

IRC 68- Confusion Reigns

Take-Away: There is much confusion arising from the *new* IRC 68 which limits income tax deductions for taxpayers in the highest marginal federal income tax bracket. Much more is involved with this new income tax deduction rule than just limiting the amount of the income tax deduction that can be claimed, including how trusts are drafted, how trusts are construed, how trusts and estates are administered, and how fiduciary duties are carried out.

Background: The One Big Beautiful Bill Act (OB3) changed IRC 68 and in the process, it created a considerable amount of confusion, especially for fiduciaries. This is the Tax Code section that limits the amount of federal income tax deductions for a taxpayer that is in the highest marginal federal income tax bracket. While this limitation on income tax deductions applies primarily to wealthy individuals, it also applies to trusts and estates which is where much of the confusion lies. Historically fiduciaries have relied on IRC 643(a), the distributable net income deduction, to simplify the taxation of estates and trusts. [IRC 651 and IRC 661.] Specifically, if the fiduciary distributed all of the estate or trust's income to its beneficiaries, the fiduciary could take a corresponding distributable net income (DNI) deduction to offset its taxable income, resulting in no taxable income to report after the DNI income tax deduction was claimed. With the *new* IRC 68, that symmetry has disappeared.

IRC 68: This *new* Tax Code provision limits the income tax deduction once taxable income exceeds a threshold amount. This is called a 2/37th limitation, or *haircut*, that results in a 5.4% reduction in the income tax deduction if an estate or a trust is taxed at the 37% marginal federal income tax bracket. Fiduciary taxpayers reach this federal income tax bracket once their income exceeds \$16,000 in a year.

Double Taxation: Consequently, when a fiduciary distributes *all* of its income to a beneficiary, it used to take a distributable net income deduction under IRC 643(a). But IRC 68 limits that income tax deduction by reducing it by 5.4%. As a result, the fiduciary will still have taxable income that it must report and on which it must pay a federal income

tax. **Limiting the fiduciary's income tax deduction for distributable net income (DNI) results in some of the income to be taxed twice.**

Example: A trust generates income of \$37,000, all of which the trustee distributes to the trust beneficiary. With the IRC 68 *haircut*/ limitation, after the trustee takes the distributable net income (DNI) deduction under IRC 643(a), the trustee still has reportable income of \$2,000. The trust beneficiaries will pay an income tax on the \$37,000 that was distributed to them by the trustee, and the trustee will pay an income tax on \$2,000 of *phantom income* caused by the IRC 68 deduction limitation. In effect, the \$2,000 will be taxed twice (at the trust level and again in the hands of the trust beneficiaries, or double taxation.)

Trust Administration: The apparent expansive interpretation of the *new* IRC 68 inferred by Treasury's limited comments on OB3 also creates more than just a situation where income is taxed twice. It also creates questions, or more accurately nightmares, in administration for fiduciaries. If the fiduciary distributes *all* income to the beneficiary, what is the source of funds that the fiduciary can use pay its income tax burden? A couple of examples follow.

Marital Trust- Pay All Income: The marital trust rules require that in order to claim the unlimited federal estate tax marital deduction the surviving spouse beneficiary must receive *all* the income of the trust as a matter of right. [IRC 2056(b)(5) or (b)(7).] The trustee of the marital trust thus is required to pay *all* the trust's income to the surviving spouse beneficiary, which in the past meant that the marital trust itself had no taxable income to report since *all* income was distributed to the spouse-beneficiary who paid the income tax. With the IRC 68 *haircut* the trustee's distribution deduction is limited, and the marital trust will now have an entity-level income tax despite having paid out *all* of the trust's income to the surviving spouse.

Does that 'retained' income tax burden effectively reduce what is treated as distributable net income (DNI) to the surviving spouse, which in turn might affect the trust even qualifying for the unlimited marital deduction? Does the marital trust's income tax get paid from marital trust principal? These are questions without answers.

With a QTIP trust frequently used in a second marriage situation, the remainder QTIP trust beneficiaries will not be happy if trust principal is used to pay the marital trust's income tax burden; expect those remainder beneficiaries to complain that the QTIP trustee caused the trust's principal to unnecessarily be used in order to indirectly support distributions that economically benefit their step-parent. Tension already existed between the step-parent's interest and his/her step-children in the QTIP trust; that tension could now increase to even higher levels if principal is used to pay the trust's income tax liability.

