# CHALLENGES TO TRUST ACCOUNT GROWTH

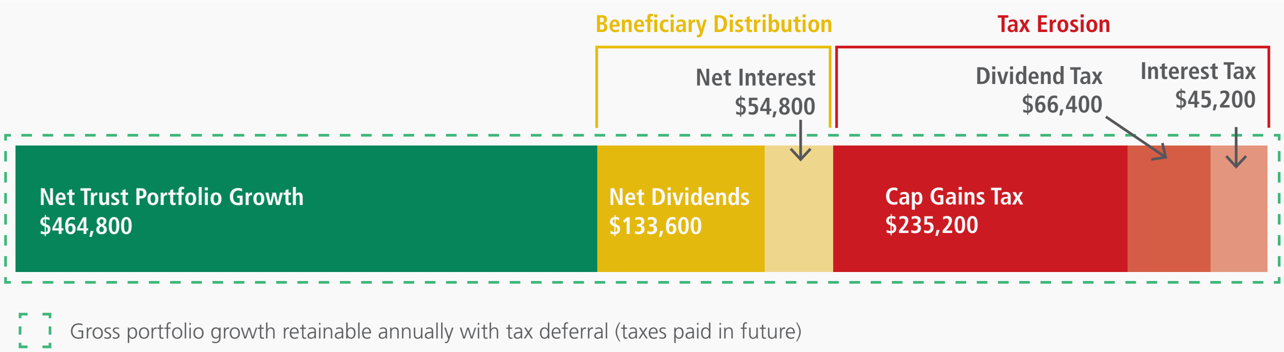
**Taxes and distributions can erode account value of a trust.**

Irrevocable trusts represent a tremendous opportunity to grow and protect wealth and to control its transfer within a family. However, the growth potential of these trusts often goes unfulfilled. Why? Taxes and distributions.

The tax code is designed to reduce accumulation outside of a taxable estate. This is why trusts are required to pay the highest marginal income tax rate of 37% on all taxable earnings that exceed just $12,750.[1] Whereas, a household would need to make more than $612,350 to pay the highest marginal income tax rate. To help alleviate some of the tax burden, distributions are often used in the first 65 days of the year, in order to shift the tax burden from the trust tax brackets to individual brackets.[2]

While this approach can offer marginal short-term income tax relief, these distributions essentially squander the growth potential of the trust. Distributed earnings are once again subject to the potential estate tax of the beneficiary. When funds leave the trust, they may also leave the oversight of the professional manager. Additionally, distributed assets may also alter beneficiaries' tax profiles, raising their effective tax rates and further eroding potential for growth.

As an example, consider the situation that a $12.5 million multi-generational trust experienced. Due to portfolio reallocations and a good year of returns, this trust realized a $1 million (8%) gain. Even in a banner year, the trust itself grew only $464,800 (3.72%) before management expenses. The figure below shows how distributions eroded 4.28% of the total value of the trust or more than 50% of the investment gain for that year.




This is a hypothetical example based on a scenario in which all dividends and interest are paid to trust beneficiaries. Assumptions: $1 million total income, 70% of which is capital gains (80% long-term and 20% short-term), 10% interest, and 20% dividends (80% qualified, 20% ordinary). It assumes a 47.2% federal trust income tax bracket (37% trust & estate tax, 3.8% Obamacare tax, 6.4% state tax) and a 45.2% beneficiary tax bracket (35% federal tax for individuals, 3.8% Obamacare tax, 6.4% state tax).

For trusts that include a longer-term growth goal, you can see why trustees grapple with these conflicting pressures of trust goals and taxation.

A variable annuity investment platform can provide trust officers a tool that allows the ability to manage this situation through the power of tax deferral.* Any portion of trust assets that benefits from tax deferral is not subject to annual taxation for capital gains, interest, or dividends. As a result, trustees can avoid tax-motivated distributions, which can allow the trustee to minimize income distributions while allowing any earnings to accumulate on a tax-deferred basis. Overall, utilizing a variable annuity within an irrevocable trust can help a client pursue their goals more efficiently.

Variable annuities are long-term, tax-deferred investments designed for retirement, 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 withdrawn before age 59½.

* 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.

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Financial professionals – **800/711-7397** • email – **privatewealth@jackson.com** • web – **jackson.com/private-wealth**
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Sources:
[1] Rev. Proc. 2018-57.
[2] IRS Code § 1.663(b)-1 Distributions in first 65 days of taxable year.

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