be on the trust. Trustee choice and involvement are very important.

The takeaway

Trustees of trusts that own businesses need to create a plan to deal with the new 3.8% tax. The plan should include documentation of trustee decisions relative to the business and may include minutes of meetings.

The 3.8% tax increases the tax consequences associated with trust distribution decisions. Whether trustee actions are affected by the higher taxes will depend on the delicate balance between the needs and desires of both current and future beneficiaries.

Let's talk

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