Take-Away: Making an irrevocable trust a beneficiary owned trust (BDOT) circumvents the high-income tax rate faced by the trust.

Background: Trusts and estates face extremely compressed federal income tax rates under the current Tax Code. The highest marginal federal income tax rate of 37% is reached when the trust or estate accumulates taxable income of only **$15,200.** [Revenue Procedure 2023-34.] This high rate of federal income taxation often forces the trustee to make distributions of trust income to trust beneficiaries, where the distributed income will be taxed at the beneficiary's personal income tax rate, which is far, far lower than the trust's. By way of example, a single trust beneficiary will not reach the 37% marginal federal income tax bracket this year until his/her income exceeds $609,350; a married trust beneficiary will not reach the highest marginal federal income tax bracket until his/her income exceeds $731,200. Then you get to add to the compressed trust federal income tax rates the fact that many trusts will be named as the designated beneficiary, aka a *see-through trust,* of the deceased settlor's retirement benefits, which adds even more exposure to high taxation.

Accumulation v. Conduit Trust: While a trust is often intended by the settlor to be used to protect wealth from the beneficiary's creditors (or the beneficiary's own imprudence) with an *accumulation see-through trust* when retirement benefits are made payable to the trust, the trustee often finds itself forced to distribute those retirement assets, in the form of distributable net income (DNI), to the trust beneficiary just to avoid paying the high federal income tax rate on the trust's accumulated income. In this sense, while the settlor may have intended the trust that he/she created to function as an *accumulation see-through trust* to protect the beneficiary, the trust is more likely to function as a *conduit see-through trust* merely to

avoid high income tax rates on that accumulated taxable income that comes into to the trust from an IRA or 401(k) account.

Income and Principal Acts: Added to the high federal income taxation problem faced by a non-grantor trust is when a retirement plan is made payable to the trust on the account owner's death. The general rule of the Uniform Fiduciary Income and Principal Act (UFIPA) is that a required minimum distribution (RMD) that is paid to a trust is 90% treated as principal and only 10% is treated as income. [See also Section 409 of the Uniform Principal and Income Act.] Consequently, when an IRA owner dies before his/her required beginning date (RBD), and there are no RMDs until the 10th year of the IRA owner's death, any distributions from the IRA (all taxable) to their trust will be treated by the trustee as trust principal under the Uniform Acts. Thus, a $100,000 distribution to the trust from an IRA would result in a $10,000 distribution (income) to the trust beneficiary, taxed at the beneficiary's personal income tax bracket, while the remaining $90,000 IRA distribution to the trust (taxable income) will remain in the trust as trust principal. $100,000 will be taxed yet $90,000 will remain in the trust as accumulated and undistributed *taxable* income for the year.

Duty of Impartiality: Also complicating the trustee's distribution decision is the trustee's duty of impartiality between current and remainder trust beneficiaries. If the trustee decides to distribute all trust income to the current trust beneficiary in to avoid the high-income tax rates faced by the trust, the trust remainder beneficiaries may object, claiming that flushing out all income from the trust, e.g. 100% of an IRA RMD distribution to the current trust beneficiary, is actually breach of the fiduciary duty to treat all trust beneficiaries impartially, a failure to preserve corpus, and a waste of trust assets all to benefit the current trust beneficiary, leading to a much smaller remainder interest that later passes to the remainder beneficiaries.

Consider a BDOT: To address the problem of highly compressed federal

income tax rates faced by an irrevocable trust, the trust could be drafted as a beneficiary-deemed owner trust (BDOT) under the Tax Code, or a *beneficiary defective intentional grantor-trust,* (or a BDIT.) This *grantor* trust classification will cause the trust's income to be taxed to its beneficiary, and thus exposed to the beneficiary's, not the trustee's, marginal federal income tax rate. A BDOT intentionally shifts the income tax burden way from the trust and to the beneficiary who is usually in a much lower marginal federal income tax bracket without destroying the trust's estate/gift/GST tax and asset protection benefits.

BDOT Rule: IRC 678 provides, in part: *(1)(a) General Rule: A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:*

1. *Such person has the power exercisable solely by himself to vest the corpus or the income therefrom in himself*.....

