



## GUIDE FOR TRUSTS AND TRUSTEES

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### A) Why a Trust

1. Clearly establishes to whom, when and why assets are to be transferred under the grantor's plan.
2. Prevents improper dissipation of assets when beneficiaries are minors, under a disability, susceptible to undue influence or incapable with respect to financial matters.
3. Professional management (including investment management) is available to ensure provisions of the trust are respected and enforced and to oversee distributions to beneficiaries and ensure that discretionary distributions are made impartially.
4. Limits taxes as many trusts offer grantors the ability to pass wealth to somebody else while limiting taxes.
5. Protects assets from present or future creditors.

### B) Responsibilities of Trustees

1. A trustee must understand the trust terms.
  - Why was it created?
  - What is the distribution policy?
  - How long will it last?
  - Who are the beneficiaries?
2. A trustee must make prudent investment decisions, under the Prudent Investor Act.
3. A trustee must ensure distributions are appropriately made as the grantor intended at the right time, in the right amount and for the right reasons.
4. A trustee must balance competing interests between income and principal beneficiaries.
5. A trustee must consider beneficiaries' changing needs and circumstances when making investment decisions and meet those needs to the extent the trust allows it.
6. A trustee must communicate well with all parties to the trust in areas of asset allocation, investment policy and performance and distribution policy.

**C) What are the Trustee's Tax Responsibilities**

1. At the most basic level, trustees are required to file annual Fiduciary Income Tax Returns (Federal Form 1041 and appropriate state income tax forms) for trusts with annual income exceeding \$600.
2. In recent years, the importance of fiduciary income tax planning has soared for trustees. It is imperative that trustees be cognizant of the potential for significant income tax savings that may be available, such as by making timely distributions to beneficiaries, where appropriate.
3. Because of Federal Gift, Estate and Generation Skipping Transfer Taxes on transfers of assets from a transferor on amounts exceeding \$5,490,000 (as of 2017), trustees must obtain and keep permanent records of Gift and/or Estate Tax Returns, and the Trust Agreement. This is to ensure that all required transfer tax reporting under the law has been done and that all Gift, Estate and Generation Skipping taxes that apply were paid.
  - a. Generation Skipping Transfer Tax (GSTT) reporting requirements are of particular importance to Trustees. Although Gift Tax, Estate Tax and Generation Skipping Transfer Tax Reporting is the legal responsibility of the transferor or the executor at the time of the initial transfer, trustees are responsible for all ongoing tax reporting, such as for any distributions to beneficiaries known as "skip persons" (persons considered to be one or more generations below the grantor).
  - b. The trustee must review the permanent record of the Gift and/or the Estate Tax Returns and the Trust Agreement to determine what assets were contributed to the trust and what portion, if any, of the donor's or decedent's Generation Skipping Transfer Tax Exemption was allocated to the transfer. This allocation, as reported on the Gift and/or Estate Tax Return, permanently affects all the taxability of all distributions from a trust to skip persons going forward.
  - c. Because there now exists a \$5,490,000 Exemption for the Generation Skipping Transfer Tax, many transferors or fiduciaries allocate some or all of the GSTT Exemption to a trust if some of the beneficiaries are of the next generation. For older trusts when the Exemption was much smaller, many transferors or fiduciaries elected not to allocate any of the Exemption at the time of the initial transfer, which creates special need of attention by the trustee for any distributions to a skip person in such situations because significant GSST may be due.

4. The tax law under I.R.C. Sec. 2631 and 2632 relating to the GSTT Exemption availability and utilization requires careful consideration before the filing of a Gift and or Estate Tax return. However, there are relatively simple yet very important things for a trustee to understand because the decision made by the donor or the decedent's executor binds the trustee permanently when considering distributions to beneficiaries.

a) Inclusion Ratio

One common misconception is that allocating the GSTT Exemption is thought of as exempting a portion of the trust from tax, but such is not the case. The entire trust is subject to tax. Allocating GSTT Exemption does not exempt any assets or portion of a trust from tax, rather the allocation lowers the rate of tax applicable to the entire trust.

b) Automatic Allocation Rules

Under the current tax law, the GSTT Exemption for transfers made directly to individuals or in trust where beneficiaries are skip persons (or indirectly to future beneficiaries who may become beneficiaries under the trust) are automatically allocated to make the "Inclusion Ratio" zero or as small as possible.

The objective here is that the exempted amount will not be subject to GSTT tax at the time of the transfer and any distributions made from the trust to skip persons will be fully exempt from GSST if there is an inclusion ratio or zero, or partially exempt depending on the inclusion ratio.

For Example:

Client creates a trust of a \$1,000,000 and:

- a) Allocates no GSTT Exemption to the trust. The inclusion ratio is one and the current tax rate on a taxable distribution or a taxable termination, the GST tax would be \$400,000 ( $1,000,000 \times .40 \times 1$ ).
- b) Allocates \$1,000,000 of their Exemption, the inclusion ratio is zero, and the tax rate is zero on all transfers thereafter with respect to the trust.

- c) Allocates \$500,000 of their GSTT Exemption to the trust the inclusion ratio is .5 so all distributions to skip persons thereafter would be subject to a GST tax rate of .5 times the maximum GST tax rate at the time of the distribution. Therefore, if the entire \$1,000,000 were distributed currently the tax rate would be 20% or \$200,000 of tax ( $1,000,000 \times .40 \times .5$ ).

For optimal planning trusts should have an inclusion ratio of either zero or one.

A trust with an inclusion ratio of between zero and one wastes GST exemption allocated to it whenever a distribution is made to a non-skip person (ie. distribution to a child vs. grandchild) because nonexempt assets could have been distributed to the non-skip person without any GST anyway.

A trust with an inclusion ratio of one should be used to provide for beneficiaries who are non-skip persons while the trust with an inclusion ratio of zero should be used for skip persons.

Achieving the optional inclusion ratio may not be practical in situations where the transferor doesn't want the assets divided into different trusts, the amounts in question are not significant enough or for other non tax reasons.

- 5. Important Note: All distributions from a trust to skip persons require the trustee to file Form 706-GS to report the distributions whether or not GSTT is due.

- 6. Liability for payment of GSTT:

- a) Periodic distributions:

The recipient is liable for the GSTT, but the Trustee can pay it out of trust assets which, though, is a further distribution requiring a circular calculation.

- b) Termination distributions:

The trustee is liable for the GSTT which is payable from the trust's assets reducing the amount distributable to the recipients.

**D) Sources of Further Information:**

- a) See the following BNA Tax Management Portfolios:
- Income Taxation of Trusts and Estates (852-4<sup>th</sup>)
  - Generation-Skipping Transfer Tax (850-2<sup>nd</sup>)
  - Grantor Trusts (819)
  - Managing Litigation Risks of Fiduciaries (857)
  - Trustee Investments (861-2<sup>nd</sup>)
  - Uniform Trust Code (864-2<sup>nd</sup>)
- b) See also the following Rynkar, Vail & Barrett, LLP memoranda:
- Fiduciary Income Taxes: The New Epicenter of Tax Savings for Trusts and Estates (6/1/15)
  - A Guide to Including Capital Gains in Distributable Net Income (11/1/14)
  - Trustees Commission Summary (4/1/13)
  - Estate Tax Estimator (1/18/16)

**E) Further Assistance:**

As a general rule, whenever a trustee has any questions regarding fiduciary responsibilities, fiduciary related taxes, fiduciary accountings or legal interpretations, the trustee should contact a law firm or a CPA firm that specializes in Trusts and Estates matters.

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