A Few Notes on Capital Gains Taxation in Trusts

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Last update: May 9, 2019

1 Introduction

This document started life as research I did after discussing taxation issues with Denise on 07-May-2019. There was also a confusing email thread with amy@windes.com but I have completely abandoned that as I couldn't make sense of what she said.

This document is intended to answer the narrow question:

What are the tax implications of "taking money out" of either trust?

The exact meaning of "taking money out" discussed in Section 3.

As an aside, remember that there are two main kinds of trusts: simple and complex. In our case, the Non-Exempt trust is a simple trust while the Exempt trust is a complex trust. Simple and complex trusts have a many different features. For example, a simple trust is required to distribute all *income* to the beneficiaries who then pay tax at their personal rate. On the other hand, a complex trust such as the Exempt trust is *not required* to distribute its income; however, if it holds income for more than one year then it pays tax at the trust income tax rate; see Section 4.

One other trust property that will be useful in reading the tax tables later: grantor vs. non-grantor trusts. What we need to know here is that our trusts are are non-grantor trusts.

Finally, standard disclaimer: I learned everything in this document myself by studying what I could find.

The remainder of this document is organized as follows: Section 2 briefly reviews trust terminology and concepts that we need for this discussion. Section 3 examines what "taking money out" means and what process might be used to do so. Section 4 discusses how taxation works in the trust context, focusing narrowly on capital gains taxes. Section 5 provides a few worked examples and Section 6 lists a few open questions.

2 Brief Review: Trust Terminology and Concepts

In this section I'll try to define a few terms and concepts just to be sure we're all on the same page

First, and most importantly, trusts, like estates, are taxable entities. A trust is a fiduciary entity whose objective is to hold and invest money or property held in the trust for the benefit of the beneficiaries. Trust property consists of **principal** (aka **corpus**), which is the property transferred to the trust by the grantor, and income earned by the trust, usually from investments[1]

If the trust retains *income* beyond the end of the calendar year, then it must pay taxes on it at the trust tax rate; see Section 4. If money is distributed to the beneficiaries, then whether it is taxable or not to the beneficiaries will depend on whether principal or income was distributed, and if it was income, then whether it was tax-free income or retained income from previous years that the trust has already paid tax on. In our case so far everything distributed from both trusts has been income which is taxed at the beneficiary's rate, not the trust rate.

2.1 Income Tax. vs. Capital Gains Tax: A Quick Overview

Income tax is paid on earnings from interest, dividends, employment, royalties, or self-employment, whether it's in the form of services, money, or property.

Capital gains tax is paid on income that derives from the sale or exchange of an asset, such as a stock or property that's categorized as a capital asset.

Of course there are many other kinds of tax, but income and capital gains are the taxes we are interested in for our purposes here.

[1] You can think of the principal as what was there when you received the trust, although like everything with trusts, not exactly.

2.2 What can be distributed tax-free to the beneficiaries?

Because trusts are not subject to double taxation, either principal or income on which the trust paid taxes can be distributed tax-free to the beneficiaries. Likewise, any taxable distribution to beneficiaries is deductible by the trust. You can think of this like this: either the trust pays tax or the beneficiary pays tax, but not both.

There is an interesting point to note here: Because there is no double taxation and because it is assumed that tax has been paid on the principal (there is an open question with this, see Section 6), principal can apparently be distributed **tax-free** to the beneficiaries if the trust allows this. Of course if there are any capital gains you will have to pay tax on that. This is discussed in both Sections 4 and 5.

Denise: This answers one of your questions. If the trust has stock in XYZ corporation and the cost basis is the same as the sale price, then the proceeds of the sale can be distributed to the beneficiary (you) **tax-free** (as it is assumed that any principal has already been taxed and the trusts are non-double taxxation). So in your example if your cost basis on XYZ is 10.00 and the current price of XYZ shares is 10.00, then the trust's capital gain are zero and it can distribute all of the proceeds of the sale to you tax free. At least that is what it looks like.

3 "Taking Money Out" – What exactly does this mean?

Denise and I discussed this for a while and it turns out that "taking money out" really means liquidating some asset (in our case stocks, bonds, ETFs or mutual funds, anything that is in WFA), paying the capital gains (if any), and having the proceeds distributed to the beneficiary.

I imagine this process would look something like the following. To be concrete, I'll use Denise as the beneficiary and Dan as the trustee. Essentially this is the "taking money out" process.

