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Income tax considerations in estate planning: Part 2

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This article, part 2 of our series on estate planning, explores the income tax consequences of various types of trusts, with a focus on living trusts, irrevocable non-grantor trusts, and the potential tax benefits and drawbacks of each. It also examines the strategic considerations behind transferring appreciating assets to trusts, the impact on both estate and income taxes, and key distinctions that can influence tax outcomes. By understanding these nuances, individuals can make more informed decisions about how to structure their trusts to meet both their long-term goals and immediate financial needs. For a deeper dive into the basics of estate planning and trust structures, read part 1.

Trust tax returns

Estate planning often involves trusts, which creates the issue of who pays the income tax on income generated within the trust. The most common variety in estate planning is a "living trust."

A living trust can often be updated and amended without the formality required for amending a Will. A living trust often establishes its own requirements for how it can be amended. Still, perhaps the biggest benefit of holding your assets through a living trust is that in most states, assets held through a trust do not need to be handled through a formal court-supervised probate procedure, or even through a more streamlined probate procedure, regardless of the value of assets owned through the living trust.

With a living trust, you still write a Will, just in case there are assets that you neglected or chose not to formally transfer to the living trust while you were alive. Ideally, the value of your assets held outside of the living trust should be less than the threshold for triggering a requirement to process the estate through probate. But, in this structure, the Will provides that everything you own goes to your revocable trust. It's called a "pour-over Will," since it "pours over" all assets you own on your death into your trust.

While you are alive, your living trust has no income tax effect. Living trusts allow you to have complete control over your assets, and to amend the trust or revoke it entirely if you choose. A transfer of assets to a revocable trust does not remove the assets from your estate, and therefore, the transfer is not considered a gift. For income tax purposes, these same provisions cause a living trust to be considered a "grantor trust."

A grantor trust is invisible for income tax purposes, and assets owned through a grantor trust are considered as directly owned by the trust's owners. Income generated within the trust must be reported on its owners' individual income tax returns. A revocable living trust does not save you taxes. Its purpose is to avoid the time, expense, and complexity of state probate processes.

Some trusts are non-grantor trusts, which are separate taxpayers for income tax purposes. They must report their own income and claim their own deductions on their own tax returns, IRS Form 1041. Non-grantor trusts are created in several ways. In general, when the grantors of a living trust have all died, living trusts are usually designed to become irrevocable non-grantor trusts. When the living trust becomes a non-grantor trust, the trustees must begin to file income tax returns for the trust reporting income and expenses generated within the trust that occur after the trust is no longer a grantor trust.

Other trusts used in estate planning start out their existence as irrevocable non-grantor trusts and were never intended to be anything other than irrevocable non-grantor trusts. That typically means that if you transfer assets to an irrevocable non-grantor trust, you can't take your transfer back or even amend the trust without going to court or making a request to a nominally independent "trust protector" appointed in the trust agreement who may have the power to make certain amendments to the trust agreement. Classically, irrevocable trusts are used to move assets out of your estate before the assets can continue to grow in value.

If you own shares worth $500,000, but which are expected to grow in value to $50 million by the time you die, it may be wise to use your unified credit to absorb a $500,000 gift now, than to be at risk of your estate's owing estate tax on a $50 million inheritance later. Transfers to an irrevocable trust can trigger gift taxes in the short term, but they can still save income, gift, or estate taxes in the long run, depending on the facts. Under current law, individuals and trusts have the same highest marginal federal income tax rate, 37%.

For 2025, a couple filing jointly won't reach the highest tax bracket until their taxable income exceeds $731,200 (after accounting for exemptions and deductions). A trust, however, reaches the highest 37% tax bracket at only $15,650 of net taxable income. Therefore, transferring income-producing assets to a non-grantor trust can result in larger income tax liabilities than if the assets were held directly by the trust's settlors, or through their living trust.

