MEMORANDUM TO CLIENTS AND FRIENDS
FROM JEANETTE M. LOMBARDI
OCTOBER 6, 2022

Irrevocable Trusts and Income Taxation

Dear Clients and Friends,

I truly hope you are all safe and doing well and were not significantly impacted by hurricane Ian.

I have been approached several times this summer with questions about trust income taxation. One of those queries has been about why distributions from an irrevocable trust may minimize income taxes of the trust. While you can always seek to minimize income taxes by financial planning and investment decisions, you may also be able to reduce the tax "bill" due by the trust with distributions of income to the beneficiaries. While it is desirable to minimize taxes, we do not want the "tax tail to wag the dog" and so it is important for the trustee to first evaluate the appropriateness of a distribution of income to a beneficiary based upon the trust's parameters and the beneficiary's circumstances.

This type of analysis will initially be done with the assistance of a professional advisor such as your accountant. Once the trustee is clear on who may receive a distribution and any special restrictions on distributions, the trustee may focus on the income tax benefit of certain income distributions. As part of this analysis, it is also important for the trustee to have discussions with the actual beneficiaries who may be receiving a distribution of income. It may be that some beneficiaries may not be adversely affected by a distribution because of their lower tax bracket; however, some may already be in a higher tax bracket and may be disadvantaged by a discretionary income distribution.

The following is an example of how the trust income taxation works and how the beneficiary's income tax bracket is also a consideration. For example, if the trust has undistributed taxable income of $40,000, then the trust is at the top bracket of 37% income tax because an irrevocable trust reaches the 37% tax bracket once its taxable income is $13,450. If the trust beneficiaries are in lower tax brackets – and specifically if there are several beneficiaries receiving distributions – then the total tax paid[1] could be substantially less with net taxable income distribution to the beneficiaries. Compare that 37% tax bracket for trust taxable income at $13,450 to individuals who reach the 37% tax bracket if their taxable income is $539,900 or greater (married couples filing jointly will not pay at the top tax bracket until they reach taxable income levels of $647,850 or higher). Thus, it is important for a trustee of an irrevocable trust to meet with the accountant for the trust, to know the income tax brackets for each trust beneficiary, if possible, and to discuss the investments generating taxable income with the investment advisor, in order to effectively perform an income tax planning analysis. Note that distributions must be made within the calendar year or within the first 65 days of the next

1 There are different brackets for ordinary income, net investment income tax and qualified dividends/capital gains.

calendar year. The additional 65 days allows a trustee more time to determine the total taxable income for the prior year.

Irrevocable trusts are effective estate and gift tax planning strategies and maximizing these benefits with income tax planning is certainly worthwhile. Year end is a perfect time to perform this analysis. Again, hoping all is safe with you and your families.

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