1. Denise communicates to Dan that she wan't to liquidate some part of the trust principal to receive X dollars
2. Dan, Denise and Dennis Dummit (I assume) figure out what to sell
3. Dennis makes the sale with proceeds Y
4. Someone (Dan?) computes the capital gains tax on the sale, call that Z
5. The trust distributes $Y - Z$ dollars to Denise, **tax free**. Ideally $X = Y - Z$.

ORDINARY TAX RATES AND BRACKETS

	Taxable Income	Pay	% on excess	Of the amount over:
Single	$0 - $9,700	$0	10%	$0
	9,700 – 39,475	970	12	9,700
	39,475 – 84,200	4,543	22	39,475
	84,200 – 160,725	14,382.50	24	84,200
	160,725 – 204,100	32,748.50	32	160,725
	204,100 – 510,300	46,628.50	35	204,100
	510,300+	153,798.50	37	510,300
Married Filing Jointly	$0 - $19,400	$0	10%	$0
	19,400 – 78,950	1,940	12	19,400
	78,950 – 168,400	9,086	22	78,950
	168,400 – 321,450	28,765	24	168,400
	321,450 – 408,200	65,497	32	321,450
	408,200 – 612,350	93,257	35	408,200
	612,350+	164,709.50	37	612,350
Married Filing Separately	$0 - $9,700	$0	10%	$0
	9,700 – 39,475	970	12	9,700
	39,475 – 84,200	4,543	22	39,475
	84,200 – 160,725	14,382.50	24	84,200
	160,725 – 204,100	32,748.50	32	160,725
	204,100 – 306,175	46,628.50	35	204,100
	306,175+	82,354.75	37	306,175
Head of Household	$0 - $13,850	$0	10%	$0
	13,850 – 52,850	1,385	12	13,850
	52,850 – 84,200	6,065	22	52,850
	84,200 – 160,700	12,962	24	84,200
	160,700 – 204,100	31,322	32	160,700
	204,100 – 510,300	45,210	35	204,100
	510,300+	152,380	37	510,300
Estates and Non-Grantor Trusts	$0 - $2,600	$0	10%	$0
	2,600 – 9,300	260	24	2,600
	9,300 – 12,750	1,868	35	9,300
	12,750+	3,075.50	37	12,750

Figure 1: 2019 Income Tax Schedule (table courtesy Baird [1])

Of course there will be fees from Wells Fargo and perhaps other expenses so we won't have exactly $X = Y - Z$.

Now, the question remains: How to calculate Z, the capital gains tax. That is the subject of the next section.

4 Overview: Taxation in Trusts

First, for income earned by the trust and not distributed, the trust (not the beneficiary) pays tax at the rate show in the row labeled "Estates and Non-Grantor Trusts" in Figure 1. As you can see the top rate is 37% on income greater $12,750.00 (not 12,000, as Amy said). The thing to notice is the last column: the trust tax rate grows much faster than individual (or married, etc) rates do. For example, for Married Filing Jointly you don't hit the top bracket of 37% until $612,350.00 (as opposed to $12,750.00 for the trust). In any event none of this comes into play for the capital gains case we are considering here.

Denise: A lot of the confusion with Amy came from her apparent confusion over what

Long-Term Capital Gain Tax Rate	Single	Married Filing Joint	Married Filing Separately	Head of Household	Estates & Non-Grantor Trusts
0%	$0 – 39,375	$0 – 78,750	$0 – 39,375	$0 – 52,750	$0 – 2,650
15%	$39,375 – 434,550	$78,750 – 488,850	$39,375 – 244,425	$52,750 – 461,700	$2,650 – 12,950
20%	$434,550+	$488,850+	$244,425+	$461,700+	$12,950+

Figure 2: 2019 Capital Gains Schedule (table courtesy Baird [1])

your personal tax rates are and what the trust tax rates are. She seemed to be using of the word "your" to describe both your FBO trust and your personal tax situation. In any event that confused most of what she said.

Next, consider the capital gains case. The tax schedule is shown in Figure 2. Here you can see that the maximum tax rate of 20% for non-grantor trusts cuts in at capital gains above $12,950.00. Again the rate increases much faster for trusts than it does for the other categories.

