IN THIS ISSUE

TRUST COMPANY of NORTH CAROLINA

WEALTH MANAGEMENT

UPDATE

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Is a team approach better than having one trustee?

Historically, a trust had a single trustee and many beneficiaries, often in multiple generations. The trustee was responsible for administering the trust according to its terms, which included asset management responsibilities. If a trust allowed for discretionary distributions to beneficiaries, it was up to the trustee to exercise that discretion, subject to the obligations of fiduciary duty to all parties to the trust. Such distributions might be related to education, to health, to achieve a goal or a certain age, or even to living according to an accustomed standard.

"The MODERN TRUST may have four, five, or more fiduciary and non-fiduciary positions."

Recently there has been a trend toward dividing up these responsibilities, having a team of professionals working together. For example, if the trust will own a family business, the creator of the trust may want to entrust decisions about that business to a family member or business partner, one who has direct knowledge and relevant experience. When it comes to discretionary trust distributions, some may feel that family members should have a voice in the process. A trust may also employ a mechanism for granting someone other than the trustee the power to change the trust itself in response to unanticipated changing circumstances—such as changing tax laws, economic disruptions, or deteriorating global markets.

When there are multiple responsible parties for trust management, the administrator of the trust is said to be "directed" by the others, and hence the genesis of the term "directed trust." The modern trust may have four, five, or more fiduciary and non-fiduciary positions. Many of these positions, because they are relatively new, are known by different names. Different state laws might use different terminology, and there are wide variations in how different attorneys draft the provisions governing these positions. Thus, trustees, beneficiaries, and anyone involved with a trust should review the specific terms of each instrument governing each position and not presume that a particular title has a specific meaning without further investigation.

Examples of divided responsibilities

Administrative and general trustee. An institutional administrative and general trustee may be designated, typically a bank trust department or trust company. This position will hold all trustee powers in the governing instrument that have not been allocated to other fiduciaries. The administrative trustee handles the bookkeeping, statements, the tax filings, and implementing investment changes.

Investment trustee. A person may be designated to make all of the investment decisions, which the trustee will then execute on behalf of the trust. The investment trustee may decide, for example, that a concentrated holding should not be sold, notwithstanding the general duty of trustees to diversify and make productive the assets of the trust. Another area of contention may be whether the investments should be chosen to maximize current income for the income beneficiaries or whether growth should be the focus, so as to have more for the remainder beneficiaries.

Distribution trustee. The trust could name a person, or a group of persons acting as a committee, to be responsible for trust distributions. This puts the responsibility in the hands of persons with a more intimate knowledge of family dynamics. However, caution should be exercised, as the power to distribute from a trust is a tax-sensitive power, one that could sometimes cause nasty tax problems.

Insurance trustee. A person could be designated to be responsible for life insurance decisions of the trust. This person should not be the insured. By providing for a separate person to be responsible for insurance decisions, and including prohibitions against the settlor/insured being involved in these decisions, the trust can hold both life insurance and other assets. Some of the advantages of this include the ability to use a single trust to hold business interests and life insurance, instead of multiple trusts, and the ability to use income generated by trust investments to pay for life insurance premiums.

Trust Protector. This is a person appointed to hold important powers over the trust and, perhaps, to perform certain other defined roles. The protector may be given the power to remove and replace existing trustees, correct drafting errors, modify administrative provisions, change trust situs and governing law, and other powers depending on the circumstances and goals.

Substitutor. This person, who may be the settlor or another person, can be given the power to exchange or "swap" assets of the trust for assets of equivalent value. The common application of this technique is to swap highly appreciated trust assets back into the grantor's estate so that on death they will qualify for a step-up in income tax basis. Provisions should be added to any durable power of attorney to address this power in the event of disability. It also is prudent to arrange lines of credit to facilitate acting on this swap power in an emergency situation.

Charitable designator. One of the means of creating grantor trust status is to empower a person to add to the class of beneficiaries, such as a charity. With the present restrictions on income tax benefits of itemized deductions, perhaps it is advisable to include a mechanism to add charitable beneficiaries in more trusts to provide flexibility for settlors to make contributions out of irrevocable trusts if that proves advantageous in the future.

Too many cooks?

The advantages that may come with dividing up tasks in trust administration must be weighed against potential pitfalls. For example, trustees are tasked with regular communication with all trust beneficiaries. Multiple fiduciaries will need to communicate with each other as well as those who have interests in the trust. That can get complicated.

Such complications may lead to delays in making decisions, delays in beneficiaries getting the answers they need, and could adversely impact the purpose of the trust. A trust should do more than divide responsibilities, it should include a process for the resolution of conflicts that may emerge.

