

IRC 68- The Phantom Income Distortion

Take-Away: New IRC 68 poses a significant challenge to the administration of trust and estates, more than just how income tax returns are prepared, as it creates *phantom income* tax liability that affects fiduciary administration in several significant ways.

Background: The One Big Beautiful Bill Act (OB3) gave us a new IRC 68 that introduced the 2/37th limitation on income tax deductions. The IRS recently interpreted this limitation as applying to the distributable net income (DNI) deduction historically taken by estates and irrevocable trusts [IRC 651 and IRC 661], along with other deductions that historically have been available to estates and trusts, like the charitable deduction. [IRC 642(c).] The impact of the curtail of these deductions has been covered in prior missives, pointing out that the mechanics of the IRC 68 limitation effectively creates *phantom income*, or another way to look at the mechanics, is that the section results in some double taxation. How IRC 68 impacts conventional estate planning is described in the following examples.

Pay All Income Trust- Example 1: An irrevocable trust is taxed at the 37% federal income tax bracket once its income exceeds \$16,000 in 2026. Assume that the trust has \$500,000 of income. IRC 68 limits the distribution deduction of trust income claimed by the trust to its beneficiary to 35/37th, sometimes called the 2/37th *haircut*. While the trustee might distribute the entire \$500,000 of income to the trust beneficiary, the income tax deduction that the trust can claim for that income distribution is limited to \$472,972. The result is that the trust beneficiary pays income taxes on the full \$500,000, while the trust has *phantom income* of \$27,028 that it must report. The trust must report \$27,028 as taxable income on which it must pay an income tax at the 37% on the income amount above \$16,000. IRC 68 effectively creates a mismatch between the full taxable income that the beneficiary must report, and an incomplete tax deduction offset to the trust, exposing *phantom income* to the trust's compressed federal income tax bracket. Who pays the income tax on this *phantom income* if the trust instrument directs that the trustee must distribute '*all income*' to the trust beneficiary, when it has no income? From trust corpus? Charged against fiduciary accounting income? By applying some type of equitable adjustment available under state trust and/or fiduciary accounting laws?

Marital Deduction-Example 2: The trust is a marital deduction trust that requires that all income be distributed to the surviving spouse beneficiary. [IRC 2056 (b)(5)(7).] IRC 68 reduces the distribution deduction that historically was available to the trustee of the

marital deduction trust. Again, the marital deduction trust will have taxable income despite paying all of the trust income to the surviving spouse as required by law. If the trustee pays all income to the surviving spouse, the question then becomes if that trust's income tax burden reduces what is treated as distributable net income to the spouse, or if the trust's income tax liability must be paid from trust principal (something the remainder beneficiaries might resent as it depletes their expected inheritance once the surviving spouse dies.) If the trustee attempts to pay the trust's income tax liability from trust income, will the trust continue to satisfy the requirements to claim the unlimited marital deduction?

Discretionary Trust- Example 3: The trust is a conventional credit shelter trust where the trustee is given the discretion to spray trust income among a group of beneficiaries that consists of the settlor's surviving spouse and children from the settlor's first marriage, with the surviving spouse given priority in distributions. The surviving spouse claims a pressing financial need for distributions, and he/she requests a distribution of all the trust's income. The trustee distributes all the trust income to the surviving spouse. With IRC 68, the trust will still owe income taxes on the disallowed portion of the income tax deduction, i.e., it will have to report *phantom income*. The other trust beneficiaries will not be happy if trust principal is 'invaded' by the trustee to find cash to pay the trust's *phantom income* tax liability. Should the trustee have made a loan to the surviving spouse instead of distributing all trust income, knowing that the other trust beneficiaries will with hindsight second-guess that income distribution? Should the trustee have created some cash reserve using trust income to cover the 'new' *phantom income* tax liability that it never had in the past, and not been so generous in accommodating the survivor's income distribution request?

Charitable Lead Annuity Trust- Example 4: The trustee is directed to pay the sum of \$370,000 a year as the annuity amount to a donor advised fund for two decades, after which the CLAT remainder is then paid to the settlor's children. The CLAT can only deduct \$350,000 each year, which leaves \$20,000 in *phantom income* on which the trustee must pay an income tax. That means that the trust's corpus will be eroded each year to pay the trust's tax burden. Over the years, that annual erosion, while a modest each year, will mean that there will be fewer assets in the CLAT remainder that will ultimately be distributed to the settlor's heirs.

IRD/IRA- Example 5: The decedent dies with a very large traditional IRA and a taxable estate. The estate tax attributable to the decedent's IRA balance is income in respect of a decedent (IRD.) The recipient of the decedent's traditional IRA is entitled to an income tax deduction attributable to the federal estate tax associated with the IRA. [IRC 691(c).] This Tax Code section is intended to avoid double taxation (first, federal estate tax, second, federal income tax on IRA distributions) as an intended offset. If the IRC 68 limitation applies to the IRC 691(c) deduction, the recipient of the decedent's IRA could receive less than the fully intended offset which is IRC 691(c)'s purpose. So much for relying on IRC 691(c) to avoid 'double taxation' that results from IRD if IRC 68 is interpreted a broadly as the IRS claims. With the limitation in the deduction, an inherited IRA will carry a heavier tax burden overall (estate and income) compared to any other type of asset that the beneficiary might have otherwise inherited.

Dealing with IRC 68: Trusts that are currently being drafted (or decanted?) should be prepared with the following provisions in mind to respond to the uncertainties and risks created by IRC 68.

- Define *income* in a manner that absorbs taxes at the income level.
- Expressly permit *equitable adjustments* by the trustee between principal and income.
- Direct the trustee to prefer one beneficiary class over another, i.e., *waive the duty of impartiality*.
- Provide broad indemnification and/or exculpation for the trustee regarding tax sensitive allocation decisions.
- If adjustments are to be made by the trustee between income and principal, authorize the trustee to seek judicial approval and obtain court orders as a customary expense of trust administration.
- Note the possible use of nonjudicial settlement agreements between the trustee and the trust beneficiaries regarding administrative adjustments to respond to IRC 68 or how it might be altered by future legislation or future IRS interpretation.
- Address the likelihood of more principal-vs-income disputes and beneficiary conflicts and more litigation over a trustee's decision of fairness and allocation.

Conclusion: IRC 68 is important for those who administer trusts or estates. There was some hope that when the IRS published its proposed Regulations on IRC 68 that its impact

would be substantially mitigated, but that was not the case, resulting in *phantom taxable income* that never had to be dealt with in the past. IRC 68 ignores existing Tax Code statutes and their requirements, e.g., 2056(b)(5), that are based on the decades-long presumption that *all* income will be distributed by the fiduciary with a corresponding income tax deduction for the distribution of *all income*, thus avoiding 'double taxation' on some of the distributed income. Once again I revisit my old refrain- this is what you get when you hurry to meet a self-imposed artificial deadline, i.e., OB3, without much thought other than to appease a 'master.'

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