4.1 How To Calculate Capital Gains Tax

First, every asset in the trust principal has a cost basis. The cost basis is essentially what you (well, Dad) originally paid for the asset.[2] So calculating the capital gains tax is pretty simple:

1. Calculate the capital gains
2. Apply the rate show in Figure 2

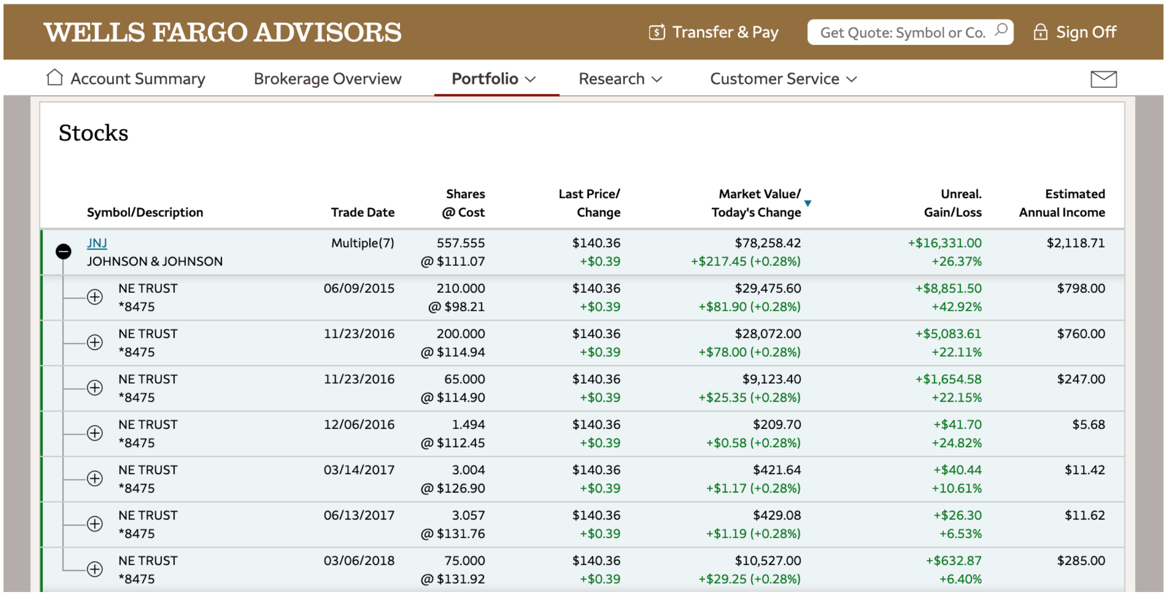
All this will become clearer if we look at a couple of examples.

5 Examples

Example 1: Suppose we want to "take out" $100,000.00 from one of the trusts and we choose to have the trust sell shares of XYZ corporation to accomplish this. Say XYZ shares are trading at $10.00/share so the trust needs to sell 10,000 shares ($10,000 = \frac{100{,}000.00}{10.00}$). Suppose further that the trust's cost basis on XYZ shares is $5.00 so that the trust's *capital gains* per share is $10.00 - 5.00 = 5.00$.

Ok, but questions:

[2] I think the cost basis was reset when we received the trusts, but not sure.



Symbol/Description	Trade Date	Shares @ Cost	Last Price/ Change	Market Value/ Today's Change	Unreal. Gain/Loss	Estimated Annual Income
JNJ JOHNSON & JOHNSON	Multiple(7)	557.555 @ $111.07	$140.36 +$0.39	$78,258.42 +$217.45 (+0.28%)	+$16,331.00 +26.37%	$2,118.71
NE TRUST *8475	06/09/2015	210.000 @ $98.21	$140.36 +$0.39	$29,475.60 +$81.90 (+0.28%)	+$8,851.50 +42.92%	$798.00
NE TRUST *8475	11/23/2016	200.000 @ $114.94	$140.36 +$0.39	$28,072.00 +$78.00 (+0.28%)	+$5,083.61 +22.11%	$760.00
NE TRUST *8475	11/23/2016	65.000 @ $114.90	$140.36 +$0.39	$9,123.40 +$25.35 (+0.28%)	+$1,654.58 +22.15%	$247.00
NE TRUST *8475	12/06/2016	1.494 @ $112.45	$140.36 +$0.39	$209.70 +$0.58 (+0.28%)	+$41.70 +24.82%	$5.68
NE TRUST *8475	03/14/2017	3.004 @ $126.90	$140.36 +$0.39	$421.64 +$1.17 (+0.28%)	+$40.44 +10.61%	$11.42
NE TRUST *8475	06/13/2017	3.057 @ $131.76	$140.36 +$0.39	$429.08 +$1.19 (+0.28%)	+$26.30 +6.53%	$11.62
NE TRUST *8475	03/06/2018	75.000 @ $131.92	$140.36 +$0.39	$10,527.00 +$29.25 (+0.28%)	+$632.87 +6.40%	$285.00

