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Trust UPDATE

Citizens Bank
A Bank Built For You

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Trust accounting

"DNI? What's that?"

In general, a trust-based wealth management plan has as its goals the preserving, protecting, managing and ultimately, the distribution of wealth that has already been accumulated. An irrevocable trust is handicapped in growing wealth by a tax code with much higher tax rates than most individuals face. A married couple filing jointly will pass through seven tax brackets before reaching the top 37% rate at $731,200 of taxable income. An estate or trust, in contrast, faces just four tax brackets, and the 37% tax rate begins at $15,200 of income (see the table below).

For that reason, most trusts distribute their income to their beneficiaries, rather than accumulating it. When the income is distributed in this fashion, it is taxable to the beneficiary, and the trust is allowed a deduction for the distribution. This approach reduces the overall income tax owed by the trust and its beneficiaries.

Distributable net income

But what is income, in the context of a trust? This is where complexity begins to set in. The taxable income of a trust will include, for example, interest, dividends, rents, royalties, and capital gains. A series of adjustments must be made to this figure to determine Distributable Net Income, or DNI. The DNI acts as a limit on what the trust may deduct from taxable income, and it is also a ceiling for the amount the beneficiaries will have to include on their tax returns.

From taxable trust income, one subtracts deductions allowed for trusts and estates, such as administrative expenses and legal fees; adds back tax-exempt income;

Where does the 37% income tax bracket start?

Filing status	Taxable income of:
Estates and trusts	$15,200
Married filing separately	$365,600
Singles or heads of households	$609,350
Married filing jointly	$731,200

Source: Internal Revenue Bulletin 2023-48; M.A. Co.

37%

adds back capital gains that were not distributed to beneficiaries to be taxed on their tax returns; and subtracts the capital gains tax liability of the trust or estate. See your accountant or a trust officer for a more complete explanation.

Simple versus complex

A simple trust is one that, by its terms, is required to distribute all trust income every year, makes no distributions of principal, and makes no distributions to charity. With a complex trust, the trustee has broad discretion in distributing trust income; the trustee may make mandatory or discretionary principal distributions; and there may be charitable distributions.

Example. A simple trust has two beneficiaries, $90,000 of trust accounting income, and a DNI of $90,000. Beneficiary 1 has the right to two-thirds of the income ($60,000); Beneficiary 2 gets one-third ($30,000). The trust will be able to deduct the full $90,000, and so will owe no income tax.

To understand the allocation of DNI for complex trusts, six concepts come into play under the IRS Regulations:

1. DNI is distributed to beneficiaries on a pro rata basis;
2. The “tier system” of distributions;
3. The separate share rule;
4. The 65-day rule;
5. Specific bequests; and
6. Distributions in kind.

Discussion of these concepts is left to the professional advisors.

Who should be your trustee?

The specific characteristics that good trustees have include:

Experience and expertise. The more that a trustee can do, the less need there will be to engage expert agents.

Free of conflict of interest. In general, the trustee should not be a beneficiary, nor should the trustee have an economic stake in the trust assets.

Permanence. The age and health of a proposed trustee must be taken into consideration, unless one is choosing a corporate fiduciary.

Location. Close geographic proximity to the beneficiaries is not required, but it can be helpful in trust administration.

Payment. Trust administration is not expensive, as investment services go, but neither is it free. The trustee should expect to be compensated.

Accountability. Should there be trust maladministration of some sort, can the trust and the beneficiaries be made whole? The answer is “yes” with a corporate fiduciary, but with an individual trustee, in many cases, the answer could be “no.”

A complex trust in action

Grandfather arranged for two revocable trusts—one for himself and one for Grandmother. Each trust is worth about $5 million, and each produces about $150,000 of income each year. The couple paid their income taxes jointly on the total from both trusts.

Over the years, Grandfather made tax-free annual exclusion gifts to his four children and six grandchildren. When he started that program, the amount exempt from federal estate tax was much lower, and he thought he was lowering his eventual taxable estate. Those getting the gifts understood that they did not owe income tax on them.

Now Grandfather has died. His revocable trust becomes irrevocable, but the trust has wide discretion in the distribution of trust income. The possible income beneficiaries include Grandmother, if her own trust proves insufficient, and the four children. The trust will continue until the death of Grandmother. At that point, it divides into four equal shares for the children.

Grandfather’s trust is well below the threshold for the federal estate tax, $13.61 million in 2024, so that is not an issue. His trust was drafted so as to bypass Grandmother’s estate. Still, her $5 million trust could grow large enough to become taxable if the amount exempt from federal estate tax falls to about $7 million in 2026, as required under current law.

Accordingly, the trustee should probably not distribute income from Grandfather’s trust to Grandmother, if the income from her own trust is sufficient. In fact, she may want to continue Grandfather’s gift-giving program to the descendants.

The four children have very different financial situations. The oldest is retired, collecting Social Security and his Required Minimum Distributions from his 401(k) plan—he doesn’t need more income. The youngest is struggling financially after a divorce and some medical setbacks. The other two are in the middle in terms of financial resources and needs.

The trustee can take all these factors into account in deciding the best way to distribute the trust income. However the beneficiaries need to be made aware that, unlike the earlier tax-free gifts, they will be paying income tax on these trust distributions.

Would you like to know more?

