



Income Shifting and its Benefits

- Income shifting means causing an income stream to inure to the benefit of a different person in a lower tax bracket, typically a child or other close relatives of the taxpayer. This can result in a benefit for the family as a whole.
- Income shifting is irrelevant between spouses because filing a joint return in any case usually results in the best tax treatment.
- This can only be done with *unearned* income (e.g., interest and other investment income) as earned income has to go to the employee or contractor who did the work. Even if s/he gives the money away, s/he still must pay income tax on the earnings.



The “Kiddie Tax”

- The Kiddie Tax is a rule that is designed to prevent people from shifting large assets that produce income to one’s children just to have the income apply to a lower tax bracket.
- The rule applies to unearned income only (interest, investments, etc.). Earned income cannot be shifted anyway.
- The rule states that unearned income above twice the child’s standard deduction (usually a low amount because the child is a dependent and dependents get low standard deductions (\$800 or so) is taxed at the highest marginal tax rate of his parents. The child still pays the tax.



Providing Free Services

- If one provides a favor by doing free services for someone (or only charges an amount equal to out of pocket costs), there's no income tax on that.
- However, if one provides services for the benefit of a third party who must then pay someone else, the service provider must declare the money earned as income and the fact that the money goes to a third party is a gift! This applies even if the third party is a charity although there may, of course, be an applicable charitable deduction.
- Therefore, if you volunteer your services on behalf of the charity, make sure the charity is the purported recipient of the services!



Trusts and Estates

- Trusts are arrangements that include 3 parties:
 - The Grantor - Establishes and usually funds the trust
 - The Trustee - Handles the trust assets
 - The Beneficiary - Is meant to be the ultimate recipient of the trust assets

- An estate is established to hold the property of a decedent until the property is distributed.

- For income tax purposes, trusts and estates are treated in the same manner.



Simple Trusts

- A simple trust is a trust that, under its terms, is required to distribute all of its income to a beneficiary (or beneficiaries).
- Although the trust still has to file an income tax return (Form 1041), it doesn't pay any tax.
- Instead, the beneficiaries who receive the income are taxed on the distributions as ordinary (unearned) income.



Complex Trusts

- ❑ A complex trust is one that may, but need not, distribute its income to one or more beneficiaries.
- ❑ To the extent that it does distribute its income, the income is taxed to the beneficiaries and not to the trust.
- ❑ To the extent that it's not distributed it's taxed to the trust at trust rates.
- ❑ Under Section 663(b), a trust can distribute income for the previous year up to 65 days into the next year.

Trust and Estate Income Tax Rates

2007 Tax Rate Schedule

If taxable
income
is:

Over—	But not over —	Its tax is:	Of the amount over —
\$0	\$2,150	15%	\$0
2,150	5,000	\$322.50 + 25%	2,150
5,000	7,650	1,035.00 + 28%	5,000
7,650	10,450	1,777.00 + 33%	7,650
10,450	---	2,701.00 + 35%	10,450

- Note that except for very low income trusts, it usually pays to distribute the income to avoid the high trust tax rates on low amounts of income.
- Unlike individuals, trusts can get unlimited charitable deductions.



Grantor Trusts

- A Grantor Trust is a trust whose income is treated directly as the Grantor's income.
- These rules were originally designed to prevent high income people from ensuring a lower tax bracket by putting their assets into a trust.
- Today, because of lower individual brackets and higher trust tax rates, using a Grantor trust can often be advantageous today. In fact, many trusts are intentionally made as grantor trusts so as to avoid trust income tax rates.



How a Trust Becomes a Grantor Trust

- Under Sections 671-679, there are a variety of complex rules that determine whether a trust is a grantor trust.
- In essence, if the grantor has certain powers or authorities over the trust, it's a grantor trust.
- If you want to make a trust into a grantor trust, all you have to do is give the grantor one of these powers.
- Trusts that hold life insurance on the Grantor (ILIT) are inherently Grantor trusts.



Some Provisions that Cause a Trust to be Considered a Grantor Trust

- Section 673: The grantor has a reversionary interest in excess of 5%
- Section 674: The Grantor or any “non-adverse party” has the power to control beneficial enjoyment of the trust assets with certain exceptions.
- Section 675: The Grantor retains certain administrative powers, such as to exchange property or repurchase property for less than fair value
- Section 676: The Grantor can revoke the trust
- Section 677: Income can be distributed to the Grantor or spouse or to pay life insurance premiums on the Grantor’s life