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The Income Tax Mulligan for Trusts: **65 Day Elections**

For those fortunate souls who have not succumbed to the Siren's call that is the game of golf, a Mulligan is basically a free "do-over." The term "mulligan" represents an opportunity to have a second chance to do what you wish you had done from the start. In the world of federal income taxes, there are not many chances at a mulligan. There are even fewer chances at a mulligan for wealthy families. But one such opportunity exists in the tax code under Section 663(b), commonly referred to as a 65 Day Election.

The rule itself is quite simple: Any distribution of income by an estate or irrevocable trust within the first 65 days of a tax year can be treated as having been made on the final day of the preceding tax year.

In most years (i.e., non-Leap Years), the last day to take advantage of this rule is March 6. That means that executors and trustees have till early March to use a mulligan for the prior tax year and decide to make a distribution to the beneficiaries of the estate or trust from the income that would otherwise be taxed to the estate or trust.

To be eligible for an election, an estate or a trust must be a "complex" trust, which basically means that the trustee has the discretion over whether (or not) income is distributed to one or more of the trust's beneficiaries. An eligible complex trust would also need to be an irrevocable trust, and not deemed to be a "grantor trust" for income tax purposes.

So why does it matter? Why would a fiduciary want to use their mulligan? The answer lies in the disparity between ordinary income tax rates for humans as compared to the rates for estates and trusts.

Estates and complex trusts have far more compressed federal income tax rates, meaning the effective federal income tax rates for estates and trusts are going to be significantly higher. Plainly stated, in exchange for several wealth transfer and asset protection benefits, irrevocable trusts are subject to more punitive federal income taxes.

To compare the 2022 brackets and rates, see the table below and compare the married filing jointly (MFJ) column to the trusts and estates column on the far left:

Tax Brackets and Rates – 2022 ¹

Rate	For Individuals, Taxable Income over:	For Married Couples Filing Joint, Taxable Income over:	For Heads of Household, Taxable Income over:	For Estates & Trusts, Taxable Income over:
10%	\$0	\$0	\$0	\$0
12%	\$10,275	\$20,550	\$14,650	
22%	\$41,775	\$83,550	\$55,900	
24%	\$89,075	\$178,150	\$89,050	\$2,750
32%	\$170,050	\$340,100	\$170,050	
35%	\$215,950	\$431,900	\$215,950	\$9,850
37%	\$539,900	\$647,850	\$539,900	\$13,450

Source: Internal Revenue Service

A married couple must have income exceeding \$647,850 before their income is exposed to the 37% tax bracket in 2022. An estate or trust hits that same highest marginal bracket after only \$13,450 of income.

In other words, if a married individual and a trust earned the same amount of gross income, the married individual will pay far less tax for that income than the trust would. So the power of the 65 Day Election is to shift income from the trust to one of the trust's beneficiaries, thereby reducing the amount of tax associated with the gain. And the election allows this shift to be applied retroactively for about 2 months after the end of a tax year.

Here's a hypothetical example to highlight the potential tax savings offered by the rule. An irrevocable trust generated \$250,000 of income in 2022. Ignoring state income taxes, this would result in \$90,761 dollars of tax for an effective tax rate of 36.3%. If the trust instead had distributed 100% of that income to a married beneficiary with no other income sources, the same \$250k of income would be subjected to federal income taxes at the MFJ rates and brackets. The result would be that the same amount of income would create a federal income tax liability of \$47,671 at an effective rate of 19.1%.

While that exact scenario is unlikely (rarely does a trust beneficiary have zero income outside of trust distributions), it serves to highlight the point that application of the 65 Day Election can offer meaningful tax savings when taking a comprehensive view of taxes at a family level. In that example, the tax savings can be quantified as a little more than \$43k,² roughly the cost of a midsize SUV!

¹ For information on 2023 income tax brackets, see our annual update [here](#).

² These benefits may be further enhanced by incorporating state income taxes as well. For example, if a trust is situated in California or New York (or even North Carolina), and the beneficiary's state residency for income tax purposes is in Florida, then the distribution could result in no state income taxes, thereby exacerbating the results. Even if both the trust and its beneficiaries are residents of the same state, and it happens to be one of the 33 states with a graduated state income tax, the same concepts could result in lower state income taxes in the aggregate.

To make the election, it's as simple as checking the box on line 6 under "Other Information" at the bottom of page 2 of Form 1041. Once made, the election is irrevocable for the particular tax year.

At the risk of pointing out something obvious, we should note that the income tax burden cannot be shifted from the trust to the individual beneficiary without also actually transferring the funds from the trust to the same individual beneficiary. So in the hypothetical scenario above, the trust would have to distribute the \$250,000 to the individual, and the individual would receive that amount to do with as he or she wishes.

It is worth further reiterating the point that it's rarely advisable to let the "tax tail" wag the dog. There may be other compelling reasons to retain the income and pay the higher income taxes at the trust's rates. Those reasons can vary, and at the end of the day a trustee is bound by fiduciary duty to act in the best interests of the current and future beneficiaries. Taxes are important, but not the only relevant consideration when a trustee is exercising his fiduciary duties of care and loyalty.

Long story short, if you get a 1099 for an irrevocable non-grantor trust in January or February that makes you gulp, there may be a way to substantially reduce the amount you'll have to send to Uncle Sam in April by making a distribution to the beneficiaries and electing to have that distribution treated as having been made in 2022. As always, we're happy to discuss and help think through the decision.

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