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Taxation of Irrevocable Trusts

Income taxation of trusts play a more prominent role in estate planning today

- An irrevocable trust is a frequently used estate planning vehicle used for a variety of planning objectives, including reduction or elimination of estate tax, creditor protection, long term control of trust assets down several generations, and to achieve specific wealth management goals.
- Due to the high $12,060,000 (2022) and $12,920,000 (2023 indexed annually) federal estate tax exemption amount, special focus should be placed on the income tax aspects of irrevocable trusts to evaluate their impact on the client's planning objectives.

Specific client objectives that intersect with trust taxation:

- Avoid paying estate taxes on wealth being transferred through a trust.
- Minimize the impact of income taxes on wealth inside the irrevocable trust.
- Preserve the amount of the lifetime gift tax exemption amount when gifting assets into an irrevocable trust.
- Transfer assets during life to trust to remove future appreciation from estate. Irrevocable trusts can hold many other assets including real estate, closely held business interests, LLC units, partnership interests, marketable securities, mutual funds, hard assets (gold, silver, precious metals), art, and a variety of other assets.

Taxation of Trust Shapes the Planning Decisions

It is common for a grantor to establish an irrevocable trust to hold a life insurance policy on his life outside the taxable estate, so that the death proceeds could be used buy assets from the deceased's estate in order to provide the estate with liquidity to pay estate taxes. The trust could be structured as follows:

- The grantor's spouse will be both the trustee and one of the trust beneficiaries, able to receive distributions for her health, education, maintenance and support ("HEMS").
- By structuring the trust with the HEMS ascertainable standard, the spouse will be able to remove assets from the trust without the trust assets being included in her taxable estate.
- The non-insured spouse, as trustee, could have a general power to distribute assets out of the trust to the couple's adult children beneficiaries for a broad range of needs.

Income Taxation of the Irrevocable Trust: Two types of taxation

There are very different income tax results that result depending on whether the irrevocable trust is a grantor trust or a non-grantor trust.

Income Taxation of Grantor Trusts

1. **Creating a grantor trust**: Many grantors intentionally create grantor trusts so they get taxed on the income inside the trust. The grantor is treated as owner of trust assets for income tax purposes but not for estate tax purposes. Meeting the requirements of IRC §§ 673 – 679 makes a trust a "grantor trust." Typically, retaining the power the power to substitute property of equivalent value (the "swap power") is used with an irrevocable trust or giving the trustee authority to pay life insurance premiums trigger the "grantor trust"

rules. IRC § 675(4)(c) and IRC § 677(a)(3). The income tax on trust assets becomes the responsibility of the trust's grantor and when the grantor pays the income tax, he is not making a taxable gift to the trust.

2. **Trust's tax rate**: The grantor trust is not a separate taxpayer, and grantor's taxpayer identification or social security number will often be used because all items of income, deduction, and credit will be reported on grantor's personal income tax return. IRC §671. No separate return is filed for the trust – the grantor is the income taxpayer for the grantor trust.

3. **Trust's tax basis of trust assets**: The trust retains the income tax basis of the asset that the donor held before it was gifted to the trust. Further, if the trust purchases an asset from anyone other than the grantor or the grantor's spouse, the purchase price of that asset becomes the trust's income tax basis in that newly acquired trust asset. This tax basis will remain the trust's basis even after the grantor's death. There is no adjustment in basis at the grantor's death because he was not the "owner" of the trust assets for estate inclusion purposes under IRC § 2036 or §2038.

4. **Tax advantages of a grantor trust**: There are several benefits to a grantor trust, including:

   - The grantor reduces the size of his estate when he pays any income tax due from trust income and earnings;

   - The grantor makes a tax-free gift to the trust when paying the trust generated income tax. See Rev. Rul. 2004-64, 2004-27 I.R.B. 7;

   - More funds remain in the trust to fund current or future life insurance premiums for life insurance contracts held in the trust; and,

   - If the grantor sells a life insurance policy that he owns to his own grantor trust, there is a transfer for value exception because this is treated as a transfer to the "insured." Rev. Rul. 2007-13. Further, the sale for the policy's fair market value avoids the three-year rule of IRC §2035 and the death benefit is immediately outside the insured's estate.