Step-up in basis on death

Placing appreciating assets in an irrevocable trust for future estate tax savings can also have income tax consequences down the line. A hallmark of our income tax system for generations has been that everybody gets a stepped-up basis on death for income tax purposes. If you hold assets on your death, your estate and/or your heirs will get a step-up in basis for income tax purposes on your death. That way, if your heirs sell the assets they inherit, they do not have to pay all the capital gain tax that they would otherwise owe.

If the rule were otherwise, then someone selling the family farm that has been passed down through the family since the 1880s would have to reconstruct and substantiate over 140 years of investments, improvements, repairs, depreciation, et cetera, most of which was done by people who are now dead, to calculate the current adjusted tax basis in the family farm. This is avoided by having the basis step up to the property's fair market value at death, since the seller will only need to substantiate what the fair market value of the property was when they inherited the property and what they did with the property after inheriting it in order to arrive at the property's adjusted tax basis.

If one of your parents bought a house in the 1950s for $50,000 that is worth $5 million when they pass, their estate, and, subsequently, you, inherit the house with an adjusted tax basis of $5 million. Therefore, if the estate or you choose to sell the house for $5 million, you would not owe any income tax on the sale because there is no gain. The built-in gain that existed in the home while your parent owned it is essentially wiped clean by their death.

However, step-up in basis only occurs for assets that are considered part of your estate for calculating estate tax. With the current unified credit amounts at historic highs, very few taxpayers actually owe estate tax. Therefore, for most taxpayers, holding assets at death means no estate tax, and a step-up in basis for income tax purposes, all upside and no downside. This step-up in basis provides tax benefits for everyone passing down appreciated assets, including real estate, stock, family companies, and more. Small businesses count on this.

Say you have a family business worth $20 million that you started from scratch. How is it taxed if you and your spouse die? If both parents die, the nearly $28 million estate tax exemption should mean no estate tax for that $20 million business. And the equity in the business passed down to the kids gets a step-up in basis for income taxes too.

Say Mom and Dad die, and Junior gets the stock in the family company. No matter how small Mom and Dad's tax basis was in the stock, the stock gets stepped up to market value on death, $20 million. That way, Junior can run the business, or can sell it for $20 million and should pay no income tax. After all, the parents wanted Junior to inherit the business, not their income tax bill.

Junior could try running the business for a year or two--it might even be worth $22 million then--but if he sells it, he has that $20 million date of death value basis. Of course, this example is simplistic and ignores the fact that the business itself might make the sale by selling its assets. Assets held within the business do not necessarily get a step up in basis (unless the business was treated as a disregarded entity while the parents owned it). Therefore, built-in gain in assets held by a business can be passed down to the next generation, triggering income tax if the business later sells the assets. In this situation, heirs have a particular incentive to structure sales as equity sales rather than asset sales, to get the benefit of their stepped-up basis in the equity they inherit.

The purpose of transferring appreciating assets to irrevocable trusts is to get the assets out of your estate before they appreciate more in value and are subject to estate tax. When assets are gifted, including gratuitous transfers to irrevocable trusts, the recipient does not obtain a step-up in basis as a result of the gift, but instead takes the gifted asset with the donor's adjusted tax basis. Moreover, because assets transferred to irrevocable trusts are not included in the decedent's estate when they die, the assets do not receive a step-up in basis when the donor later dies. Therefore, when the trust or its beneficiaries later sell the assets held in trust, they must calculate the resulting gain for income tax based on the decedent's adjusted tax basis, adjusted for any transactions entered into by the trust with regard to the assets that might require subsequent adjustments.

For example, imagine the situation of an unmarried taxpayer who owns equity that has a $2 million basis and is worth about $7 million, but is expected to increase in value significantly. Worried about future estate tax, the taxpayer is considering whether to transfer the equity to an irrevocable trust to lock in the current $7 million value, which his unified credit against gift and estate tax can fully absorb. The best choice for the taxpayer may not be unambiguous.