Figure 3: JNJ numbers from Wells Fargo on 08-May-2019

Question 5.1. How much of the $100,000,00 can be distributed to the beneficiary? The question here is because the trust may have incurred taxes and other fees (for example, on the transaction) as a result of the sale.

Question 5.2. What tax liability does the beneficiary incur as a result of the distribution?

To answer Question 5.1, we first need to calculate the capital gains for the transaction. Here the total capital gains is capital gains/share * number of shares = $5.00/share * 10,000 shares = $50,000.00. The capital gains tax rate on $50,000.00 is 20%, so the trust's tax is $\$50,0000 * 0.20 = \$10,000.00$. So given the assumed cost basis the capital gains tax on the sale of 10,000 shares of XYZ at $10.00/share is $10,000.00. This means that the "after tax" value of the sale is $\$100,000.00 - \$10,000.00 = \$90,000.00$. Finally, the number of shares can be adjusted to get to $100,000.00 after taxes and fees but this gives you an idea of how this might work.

To answer Question 5.2, and **here's the great part:** Since it is assumed that taxes have already been paid on the principal, it appears that the beneficiary can in this case get a **tax-free** distribution of $90,000.00. This also means that the beneficiary has an effective tax rate of 10% ((100,000-90,000)/100,000 = 0.10 or 10%).

Example 2: For a more realistic example, suppose we want to take $75,000.00 out of the Non-Exempt trust. One way this could be done is to sell part of the Non-Exempt trust's position in JNJ. These positions are shown in Figure 3. Since JNJ is trading at \$140.36, the trust needs to sell 75,000/140.36 = 534.35 or about 535 shares to generate \$75,000.00.

Since we don't have 535 shares in any one JNJ position (see Figure 3), we start by using the shares with the highest cost basis (in this case 131.92) and add up shares going from highest to lowest cost basis. Here we have

# shares	Cost Basis	Capital Gains/share	Total Capital Gains
75.00	131.92	140.36 - 131.92 = 8.44	75.00 * 8.44 = 633.00
3.057	131.76	140.36 - 131.76 = 8.60	3.057 * 8.60 = 26.29
3.004	126.90	140.36 - 126.90 = 13.46	3.004 * 13.46 = 40.44
1.494	112.45	140.36 - 112.45 = 27.91	1.494 * 27.91 = 41.70
65.00	114.90	140.36 - 114.90 = 25.46	65.00 * 25.46 = 1654.90
200.00	114.94	140.36 -114.94 = 25.42	200.00 * 25.42 = 5084.00
187.45	98.21	140.36 - 98.21 = 42.15	187.45 * 42.15 = 7901.02
535.005			15381.35

Table 1: JNJ Positions: Cost Basis and Capital Gains

As shown in Table 1, the trust's capital gains on the sale of 535.005 shares of JNJ is \$15,381.35 so the trust will incur capital gains tax of \$3,076.27 ($15381.35 * 0.20 = 3076.27$), see Figure 2). The total proceeds from the sale are $535.005 * \$140.36 = \$75,093.30$ (ignoring fees, etc).

So if correct the trust could distribute $\$75,093.30 - \$3,076.27 = \$72,017.03$ to the beneficiary **tax-free**. BTW, this is an effective tax rate of $(75093.30 - 72017.03)/75093.30 = .041$ or 4.1%.

6 Open Questions

Question 6.1. Is the principal in the Exempt trust assumed to have been already taxed (like the Non-Exempt trust)?

Question 6.2. Are there any restrictions on the distribution of principal, and if so is it different for the Exempt trust vs. the Non-Exempt Trust?

Question 6.3. Was the cost basis on the assets in the Wells Fargo trusts reset when we received the trusts? This one has no bearing on any of the above; just curiosity.

References

[1] Baird. 2019 Tax Facts. https://content.rwbaird.com/RWB/Content/PDF/Help/2019-Tax-Facts.pdf, 2014. [Online; accessed 08-May-2019].