Income Taxation of Non-Grantor Trusts

1. **Lack of grantor trust power**: Every irrevocable trust is a non-grantor trust unless a specific grantor trust power exists in the trust. If the irrevocable trust does not contain one of the specific grantor trust powers in IRC §§ 673- 679, such as the power to substitute assets for equivalent value ("swap power"), then the trust is a non-grantor trust. Or trusts that started out as revocable trusts become irrevocable when the grantor dies and convert to non-grantor trusts.

2. **Trust TIN**: The trust obtains its own taxpayer identification number ("TIN") and pays income tax at the trust tax rates.

3. **Trust income tax rates**: Ordinary income is taxed at the same rates as individuals, including qualified dividends, however, the tax brackets are greatly compressed and the trust gets to the highest income tax rate of 37% when the trust has more than $14,450 of oncome (2023). For trust income and earnings remaining in the trust, the trust taxation rates in 2023 are as follows:

   - **Ordinary income rates** range from 10% to 37% with the 24% bracket starting at only $2,900, the 35% bracket at income above $10,550, and the 37% bracket above $14,450 of taxable income.
   - **Long term capital gains** are trust taxed at the 0%, 15% and 20% ranges, with the 15% rate for capital gains above $3,000, and the 20% rate for capital gains above $14,650.
   - The **3.8% net investment income** tax threshold amount is only $14,450 for trust income.

4. **Distributions of trust income and principal**: The taxation of trust income follows where the money goes.

   - **Principal distributed:** When the trustee distributes principal to a beneficiary, there is no taxable event to the trust beneficiary and that beneficiary assumes the income tax basis of that asset.
   - **Income distributed**: If the trust requires that trust income be distributed to the beneficiaries, then taxable income (other than capital gain income) is taxed to the beneficiaries, even if the trustee fails to make the distribution. IRC § 651.
   - **Distributable Net Income**: If the trust does not require that trust income be distributed to the trust beneficiaries, actual distributions made to them can carry out some or all of the trust's taxable income under the concept of distributable net income ("DNI"). IRC §§ 651, 652, 661, and 662.
   - **Retaining trust income**: To the extent that the trust retains the income earned in the trust, then the trust pays the income tax on the income at the compressed trust tax rates.

Estate & Gift Taxation of Irrevocable Trusts

1. **Transferring assets/wealth into the trust:** A common objective of an irrevocable trust is to transfer assets that have a strong likelihood of substantial growth in the trust, so that many years of increasing asset value will not subject the grantor/donor to estate taxation at the grantor's death.

   - **Gift Tax & Annual Exclusion:** A gift to an irrevocable trust is a taxable wealth transfer, however, if the annual exclusion is used, the gift can be transfer tax free up to $16,000 (indexed in 2023 to $17,000) per beneficiary of the trust. If you have 5 beneficiaries of the trust, that's $80,000 ($16,000 x 5) that can be gifted to the trust without utilizing the lifetime gift tax exemption. You can double the annual exclusion if a married couple makes the annual gifts.
   - **Estate Tax**: After the gift to the trust has been made, the wealth is removed from the grantor's estate and not subject to estate tax. See IRC §§ 2036, 2038. The growth of the trust assets is not subject to estate tax.

2. **Gifts in excess of the annual exclusion:** Any gift to a trust over the annual exclusion amount must be reported as a taxable on a gift tax return, which is IRS Form 709. However, the grantor does not pay gift tax and instead uses his or her gift tax exemption. For example, if $1 million in excess of the annual exclusion is gifted to the trust, the grantor will first apply his or her lifetime gift tax exemption amount, ($12.92 million in 2023, indexed) to the $1 million gift. The grantor's estate exemption amount is also reduced by $1 million.

3. **Gifts above the gift tax exemption amount**: Once a taxpayer uses up his entire lifetime gift tax exemption, gift tax is owed on additional gifts.

4. **Trust's tax basis**: The trust's basis for gifted property is the same basis as the grantor. This is often referred to as carryover basis. IRC § 1015(c).

The income tax, gift tax, and estate tax rules are varied and offer many planning opportunities for clients who intend to leave substantial wealth for their family members in a trust, achieve tax leverage, and receive expert management and control of their trust assets.

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