Bypass Trust- *Discretionary Distributions*: Consider a bypass trust that gives the trustee the discretion to distribute trust income and principal to or among a group of trust beneficiaries, e.g., the surviving spouse and the settlor's children. With the *new* IRC 68, each dollar that is distributed by the trustee may fail to carry out a matching income tax deduction which will force the trustee to decide whether the resulting income tax burden belongs to trust income or to trust principal. If the trustee decides to distribute income to only one beneficiary, e.g., the settlor's surviving spouse, the trust will still owe an income tax on the disallowed portion of the income tax deduction. Some of the beneficiaries might claim that rather than make the income distribution to that 'lucky' beneficiary, the trustee (with hindsight) should have loaned funds to the beneficiary instead of an income distribution to preserve trust principal for future income generation. Alternatively, the trustee might decide to reduce future income distributions to the trust beneficiaries in order to preserve sufficient cash to be available to pay

the income tax cost caused by IRC 68 instead of distributing the full economic amount as the settlor may have intended.

Duty of Impartiality: The *phantom income* problem created by IRC 68 also implicates the trustee's duty of impartiality if it is not waived by the settlor in the trust instrument. If trust principal is used to pay the trust's residual income tax liability on its *phantom income*, does that violate the trustee's duty of impartiality? Perhaps not if the trust instrument directs that the lifetime needs of the current trust beneficiary is a priority over the needs of the trust's remainder beneficiaries. If the trust instrument is silent, then the trustee is left to guess. Conversely, if the trust instrument directs the trustee to preserve trust principal, if possible, e.g., a dynasty-type trust or a GST exempt trust, then the use of trust principal to pay the trust's income tax liability on its *phantom income* might expose the trustee to the beneficiaries' breach of fiduciary claims.

Retirement Accounts-Federal Estate Taxes: New IRC 68 may also affect the deduction for federal estate taxes attributable to income in respect of a decedent (IRD) under IRC 691(c). This is important if a decedent's IRA (or perhaps deferred compensation) is payable to a trust or the decedent's heirs. If the decedent died with a large IRA which was included in the decedent's gross estate for federal estate tax purposes, the recipient of that inherited IRA can claim an income tax deduction for the federal estate tax that is attributable to the retirement account assets (IRD), which mitigates any double taxation, i.e., the estate tax paid, followed by the income tax paid when the retirement account assets are distributed and taxed as ordinary income. With the *new* IRC 68 the recipient of the inherited IRA could receive less than the full intended offset, which is the express purpose of IRC 691(c). If *new* IRC 68 applies to the IRC 691(c) income tax deduction, the effect is to increase the total tax burden associated with retirement account or deferred compensation assets.

Practical Observations: Many trusts were drafted years or decades ago with the assumption that the full distributable net income (DNI) offset of IRC 643(a) was available to prevent the trust or the estate from having to report and pay an income tax. Those trusts are now inconsistent with what the law now requires. The fallout might be some or all of the following

New IRC 68 now creates *phantom income* that no one ever contemplated before, not to mention *double taxation* of that income. That is certainly the case with marital deduction trusts.

With more use of dynasty-type trusts with multiple generations of trust beneficiaries, more blended families, and GST tax concerns, preservation of trust principal is more important than ever.

The source of funds used to pay the income tax on a trust's *phantom income* requires looking to state law (not the Tax Code) to determine where the tax dollars can legitimately be found.

More trusts will contain provisions that clearly define what is trust accounting income.

The equitable adjustment rules of Michigan's Trust Code and also the Fiduciary Uniform Principal and Income Act will now be consulted, or followed, by fiduciaries.

New IRC 68 may create more than just *phantom income*; also impacted will be state fiduciary accounting principles, trust construction and interpretation proceedings, and fiduciary duties.

With the uncertainty caused by *new* IRC 68, the structure of a trust instrument and its terms becomes more important, e.g., waiving the duty of impartiality; favoring one trust beneficiaries over other trust beneficiaries; directing the trustee in the exercise of its discretion to

take into consideration the beneficiary's other available financial resources, as the fiduciary contends with IRC 68 and its impact on trust administration.

Trust modifications, trust decanting, and trust termination proceedings may accelerate caused by the *phantom income*/ principal invasion implications of IRC 68.

Conclusion: New IRC 68 has raised many complex questions that Treasury has yet to answer or to provide any guidance to fiduciaries. Certainly, thousands of trusts have been drafted over the decades with the assumption that the IRC 643(a) distributable net income (DNI) income tax deduction would be available to offset the taxable income of the trust. Now all of those trusts are impacted by the broad prohibition language that is used in IRC 68 that Congress hastened to enact to accommodate an artificial deadline of July 4, 2025, that the President imposed. Trust beneficiaries will need to be communicated with regarding the impact of IRC 68 on their trust along with how the fiduciary plans to respond. Some trusts may have to be modified in court proceedings due to this circumstance that was not anticipated by the settlor (or his/her probable intention) [MCL 700.7412(2)], or because the settlor's tax objectives cannot be achieved with this law change. [MCL 700.4716.] Guidance from Treasury would be helpful, but a year has passed, so I'm not holding my breath.

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