

Qualified Funeral Trusts and Lower Tax Rates

Prior to January 1988, a substantial portion of the funeral industry set up their preneed trusts with the funeral home as the grantor. The funeral home/grantor method allowed the funeral home to substantially avoid taxes at the trust level. This came to an end in 1988 when the IRS issued Rev. Ruling, 87-127, and deemed purchasers, not funeral homes, were the grantors of preneed trusts. For a period of ten years, trustees were required to treat the purchasers as owners of the income, and whether the purchaser's individual circumstances required back up withholding.

The burdens caused by Rev. Ruling 87-127 led Congress to pass Section 685. This provision of the tax code authorizes trustees to elect to terminate the purchaser/grantor status, and to have the trust treated as a separate taxpayer. Trusts that take the election are then called Qualified Funeral Trusts or QFTs. The first year that a QFT return could be filed was in 1998. Our firm has been preparing Section 685 QFT returns since 1999.

The IRS created a new tax return form for the QFT (Federal Form 1041qft) but provided very little instruction for income, expense and tax allocations. The Form 1041qft was clear that the IRS considered each purchaser preneed contract to constitute a single trust. To avoid requiring a trustee to prepare hundreds of returns for a seller's trust, the Form 1041qft allowed trustees to file either a composite return or a single unified return. The single, unified return was the easier of the two approaches, but required the trustee to use aggregate income numbers to determine what tax rate would apply. For most seller trusts, the aggregate income would quickly trigger the top tax rate of 39.6%. When a composite return is used, the trustee applies the different tax rates to each purchaser's account. A purchaser's account would have to realize net income of \$2,450 before triggering the second tier of tax rates. For the average funeral trust, the account would need an investment return of about 50%. Clients can dream for such investment returns, but for purposes of programming we assumed it would be impossible for a purchaser's account to earn enough income to trigger a higher tax rate than the 15% rate.

Composite returns require more administration from the trustee because income has to be tracked by character (interest, dividends, short term gains/losses, long term gains/losses, and tax exempt) and each character of income must be allocated periodically to each purchaser's account. (PRC allocates income on a monthly basis.) For years, we assumed that the majority of QFTs were prepared on the composite method. However, when the IRS amended Section 685 in 2009 to remove the QFT cap of \$7,000, the Service included comments that indicated otherwise. (See our blog post: **The Section 685 QFT amendment: Supporting Soldiers' Survivors**)

Section 685 was based in part on an industry proposal made to the IRS to avoid Rev. Ruling 87-127. The industry proposed a simplified return that would report aggregate trust income and pay a flat rate of 10%. The industry raised the concept with the IRS after Rev. Ruling 87-127 proved a disaster, but the IRS responded with Section 685, and its alternate methods: a lower tax rate that required individual contract allocations or the simplified return that guaranteed high tax rates.

The Form 1041qft form and instruction were created by the IRS years before lower tax rates for capital gains and qualified dividends were introduced by George W. Bush' administration. The QFT includes

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both of these characters of income in net taxable income. The only income that could be clearly excluded from the lowest tax rate was tax exempt interest. This was not much of an issue when the Section was passed because most trusts were invested exclusively in fixed income (or tax exempt income). The issue first began to arise as preneed trusts responded to declining bond rates by diversifying into equity investments. That diversification trend accelerated with the 2008-09 mortgage crisis, and preneed administrators began to question whether a QFT could use individual taxpayer's lower capital gains rates and qualified dividends tax rates. However, preneed administrators were also using capital losses to offset other trust income.

At the conclusion of 2012, a handful of PRC trusts had three consecutive years of significant capital gains, and had exhausted their capital loss carryovers. Accordingly, we began to research for authorities that would support the application of lower qualified dividends rate and the long term capital gains rate to the composite QFT return. With a few of our client's trusts now 50% diversified into equities, the lower tax rates could save them \$10,000 in income taxes. By November, we found nothing conclusive to either support or to prohibit the application of the lower tax rates to a Form 1041QFT that is prepared as a composite return. At that point we began to contact clients regarding the benefits, and the risks to applying the lower individual tax rates of capital gains and qualified dividends to a 1041QFT. While the tax savings were substantial, the IRS could assert that 15% is the lowest possible tax rate for a 1041QFT, and the capital gains and qualified dividends reported at 0% were underreported and subject to taxes and interest. Such amounts could be paid out of the trust to the extent the underlying preneed contract is still outstanding and income had been accrued. If a contract had been performed and paid out, the trustee would have to seek payment for the taxes and interest from the funeral home.

But in December 2013, the IRS issued its final rule for the Medicare tax intended to fund Affordable Care Act. In applying the Medicare tax to QFTs, the IRS advises that each purchaser's trust income will determine whether the Medicare tax has to be paid. For the 2013 tax year, a trust would have to realize taxable income of \$11,950 before triggering the Medicare tax. If a QFT is prepared on a composite basis, it is inconceivable that any preneed contract should ever incur the Medicare tax. For the composite QFT returns, the IRS Medicare rule adopts the same approach that PRC had been seeking for capital gains and qualified dividends. Even though income will not be reported to the preneed purchaser, the individual trust's net taxable income should be used to determine whether capital gains and qualified dividends are taxable to the trust. While the IRS could yet challenge this approach with regard to qualified dividends and long term capital gains, the approach can be better defended in light of the Medicare Tax Rule. (We discuss this Medicare tax rule in our blog post: The Medicare Tax and QFTs: Don't look a gift horse in the mouth)