CliftonLarsonAllen

You may have set up a grantor trust for income tax purposes, as these types of trusts are incorporated into many effective estate planning strategies. But do you know how the trust's income will be taxed?

WEALTH TRANSFER

Income Tax Implications of Grantor and Non-Grantor Trusts

By Sue Clark
3/13/2013

Update 10/30/2014*: This article was updated to reflect the increased income tax rates in the American Taxpayer Relief Act of 2012 and the new net investment income tax (NIIT).*

So, you set up a trust as part of your estate planning. But do you know how the trust's income will be taxed? And how does the *American Taxpayer Relief Act of 2012* (ATRA), which increased income tax rates and added the new net investment income tax (NIIT), affect the taxation of trusts?

It is important to understand the different types of trusts and how the latest income tax rules affect the trust and its beneficiaries.

What is a grantor trust?

There is a good chance that you set up a grantor trust for income tax purposes, as grantor trusts are incorporated into many effective estate planning strategies. Spousal access trusts, grantor retained annuity trusts (GRAT), defective grantor trusts (e.g., an IDGT or DIGIT), and most irrevocable life insurance trusts (ILITs) are grantor trusts. Dynasty trusts can also be structured as grantor trusts.

Explore our collection of trust and estate planning articles to help you build the financial future you envision.

A grantor trust means that you, as the grantor (the person who established the trust by gift or grant), retain certain powers over the trust that result in you continuing to pay income tax on the trust assets. This can be the income tax result even though you established an irrevocable trust

Learn about using trusts in financial planning, including nonfinancial questions and choices to consider. Read the article

and made a completed gift to the trust. For example, the
power of substitution (i.e., the power to swap assets with the trust) is one of the most popular powers used for grantor trusts.

A grantor trust is considered a disregarded entity for income tax purposes. Therefore, any taxable income or deduction earned by the trust will be taxed on the grantor's tax return. In most cases, there will not even be a requirement to file a trust income tax return, as the income of the trust assets can be reported with your social security number.

Tax advantages of grantor trusts

Establishing a grantor trust has a number of tax advantages. For example, you can sell assets to the trust without recognizing the gain on the sale. You can also loan money to the trust, and although the trust must pay you at least a minimum IRS-prescribed interest rate (called the applicable federal rate [AFR]), the interest income is not taxable to you. In addition, your trust's income tax, paid by you as the grantor, is not considered an additional gift to the trust. Basically, the trust assets can grow for the benefit of the beneficiaries, without the economic burden of paying income tax. In essence, this is a tax-free gift.

However, at some point you may realize that the trust has sufficient assets for its intended beneficiaries — perhaps your children and grandchildren. Or you may no longer find it economical to your personal finances to pay the trust's income taxes. In these circumstances, it may be possible to give up or waive the grantor trust powers, which would then convert the grantor trust to a non-grantor trust. Also, after the death of the grantor, the trust will become a non-grantor trust.

What is a non-grantor trust?

A non-grantor trust pays income tax at the trust level on any taxable income retained by the trust.

If a trust makes a distribution to a beneficiary, such distribution will pass the taxable ordinary income (but generally not capital gains) to the beneficiary, to be taxed on the beneficiary's personal income tax return. The trustee must complete Form 1041 and issue a Schedule K-1 to the beneficiary, showing the amount and type of income from the trust to be included on his/her individual tax return.

Effect of ATRA

The ATRA was not kind to trusts, and especially to those that accumulate income. A trust's income taxation is similar to individuals, but the tax brackets are very compressed. For 2014, a trust will pay income tax at the 39.6 percent tax rate when taxable income is more than $12,150. Compare this with an individual, where the same income tax bracket kicks in at $406,750 of taxable income ($457,600 for married couples filing jointly).

Trusts are eligible for the special income tax rate on long-term capital gains and qualified dividends; in 2014, the 20 percent capital gains rate will apply when trust taxable income exceeds $12,150. The 15 percent and 0 percent capital gains rates also apply to trusts in lower tax brackets.

Net investment income

Also, the new NIIT of 3.8 percent applies to certain income retained by trusts and estates if taxable income exceeds $12,150. Net investment income includes interest and dividend income and capital gains, but also includes passive income from rental and business activities, and from pass-through entities such as partnerships, limited liability companies (LLCs), and S corporations.* As a result, many trusts and estates will be taxed in 2014 at 43.4 percent on ordinary income and 23.8 percent on qualified dividends and long-term capital gains, plus state level income taxes.

Individual beneficiaries may be eligible for lower tax brackets. The NIIT does not affect single beneficiaries unless their Adjusted Gross Income (AGI) exceeds $200,000 or beneficiaries who are married filing jointly with AGI exceeding $250,000.

Managing taxable income

This difference in income tax brackets between trusts and individual beneficiaries presents an opportunity to effectively manage the trust's taxable income. If the trust's distribution provisions allow discretionary distributions, a trust distribution will result in income taxed at the beneficiary level.

There is a good chance that beneficiaries are in lower income tax brackets. However, keep in mind the estate planning and asset protection objectives of the trust. To the extent that income is distributed from a trust, the income will be included in the beneficiary's estate, and will also be subject to beneficiary's creditors, contrary to the original objectives of the trust. Therefore, the trustee should carefully consider discretionary distribution in light of all of the facts and circumstances.

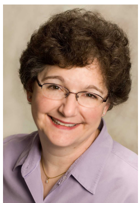
Note that ATRA also made the federal estate tax exclusion $5 million, which permanently indexed it for inflation. The exclusion is $5.34 million for 2014. This legislation will reduce the number of taxpayers subject to federal estate tax. Therefore income tax planning may be more important that estate tax planning for most taxpayers.

Most trusts can also make distributions within 65 days of the end of the year and elect to consider such distribution as occurring on December 31 of the preceding year. This allows a trustee the flexibility to manage the trust's taxable income and make a distribution decision based on trust income after gathering all of the information for the tax year.

Tax considerations

The trust that you established for estate planning purposes may have some interesting income tax considerations. Be aware of who pays the income tax on the trust income, the opportunities with grantor trust planning, and the income tax effect and distribution planning opportunities for non-grantor trusts.

**A trust that holds S corporation stock will need special handling! A grantor trust is an eligible S corporation shareholder; however, other trusts will need to meet special requirements and must make a timely election as a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) to own S corporation stock. QSSTs and ESBTs have income taxation unique to their specific status.*



Sue Clark
Principal
CLA Minneapolis

T: 612-376-4725

Please refer to the site disclaimers (http://www.CLAconnect.com/disclaimer and http://www.CLAconnect.com/Wealth-Advisors/Disclosures/) to review disclosures and legal terms of use ("Terms") carefully before using this CliftonLarsonAllen LLP and its affiliates ("CliftonLarsonAllen") material ("Material"). By using this Material you indicate that you acknowledge and accept these Terms.

© 2017 CliftonLarsonAllen. All rights reserved. "CliftonLarsonAllen" and "CLA" refer to CliftonLarsonAllen LLP.