

## **Impact of the Net Investment Income Tax on Trusts and Estates and Planning Techniques to Mitigate Its Effects**

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The Net Investment Income Tax (“NIIT”) became law under the Patient Protection and Affordable Care Act<sup>1</sup> and the Health Care and Education Reconciliation Act of 2010.<sup>2</sup> The tax can have a significant impact on trust income because of the condensed tax brackets for trusts. This article touches on techniques that can be used to reduce the tax on trust income.

### Changing Tax Landscape

#### *Net Investment Income Tax (“NIIT”)*

Since Jan. 1, 2013, a new 3.8% tax has been imposed on the lesser of a taxpayer’s “net investment income” or any modified adjusted gross income (“modified AGI”) over certain threshold amounts.<sup>3</sup> In general, net investment income includes portfolio-type income and income from passive activities.<sup>4</sup> Under Internal Revenue Code §469,<sup>5</sup> business activities are treated as passive activities unless the taxpayer “materially participates” in the activity.<sup>6</sup>

In the case of estates and trusts, the 3.8% tax is imposed on the lesser of the entity’s undistributed net investment income or the excess (if any) of its adjusted gross income (“AGI”) over the dollar amount threshold of the highest tax bracket to which estates and trusts are subject.<sup>7</sup>

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<sup>1</sup> Pub. L. No. 11-148 (2010).

<sup>2</sup> Pub. L. No. 111-152 (2010).

<sup>3</sup> I.R.C. §1411(a)(2); The threshold amounts are \$250,000 in the case of married individuals filing jointly, and \$200,000 for taxpayers filing individual returns. I.R.C. §1411(b). There is no cap on the amount of income subject to the tax. Furthermore, the threshold amounts are fixed and are not indexed for inflation.

<sup>4</sup> Specifically, “net investment income” is defined as the excess, if any, of: (1) gross income from interest, dividends, annuities, royalties, and rents, other than income generated in the ordinary course of a trade or business; (2) gross income from a trade or business that constitutes a passive activity under §469 or consists of trading financial instruments or commodities; (3) net gain (that is included in income) that is attributable to the disposition of property, excluding property held in a trade or business that does not constitute a passive activity under §469 or that does not consist of trading financial instruments or commodities. I.R.C. §1411(c).

<sup>5</sup> All section references are to the Internal Revenue Code of 1986, as amended, or to Treasury Regulations proposed or promulgated thereunder.

<sup>6</sup> The Patient Protection and Affordable Care Act and Health Care and Education Reconciliation Act of 2010 also made certain changes to Medicare taxes (*see, generally* §3101(b)(2); §1401(b)(2)) as well as changes in tax rates for individuals (the top individual tax rate for tax years beginning in 2015 was increased to 39.6% for ordinary income and 20% for long term capital gains and qualified dividends).

<sup>7</sup> This figure is indexed for inflation and in 2016 equaled \$12,400.

<sup>8</sup> The undistributed net investment income of an estate or trust is its net investment income less the share of that income that is distributed to beneficiaries and the share of that income allocated to a charitable deduction of the estate or trust. The AGI of an estate or trust is computed in the same manner as for individuals except deductions are limited to: (1) costs that are paid or incurred in connection with the administration of the estate or trust which otherwise would not have been incurred if the property were not held by an estate or trust; (2) the personal exemption deduction of \$600 for an estate, \$100 for a complex trust and \$300 for a simple trust;<sup>9</sup> and (3) distributions of income to beneficiaries, so long as the distributions are not in excess of distributable net income (“DNI”).<sup>10</sup>

## Implications for Trusts and Estates

Because estates and trusts often consist of assets such as stocks, bonds and other securities, or hold real estate on which rent is collected, the income of these entities frequently qualifies as net investment income. Therefore, the application of the NIIT to the income of estates and trusts amounts to an additional 3.8% drag on the growth of trusts that primarily consist of these investment assets.

The challenge facing practitioners wishing to implement strategies to minimize the impact of the NIIT is that these strategies often involve current distributions of net investment income to beneficiaries that do not have modified AGI above the threshold amount for individual taxpayers and to which the NIIT will therefore not apply. However, the trade-off of this strategy is that the current distribution of net investment income will ultimately impede the long-term growth of the trust assets. Therefore, both the drafting attorney and the fiduciary must weigh the pros and cons of implementing any of the planning techniques mentioned below in order to reduce the impact of the NIIT.

## Strategies and Planning Techniques

### *One-Pot Trusts*

Today most clients prefer to establish separate trusts for each individual beneficiary. Grantors often view these structures as more equitable because they provide each beneficiary with financial stability without impacting the interests of the other beneficiaries and they can lead to less tension between family members down the road. However, with the implementation of the NIIT, one-pot trusts may become more popular as a way to mitigate the impact of the tax. For example, a one-pot trust could give the trustee control over the timing of distributions, thus allowing the trustee to allocate income to those beneficiaries under the individual modified AGI

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<sup>8</sup> The 3.8% tax does not apply to tax-exempt trusts including charities and retirement plans (e.g., IRAs), Charitable Remainder Trusts, Archer Medical Savings Accounts and Health Savings Accounts, Qualified Tuition Programs (529 Plans), and Coverdell Education Savings Accounts. See I.R.C. §1411(e)(2).

<sup>9</sup> I.R.C. §642(b).

<sup>10</sup> I.R.C. §67(e).

threshold.<sup>11</sup> In this way, the trust would be able to decrease its undistributed net investment income on which the NIIT is imposed and at the same time avoid the imposition of the NIIT at the beneficiary level.<sup>12</sup> The aggregate amount of distributions from separate trusts likely would not reduce the impact of the NIIT to the same degree.