Finally, there is the question of accountability. Traditional trust services, managed by a single corporate trustee, are supervised and regulated by state or federal officials, as well as subject to internal audits. This is a fully established body of law. Derivative rules apply to trusts managed by teams. The commands of fiduciary responsibility apply in full to all parties with a hand in trust management, yet the lines of accountability for particular actions may be less than clear.

These uncertainties may be resolved with thoughtful trust planning.

Would you like to know more?

Modern trust drafting, tax uncertainty, longevity, and a range of other factors are transforming how trusts are planned, drafted, and administered. The wide array of positions, fiduciary and non-fiduciary, that may be included in a trust instrument are among the most affected areas. Creative and careful selection of these positions, and the persons named to serve in them, can infuse substantial flexibility into trust planning.

How would a modern trust benefit you and your family? We would be pleased to explore that question with you. For those who have shied away from trust planning out of a fear of "tying up" assets, the team approach may be one that gets them over the hurdle. ☐

Auditioning for parts in wealth management

The responsibilities and duties of trusteeship don't have to reside in a single person or institution. Some trusts are dividing up the job along these lines:

Role	Responsibility
Administrative and general trustee	Clerical duties, communications, recordkeeping
Investment trustee	Asset management
Distribution trustee	Discretionary transfers of trust assets
Insurance trustee	Pay premiums, evaluate policies
Trust protector	Change trustees, modify administrative provisions
Substitutor	Swap trust assets
Loan designator	Provide the settlor with temporary access to trust assets
Charitable designator	Add charitable beneficiaries

Source: M.A. Co.

Trusts, taxes, and distributions

In a recent report to Congress, the Joint Committee on Taxation summarized the taxation of trusts and estates. Trusts and estates report their income to the IRS on Form 1041. When income is distributed to a beneficiary, it is the beneficiary that pays the income tax, and the trust or estate gets a corresponding deduction. Only income that is retained and accumulated is taxable to the trust or estate.

The data reveal that most trusts and estates distribute all of their income to beneficiaries, based upon 2017 tax filings. There were 3.2 million Forms 1041 filed that year, and only 1.1 million reported net taxable income. That income is taxed at relatively high rates—the top tax rate for ordinary trust income kicks in at just $10,000 (plus inflation adjustments, the 37% rate starts at $13,450 taxable income in 2022). Total trust and estate income was $178 billion in 2017, and retained net taxable income came to $90 billion. Total tax liability was $24 billion.

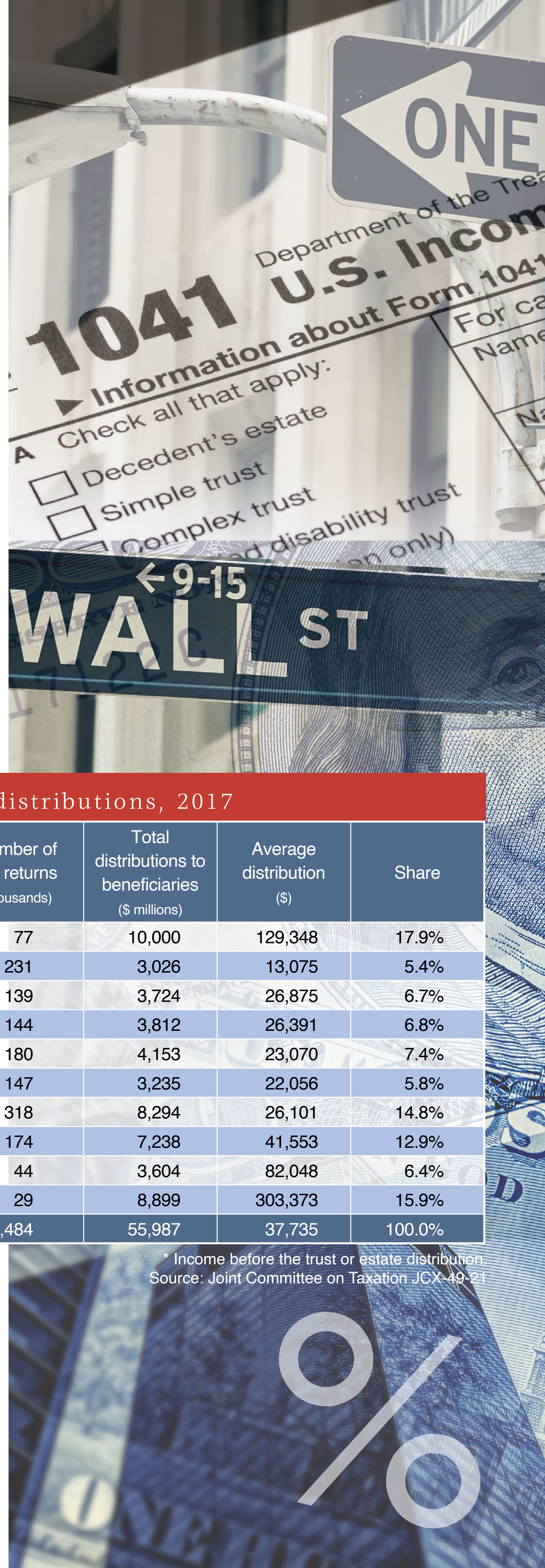
To put that in perspective, total corporate tax liability was $246.6 billion in 2017 (ten times more), and individual tax liability was $1.58 trillion (almost 66 times larger).