When the taxpayer dies, the equity is worth $20 million. Therefore, for estate tax purposes, transferring the shares to the irrevocable trust when they were worth $7 million shielded $13 million of future appreciation from potential estate tax. At a 40% tax rate, this is a potential estate tax savings of approximately $5.2 million, though the savings could be less than $5.2 million if some of the $13 million in appreciation would have been shielded from estate tax using the taxpayer's remaining unified credit.

Estate vs. income tax tradeoffs

Plainly, $5.2 million of estate tax savings seems like an obvious tax planning success, and it is, at least from an estate tax perspective. But for income tax purposes, the irrevocable trust, or the taxpayer's heirs if the equity is later distributed to them, may only still have the taxpayer's original $2 million basis. Because the equity was removed from the taxpayer's estate by the transfer to the trust, the equity does not get a step-up in basis upon his death.

If the trust or its beneficiaries immediately sell the equity for its $20 million value, they will therefore recognize $18 million in taxable gain. At a 23.8% capital gains tax rate with NIIT added, this means additional federal income tax owed, which could have been avoided, of nearly $4.3 million. Therefore, the net federal tax savings from the transfer were only about $900,000, not $5.3 million.

Other expenses may make the comparison even closer. State income taxes can create an additional cost when the basis step-up is sacrificed. One might assume that state estate tax savings could help counteract those costs. However, currently only twelve states and DC have a state-level estate tax, but forty-one states and DC have state-level income tax. If you live where there is no state estate tax, but there is a state income tax, there are no state-level estate tax savings to offset the additional state income tax the estate planning may have created.

This is not a negligible consideration. California does not have an estate tax, so the hypothetical taxpayer's transferring of the equity to an irrevocable trust did not produce any California estate tax savings. However, California's income tax can tax gains on the sale of assets at rates up to 13.3%. Therefore, at the 13.3% tax rate, the $18 million of taxable gain could generate nearly $2.4 million of additional California income tax that could have been avoided if the equity had received a step-up in basis. This hypothetical additional state income tax significantly exceeds the $900,000 federal net tax benefit from using the irrevocable trust structure.

Transferring real estate to an irrevocable trust can trigger property tax reassessment, which can create higher property tax liabilities relative to if you continue to own the real estate until your death, delaying the timing of the change in ownership. There are costs of maintaining an irrevocable trust, including trustee fees and accounting fees, which would not have to be incurred if an asset is kept in a living trust. As mentioned earlier, there is also the possibility of additional income tax generated on any income generated within the trust, for example, on dividends generated by the equity, due to its steeper tax brackets than would have been due if the taxpayer had retained direct ownership of the equity, including through a living trust.

There are situations where it is advantageous to freeze estate values by transferring appreciating assets to an irrevocable trust. Irrevocable trusts are a useful arrow in an estate planner's quiver. But, it is often a mistake to assume that it is always a net benefit to transfer appreciating assets into irrevocable trusts. No estate planning on this topic should fail to account for the offsetting income tax consequences.

Foreign trusts

Foreign trusts have special and much more complex tax rules and tax reporting requirements than we can cover in this article. As a general encapsulation, if a US person forms a foreign trust, it is generally much more difficult to avoid the foreign trust being treated as a grantor trust for US tax purposes, with its income immediately taxable to the US settlor. If a US taxpayer is a beneficiary of a non-grantor foreign trust (e.g., a trust established by a non-US relative as part of their estate planning), they may be subject to the onerous throwback-tax rules mentioned earlier in this article that can subject the distributions they receive to US income tax plus interest.

Foreign trusts can also trigger heightened and complex reporting requirements, either as a foreign grantor trust or a foreign non-grantor trust. At minimum, these heightened reporting obligations can include the frequently audited Forms 3520 and Forms 3520-A, which are in addition to the more typical foreign reporting obligations that can be triggered by foreign assets, such as FBARs, Forms 8938, Forms 5471, Forms 8865, and others.

Conclusion

Estate planning is complex, and income taxes on the surface may seem low on the list of considerations. However, the inherent tradeoffs between income and estate taxes can be worth a second look.

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