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Revocable Trust Taxation

The revocable trust is a popular estate planning tool because it is flexible and allows the grantor (person who creates the trust) to manage and control trust assets during his or her lifetime. To get the most value from revocable trusts, it is important to understand the benefits of such trusts and how the income tax, gift tax, and estate tax rules impact them.

Key features of a revocable trust

1. **Assets**: A wide variety of assets can be placed into a revocable trust, including checking/savings accounts, a residence or vacation home, brokerage accounts, investment real estate, life insurance, automobiles, jewelry, tangible personal property, coins, stamps, art, and many other items. Qualified plans, IRAs, and employer sponsored retirement plans cannot be owned in a revocable trust during the account owner's life but can pass there at death. Nonqualified annuities generally should not be placed into revocable trusts during lifetime but can pass there at death also.

2. **Control**: The grantor can manage the assets inside the trust, remove them, and distribute funds as if the trust assets were directly owned by the grantor.

3. **Avoid Probate**: Upon the grantor's death, the trust becomes irrevocable and the assets owned by the trust are outside of the grantor's probate estate. This means the assets avoid the cost and delay of probate proceedings before passing to family members.

   Post-mortem control of trust assets: After the grantor's death, assets can either be distributed or remain in trust and be managed for traditional estate planning purposes by the trustee, depending on the terms of the trust document. The trustee must follow the trust's asset management and distribution provisions, potentially providing income and principal to trust beneficiaries for many years in the future.

Revocable Trust versus a Last Will & Testament

Both a Will and a Revocable Trust are ways to direct assets to the right person at the right time when someone dies. Determining which method is more appropriate, requires consideration of a number of factors, with the avoidance of probate often being a significant factor.

The benefit of having a Revocable Trust to avoid probate varies by state, and in some cases locality. There is typically a common practice among estate planning attorneys in the state, but it is important to understand the advantages that may be achieved with a Revocable Trust compared to any disadvantages.

Benefits of a revocable trust	Drawbacks of a revocable trust
Customized and flexible provisions: The revocable trust is customized for the grantor's specific planning objectives. Should planning objectives or family circumstances change, it is easy to change the trust's provisions since the grantor will hold the right to amend the trust during his or her lifetime.	**Suitability of Assets Transferred**: Not all assets are easily transferred to a revocable trust, such as rare coins, precious metals (i.e., gold bullion or silver), and real estate located outside the United States. Further, owning non-qualified annuities in revocable trusts is usually not recommended as no tax benefit exists and a non-qualified annuity already passes outside of the probate process.
Asset management: The terms of the trust dictate how a successor trustee will manage the trust assets once the grantor dies or becomes disabled and the trust becomes irrevocable.	**Creditor Protection**: A revocable trust generally does not shield assets from creditors. Also, the trust assets are "countable assets" for purposes of determining Medicaid eligibility.
Avoid cost and delay of probate: assets that pass through probate typically take 9 months to pass to the beneficiary and are subject to probate fees of 1-4%.	**Administration during lifetime:** The grantor must sign as trustee for the trust when handling assets during lifetime and some banks may ask to see a copy of the trust document.
Orderly transfer of wealth: Trust assets are designed to transfer outside the probate process, providing a seamless and private transfer of assets to the beneficiaries.	**Estate Inclusion**: The assets in a revocable trust are included in the grantor's gross estate.

Taxation of Revocable Trusts

Income Taxation

The income tax rules of revocable trusts are straightforward:

1. **Income tax liability:** Income generated by the assets in the revocable trust is taxed to the grantor during the grantor's lifetime according to IRC § 676. At death, the trust becomes irrevocable and a stand-alone tax entity.

2. **Trust TIN:** While the grantor is alive, the trust's taxpayer identification number ("TIN") typically will be the grantor's taxpayer identification number, often the grantor's social security number. No separate tax return will be filed for the trust.

3. **Trust's basis of trust assets:** Assets transferred by the grantor into the trust retain the grantor's basis. Upon the grantor's death, the basis of most trust assets (i.e., stocks, bonds, real estate) adjusts to the fair market value of the asset on the date of death. One asset that would not adjust its tax basis at the grantor's death is a non-qualified annuity.

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Gift & Estate Taxation

The gift and estate tax rules reflect the direct control and management of the assets that the grantor exerts over a revocable trust, and are very different from the taxation of irrevocable trusts.

1. **Transferring assets to the trust result in no gift tax:** When the grantor transfers assets to the revocable trust, no gift occurs because the grantor continues to control the asset for his own benefit. See Treas. Reg. §25.2511-2(c).

2. **Gift Tax reporting:** No gift tax return is required since no gift has occurred.

3. **Revocable trust distribution to beneficiary:** If the grantor directs assets held in the revocable trust be transferred to a trust beneficiary other than the grantor, the grantor is then making a gift to that person and normal gift tax rules apply.

4. **Estate tax on trust assets:** Trust assets are included in the grantor's gross estate for estate tax purposes. IRC §§ 2036, 2038, 2042.

5. **Estate inclusion and estate tax reporting:** Assume the revocable trust owns real estate with a basis of $200,000 and an $800,000 market value, and a $2 million life insurance policy. At the grantor's death, the real estate's $800,000 fair market value is included in the gross estate along with the $2 million of life insurance.

6. **Basis Adjustment:** Upon the grantor's death, the revocable trust becomes irrevocable. Any stocks, real estate, or marketable securities held in the trust receive a basis adjustment to the fair market value on the date of death. IRC §1014. This is sometimes referred to as a "step up" in basis.

7. **Post-death irrevocable status:** Once the trust becomes irrevocable at the grantor's death, the successor trustee will follow the provisions contained in the trust document. All the income gift, and estate tax rules for non-grantor trusts apply.

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