What beneficiaries received

The largest component of distributions to beneficiaries was dividends, at 33.7%. Next was long-term capital gains (20.8%), followed by rent (17.6%) and other/unknown (14.7%). Perhaps because interest rates were so low in 2017, interest payments were only 5% of distributions. Short-term capital gains, which are not very tax efficient, comprised a scant 0.7% of the total.

Interestingly, the data showed that the perception that trusts are for millionaires is not entirely accurate. About half of the beneficiaries receiving distributions had income below $100,000. The table at right reveals how trust distributions varied with the income of the beneficiary, with adjusted gross income (AGI) determined before the distribution (which means some beneficiaries had AGI less than zero). Nearly 18% of beneficiaries had a negative AGI, and this group had the second largest average distribution. Some 32% of beneficiaries had an AGI between $0 and $100,000. In this group, the average distribution was $22,353.

Of course, millionaires do benefit from trusts as well. The 29,000 beneficiaries with an AGI of $1 million or more received an average distribution of $303,373, according to the report. These amounts were taxable to the beneficiaries. ☐



Trust and estate distributions, 2017

Income group*	Number of tax returns (thousands)	Total distributions to beneficiaries ($ millions)	Average distribution ($)	Share
Less than $0	77	10,000	129,348	17.9%
$0 - $15,000	231	3,026	13,075	5.4%
$15,000 - $30,000	139	3,724	26,875	6.7%
$30,000 - $50,000	144	3,812	26,391	6.8%
$50,000 - $75,000	180	4,153	23,070	7.4%
$75,000 - $100,000	147	3,235	22,056	5.8%
$100,000 - $200,000	318	8,294	26,101	14.8%
$200,000 - $500,000	174	7,238	41,553	12.9%
$500,000 - $ 1 million	44	3,604	82,048	6.4%
$1 million and over	29	8,899	303,373	15.9%
Total	1,484	55,987	37,735	100.0%

* Income before the trust or estate distribution.
Source: Joint Committee on Taxation JCX-49-21

Charitable giving overview

In March, the Joint Committee on Taxation prepared an overview of the tax rules for charitable gifts, in anticipation of a Senate Finance Committee hearing on the subject. The report may be accessed at https://www.jct.gov/publications/2022/jcx-2-22/. Some highlights of interest:

- There are about 1.75 million organizations registered as charities under tax code section 501(c). However, only about 1.4 million of these are eligible to receive deductible charitable contributions. Therefore, due diligence falls upon donors to ascertain whether the object of their philanthropy may generate charitable deductions for donations.
- Religious organizations received 28% of charitable gifts, the largest share, and educational organizations came in second, receiving 15% of donations.
- Assets held by donor-advised funds exploded from $31 billion in 2006 to $141 billion in 2019. Annual contributions to donor-advised funds grew from $9 billion to $38.81 billion in that period. That's an increase of 331.2%, while total U.S. charitable giving rose 52% during the same time frame.
- Although there is general agreement that the income tax deduction for charitable gifts increases the amount of such giving, there is a divergence of opinion on the strength of that incentive. In particular, some studies suggest that short-term variability in charitable giving, which is often attributable to changes in tax rules, has little long-term effect on philanthropy.
- In a progressive income tax regime, those in the top tax brackets get the greatest tax benefit from the charitable deduction. According to the reports projection for 2022, taxpayers with an adjusted gross income greater than $1 million (about 0.39% of all tax returns) will make more than 43% of total deductible charitable gifts. Their average gift will be $171,050, and the "revenue cost" of allowing that deduction will be $54,092.

Qualified Charitable Distributions from IRAs.

The report also summarizes the rules for a strategy sometimes called a "charitable IRA rollover." Those who are 70½ or older may direct their IRA trustee to make a distribution of up to $100,000 in one year to a qualified charity. Such a distribution will not be included in adjusted gross income, even though it will qualify as a required minimum distribution (RMD). The RMD rules kick in when the IRA owner reaches age 72.

According to the report, there are three additional tax benefits that may accrue with this strategy:

- Avoiding the effect of the individual percentage limits on the deduction for charitable giving.
- Avoiding additional income without an offsetting charitable deduction where a taxpayer elects to take the standard deduction.
- Minimizing Social Security taxes and Medicare premiums.

The report did not attempt to quantify how many taxpayers have used this strategy, or what the revenue effects might be for the IRS. ☐