As you can see, the operation and tax reporting for a trust is no small matter. We are well qualified for all the tasks of trusteeship. It is a job that we do every day, with our full attention. We are staffed for it, experienced and always ready to serve.

When you are ready to take the serious step of including a trust in your long-term financial and wealth management plans, please call us to learn more about how we may be of service to you. We look forward to answering all of your questions. ☐

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Choices for surviving spouses

The shift away from pensions toward employee-funded retirement benefits, such as 401(k) plans, has led to a dramatic increase in the number and value of IRA rollovers. For many families, tax-qualified retirement savings may be the largest single component of family wealth. Such assets have special financial and estate planning issues to contend with. This is especially true when the primary beneficiary will be a surviving spouse.

The SECURE Act and SECURE 2.0 brought changes to the tax rules governing the Required Minimum Distributions (RMDs) from tax qualified retirement plans, including IRAs. The reason for RMDs is to make certain that the retirement savings face an eventual income tax. The tension is that the account beneficiary wants the money to last as long as possible. Keying the distribution requirements to life expectancy balances these two interests.

The general rule now is that inherited retirement accounts must be distributed to beneficiaries during the ten years following the owner's death. The general rule does not apply to surviving spouses.

Alternatives

A surviving spouse beneficiary may keep that status, or the survivor may elect to be treated as the owner of the retirement assets. As an owner, the spouse may roll the funds into his or her own IRA rollover.

Examples. John owns a large IRA rollover and has named his wife, Mary, as the surviving beneficiary. If Mary chooses to be a beneficiary, she will have to begin taking RMDs in the year when John would have reached his required beginning date (generally, when he would have reached age 73). If she makes the IRA her own, distributions can be delayed until she reaches her own required beginning date.

If Mary is much older than John, and if he died well before his required beginning date, she is better off as a beneficiary. She will be able to defer the RMDs for many years, allowing the account to grow tax-deferred before tapping into it.

If Mary is much younger than John, she is more likely to choose to make the IRA her own, because then she can wait longer for her RMDs, maximizing the account value for her own retirement.

If John and Mary are close in age, this choice has little effect on the RMDs. In that case, Mary will want to take into consideration the fact that there will be no tax penalty for taking a distribution from an inherited IRA before reaching age 59½.

What if the IRA has been converted to a Roth IRA? In that event, she will likely want to make the account her own, eliminating the need for any RMDs during her lifetime. Roth IRAs don't have RMDs for the owners, but inherited Roth accounts do have RMDs.

Seek professional advice

Traditionally, the financial protection of a surviving spouse has been a key motivator for attending to the responsibility of having a will and an estate plan drafted. Getting professional tax and estate planning advice is doubly important when qualified retirement plan benefits will be a major component of the resources made available to the survivor. This brief review of the choices that will confront a survivor spouse is intended as preparation for meeting with advisors. ☐

A blast from the past

Jeffrey and Margaret were in their 20s when they met in a park and began dating. They moved to Sullivan County, Pennsylvania, living together while Margaret waitressed and Jeffrey got a job at Proctor and Gamble. In 1987, Jeffrey signed up for P&G's profit-sharing and savings program. He listed Margaret as his beneficiary, stating that she was a "cohabitor."

Two years later, the couple broke up. According to Margaret, it was because she wanted marriage and children; he did not. Margaret soon did marry and have children.

Jeffrey remained unmarried and childless throughout his life. He lived with a new partner, Mary Lou, for several years, until 2014. During that time, he designated his mother and Mary Lou as beneficiaries of his life insurance. After his mother died, Mary Lou was the sole beneficiary.

Jeffrey died in 2015, at age 59, a few months before he planned to retire. His largest asset was the P&G retirement fund, then worth some $750,000. He had never changed his beneficiary designation for that fund. And he had never made a will.

Under ERISA, beneficiary designations control who receives retirement accumulations after the owner dies. Jeffrey's brothers, as executors of his estate, did not believe that he wanted all this money to go to Margaret, an ex-girlfriend. P&G asked a federal court to decide who would get the money. The brothers alleged that P&G had violated its fiduciary duties by not getting Jeffrey to change his beneficiary designation, but the court noted that forms sent to Jeffrey over the years repeatedly admonished him to check this issue. The most recent court ruling was in favor of Margaret, but the brothers announced that they would appeal.

What if Jeffrey had made a will? A will does not normally overrule a beneficiary designation for insurance proceeds or retirement benefits, so it might not have prevented this litigation. However, it could have provided some insight into Jeffrey's intentions for the funds—perhaps, for an unstated emotional reason, he really did want Margaret to be the beneficiary of the retirement fund, which had grown to over $1 million by 2020. Had Jeffrey consulted an estate planning lawyer, the lawyer likely would have advised him to take steps to remove all ambiguity about his wishes.

Nine years after Jeffrey's death, the retirement money is still being held in escrow.

What about your beneficiary designations? How long has it been since you last reviewed them? Are they still optimal? Will your executor be able to quickly identify and notify those beneficiaries after your death? Checking up on beneficiary designations is a critical element of a routine will review. ☐

Let us help you choose the best options for preserving your wealth.

Utilizing life insurance, revocable living trusts, investment management accounts and more products, our Trust Division has a variety of options to help you preserve your assets for the next generation.

For more information, call (844) 350-8512