***Taxable* Income:** Key to this BDOT definition is that IRC 678(1)(a) refers to **taxable** income, not trust accounting income. [Regulation 1.671-2(b).] Accordingly, if the trust instrument provides that its beneficiary has the power solely exercisable in themselves to withdraw *all* the taxable income from the trust (regardless of whether it is principal or income under state law) the trust beneficiary must pay the federal income tax on this income, but at the trust beneficiary's income tax rate. **Whether the beneficiary withdraws the income (or how much or where it comes from) is completely irrelevant.** [Private Letter Ruling 201633021, August 12, 2016.]

Creditor Protection Preserved: IRC 678(1)(a) does not require that the trust beneficiary hold any power over trust principal beyond the trust's *taxable* income. If the beneficiary's withdrawal right is limited to trust *income,* then creditors of the trust beneficiary will not have access to the trust's principal, thus achieving one of the settlor's presumed goals in establishing the trust for the beneficiary.

Power of Withdrawal: To the extent that the trust beneficiary's power of withdrawal is not exercised, and it is allowed to lapse, only the greater of $5,000 or 5% is protected from being considered a taxable transfer, and any amounts allowed to lapse above that threshold amount will be considered as an additional contribution to the trust by the beneficiary for their own estate/gift/GST tax purposes. [IRC 2514(e).] Sometimes a *hanging lapse power* can be used to mitigate, to some extent, the trust beneficiary's exposure to federal estate/gift/GST taxes. So too, many states continue to follow the 'old' common law rule that does not regard the lapse of the beneficiary's withdrawal power as creating a self-settled trust for creditor protection purposes.

BDOT Example: Don, age 71, has a $7.0 million estate. Don's estate consists of $2.0 million held in a traditional IRA, $1.0 million held in a Roth IRA, and $4.0 million in 'other' non-retirement assets. Don splits his trust between his two children, Diane, and Sam, in two accumulation subtrusts, with $3.5 million in each subtrust: $1.0 million of which is an inherited IRA payable to each subtrust, $500,000 is the inherited Roth IRA payable to each subtrust, and $2.0 million of 'other' assets transferred to each subtrust. The SECURE Act's 10-year distribution rule will apply, as neither Diane nor Sam is an *eligible designated beneficiary.* Diane is in the 22% marginal income tax bracket. Sam is in the 24% marginal income tax bracket. In years 1 through 10 after Don's death the trustee of each subtrust takes $100,000 (it's not an RMD, just a distribution which, to simplify the example ignores any future growth.) Each subtrust earns 3% taxable interest and dividends on the other $2.0 million of 'other' assets each year, or $60,000 (again ignoring growth for simplification purposes.) Each year the subtrust grants each of Diane and Sam the right to withdraw all the taxable income which is $100,000 (from the traditional IRA) plus $60,000 (from the interest and dividends, or $160,000 total. Each child is taxed on all $160,000 of income of their subtrust, regardless of how much they take from their subtrust. Assume that each of Diane and Sam take 40% each year of the $160,000 income from their subtrust to pay their income taxes and for personal expenditures ($64,000). Diane and Sam

allow the remaining $96,000 of trust income to lapse and remain in their subtrust. Had a *conduit* or *accumulation* trust with liberal distribution standards been used by Don, $160,000 would have been distributed from each subtrust over each of the 10 years instead of only $64,000 each year. Over 10 years of distributions this results in a sizeable difference: $96,000 left in the subtrust X 10 years = $960,000 more that is protected in each subtrust at the end of 10 years, with the same income taxation minimization benefits. If Diane and Sam are wealthy, and they pay their subtrust's federal income tax liability using their own assets, even more wealth can accumulate in the subtrusts, effectively growing tax-free for their own descendants ultimate.

Conclusion: There currently exists a major tension between asset protection that intended with the use of a trust and the high-income taxation caused by the compressed federal income tax brackets faced by a trust, exacerbated by the compressed 10-year distribution schedule created by the SECURE Act for retirement assets made payable to an irrevocable trust. Leaving the retirement assets paid to the trust in the trust could double or possibly triple the income tax due to trapping the retirement assets/taxable 'income,' in the trust. It the trust is created to give the trust beneficiary the right to withdraw *taxable* income, that will shift the tax burden onto the trust beneficiary, but at much lower federal income tax rates, while preserving much of the asset protection features intended with the trust.

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