TRUST MANAGEMENT ISSUES?

Multi-generational Planning Opportunities Utilizing Tax-Deferred* Annuities

The beginning and end of each year are always a challenge for trustees. Usually fiduciaries regulated by the state or the Office of the Comptroller of the Currency will complete administrative reviews to ensure trustees are meeting all their fiduciary duties. It is also a time for trustees to ensure the asset allocation and rebalancing of trust investment portfolios comply with the Prudent Investor fiduciary rules. This can be an ordeal and a time of much hand-wringing for trustees due to the excessive tax brackets applicable to irrevocable non-grantor trusts. Discover how tax-deferred annuities can provide an efficient investment for trusts and help trustees meet their fiduciary obligations.

Why Use Trusts, Really?

Irrevocable trusts are typically funded to protect and grow assets for the trust grantor's chosen beneficiaries. The objective then is to protect assets from irresponsible beneficiaries; their creditors; irresponsible in-laws; and estate, gift, and generation-skipping taxes. In order to fulfill these objectives, trustees have a fiduciary duty to grow the assets greater than the rate of inflation and this task alone has become much more difficult.[1]

Treatment of Taxable Trust Earnings

The diversified portfolios that trustees are usually required to hold can generate a variety of taxable income, including bond interest, dividends, and capital gains. If volatility triggers investment changes, due to rebalancing or revised strategies, more and more of the last could be short-term capital gains. In turn, trustees—in order to avoid paying confiscatory trust tax rates (including the 3.8% Medicare surtax) on all but $12,950 of the portfolio's taxable earnings[2]—have adopted a practice of routinely paying out trust earnings to beneficiaries. In fact, Section 663 of the tax code, commonly known to trustees as "the 65-day rule," tells trustees they can make distributions to beneficiaries in the first 65 days of the year and essentially treat them as having been made in the prior year.[3]

Issues with Conventional Trustee Practices

The 65-day rule, in fact, presents several new issues. First, as noted above, often trusts are not intended to automatically pay out earnings to beneficiaries, but rather to grow trust assets outside of taxable estates. To the extent the trust is distributing earnings, it is losing estate-tax-free growth and increasing the beneficiaries' taxable income and taxable estates. Take, for example, a Dynastic trust, which is created to pass wealth from generation to generation without incurring transfer taxes. Typically, an attorney would advise the grantor to use this trust to move assets and earnings down through the family over a long period of time because the grantor's beneficiaries may also have taxable estates.

Therefore, it may make little sense to distribute earnings which would increase the value of those beneficiaries' taxable estates. Second, some beneficiaries will receive tax-motivated trust distributions which may cause them to pay more taxes on their other required income distributions—such as pensions, IRAs, or 401(k)s—and may cause them to pay more taxes on Social Security benefits or pay more for Medicare. Third, irrevocable trusts are subject to unique accounting rules and the concept of fiduciary accounting income under the Uniform Principal and Income Act (UPAIA) which was designed to ensure the intention of the trust creator or decedent is carried out.[4] The UPAIA applies to most irrevocable trusts, and its fiduciary accounting income concept essentially defines which earnings are income and which are principal. Under this concept, capital gains are added to the principal so that the trust can grow to ensure inflation-adjusted amounts are available for future beneficiaries.[4]

The problem then becomes that if capital gains must be added to trust corpus, then the trust must pay those confiscatory trust tax rates, thereby losing up to 40.8%[5] of those capital gains to taxes (plus any applicable state income taxes).[2] All these factors can cause trustees to make questionable judgments—ones that may be difficult for a fiduciary to justify in a lawsuit by beneficiaries challenging why the trust is not growing. Fortunately, the evolution of tax-deferred annuities has given trustees new and innovative investment options that will allow them to invest appropriately and ameliorate many of these challenges.

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* Tax deferral offers no additional value if an annuity is used to fund a qualified plan, such as a 401(k) or IRA. It also may not be available if the annuity is owned by a legal entity such as a corporation or certain types of trusts.

How Tax-Deferred Annuities Can Help

Tax-deferred annuities can take many forms. Traditional annuities were usually income-generating annuities, and they could be fixed, fixed index, or variable annuities with an add-on income guarantee.[†] Additionally, there are investment-only variable annuities (IOVAs), specifically designed for tax-efficient accumulation. For many trustees, the biggest challenge has indeed been trying to accumulate value in trust portfolios: 1) against a top federal tax rate of 40.8%[5] (and sometimes significant state income taxes); 2) via more short-term capital gains and ordinary income; and 3) with capital gains being trapped in the trust tax brackets via UPAIA—all of which can decimate trust growth when earnings are applied against those confiscatory trust tax rates. These factors can make IOVAs a compelling alternative for growth and accumulation.

The IOVA platform gives trustees the ability to defer all taxes in each year that no distributions are taken from the annuity. And the trustee may well not take earnings out of the annuity until a beneficiary actually needs the money to spend (after paying taxes at individual tax rates). It may well mean that the trust can be invested for total return without the necessity of making an irrevocable election under the Statutory Power to Adjust, which is a power to allocate income to principal or principal to income if the trustee is unable to administer a trust impartially between the current and remainder beneficiaries.[4] This has become common practice for many professional fiduciaries.

What is a variable annuity? Variable annuities are long-term, tax-deferred investments, involve investment risks, and may lose value. Earnings are taxable as ordinary income when distributed and may be subject to a 10% additional tax if an exception to the tax is not met.[6] Add-on living benefits are available for an extra charge in addition to the ongoing fees and expenses of the variable annuity.

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‡ With variable annuities, a contract charge and subaccount charges apply.
1 Robert J. Aalberts and Percy S. Poon, American Business Law Journal, "The New Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries," Fall 1996.
2 IRS, Revenue Procedure 2019-44.
3 IRS, IRC § 663(b)(1).
4 National Conference of Commissioners on Uniform State Laws, "Uniform Principal and Income Act," 2008.
5 Tax Cuts and Jobs Act, December 15, 2017.
6 IRS Private Letter Ruling (PLR) 202031008, says an annuity owned by a non-grantor trust is deemed to be owned by the trust, not a natural person, for purposes for Section 72(q) and cannot utilize the exceptions for (1) reaching age 59½, (2) disability, or (3) substantially equal periodic payments. The ruling recognized non-grantor trusts may utilize the Section 72(q) exception for death. While a PLR may provide insight as to the IRS interpretation of tax law, it can only be relied on by the party to whom it was issued. Jackson's processing of trust-owned annuity transactions with respect to Sections 72(q) and 72(u) relies on the statements and indemnifications provided by the trustee. It is the annuity owner's responsibility to ensure that withdrawals comply with IRS rules, so clients should seek and rely on independent tax and legal counsel.

Before investing, investors should carefully consider the investment objectives, risks, charges, and expenses of the variable annuity and its underlying investment options. The current contract prospectus and underlying fund prospectuses, which are contained in the same document, provide this and other important information. Please contact the Company to obtain the prospectuses. Please read the prospectuses carefully before investing or sending money.

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