### *Distributions In-Kind*

Net investment income includes gain from the disposition of property (i.e., capital gain income) unless the property was used in a trade or business that is not taxable under the trade or business provision of the Code.<sup>13</sup> Therefore, where a trust owns a capital asset with built-in gain and has the option to either sell the asset and distribute the cash or distribute the asset directly, a distribution of the asset to the beneficiary can reduce the amount of NIIT by not forcing the trust to recognize capital gain upon the sale of the asset.

The distribution of the asset, rather than cash, will only make sense in certain situations, depending on the beneficiary's financial position. For example, a distribution in-kind would be appropriate if: (i) the beneficiary plans to sell the asset and is able to offset the gain with capital losses; (ii) the beneficiary plans to sell the asset but the gain would not increase his or her AGI over the individual NIIT threshold amount; (iii) the beneficiary plans to hold on to the asset; or (iv) the beneficiary agrees to sell the asset and incur the NIIT so the trust, and ultimately the other beneficiaries, will not have to bear the burden.

### *Including Capital Gain in Distributable Net Income ("DNI")*

Rather than distributing the asset in-kind, another option is to allocate the capital gain from the sale of the asset to the net income distributed to the beneficiaries. Generally, capital gains are credited to the trust principal for accounting purposes and cannot be allocated to distributable net income by the trustee without explicit authority under the governing trust instrument or applicable state law. Consequently, because trusts are subject to such a low threshold amount, often the gain from the sale of a trust-owned investment asset will be subject to the NIIT.

Capital gains are includable in DNI to the extent they are: (i) allocated to income; (ii) allocated to corpus but treated consistently by the fiduciary on the trust's books, records and tax returns as part of a distribution to a beneficiary; or (iii) allocated to corpus but actually distributed to the

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<sup>11</sup> Discretionary distributions must be consistent with the terms of the trust.

<sup>12</sup> An increase in a beneficiary's income may have unintended consequences, especially to those tax items that use AGI as the threshold for application. For example, the ability to contribute to a Roth IRA is phased out as modified AGI exceeds certain thresholds, the taxability of Social Security benefits is affected by AGI, certain itemized deductions are phased out as AGI increases, and the deductibility of contributions to a traditional IRA are dependent on AGI. However, such distributions may also have positive results such as allowing a taxpayer to take a larger charitable deduction because the allowable amount increases as AGI increases and allowing for the deduction of investment interest that is deductible only to the extent of net investment income.

<sup>13</sup> I.R.C. §1411(c)(1)(A)(iii); Treas. Reg. §§1.1411-4(a)(1)(iii), 1.1411-4(d)(4)(i). The regulations give a broad construction to the term "disposition." See Treas. Reg. §1.1411-4(d)(1).

beneficiary or used by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.<sup>14</sup> So long as the trust instrument allows, the impact of the NIIT on the growth of the trust can be reduced by allocating capital gains to the income distributed to beneficiaries rather than to the corpus. Furthermore, so long as the beneficiaries receiving the distribution do not have AGI exceeding the individual threshold amount, NIIT on the capital gain will be avoided entirely, at both the trust and the individual level.

## *Material Participation*

As mentioned above, if a taxpayer materially participates in a trade or business, the income generated from that business will not be net investment income and therefore will not be subject to the NIIT. Section 469(h)(1) states that a taxpayer materially participates in an activity when the taxpayer is involved in its operations on a regular, continuous and substantial basis. Neither the section 469 nor section 1411 regulations provide guidance on how an estate or trust can satisfy the material participation test.

In enacting section 469 as part of the Tax Reform Act of 1986,<sup>15</sup> the Senate Finance Committee stated “[a]n estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating.”<sup>16</sup> In general, the IRS’s position has been consistent with that of the Senate Finance Committee and looks to the activities of the trustee to determine whether a trust materially participates in an activity.<sup>17</sup> Until the IRS chooses to enact further guidance defining material participation as it relates to estates and trusts, trusts may be able to avoid accumulating net investment income by having the trustee participate in an activity of the trust on a regular, continuous and substantial basis and satisfying one of the seven material participation tests found in Temporary Treasury Regulation §1.469-5T(a).<sup>18</sup>

## Conclusion

The increased burden that the NIIT places on estates and trusts can be a significant incentive to grantors to seek out alternative planning techniques in order to reduce its impact on the long-term growth of a trust. The selection of a fiduciary and the language of the governing document will both play a substantial role in determining the options available to a fiduciary in mitigating the NIIT liability. During the planning process, the client and attorney can work through the options available and tradeoffs that might be required to capture both non-tax and tax intentions for the trust.

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<sup>14</sup> Treas. Reg. §1.643(a)-3(b).

<sup>15</sup> P.L. 99-514.

<sup>16</sup> S. Rep’t No. 99-313, 99th Cong., 2d Sess., at 735 (1985).

<sup>17</sup> See PLR 201029014 and TAM 200733023. *But see, Mattie K. Carter Trust*, 256 F.Supp.2d 536 (N.D. Tex. 2003) (district court held that a trust materially participated in ranching activities where individuals (not just the trustee) conducted the business on behalf of the trust. The acts of all agents and employees of the trust must be considered, along with the actions of the trustee, in measuring the material participation of the trust in an activity).

<sup>18</sup> A taxpayer (and in the case of a trust, the trustee) must satisfy at least one of the seven tests set forth in Temp. Regs. §§1.469-5T(a)(1) – (7) in order to meet the “material participation” requirement.