A Short Primer on Trusts and Trust Taxation

This issue of The Voice® is a refreshed and updated version of an article that was written by SNA member [Tara Anne Pleat, CELA] of [Wilcenski & Pleat] of Clifton Park, NY, and SNA Emeritus member Barbara Hughes, who was formerly with [Johnson Teigen LLC] of Fitchburg, WI. The [original article] was posted in January 2012.

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In everyday practice, trust and estate planning attorneys often advise clients and their family members about the importance and benefits of various trust arrangements. When planning for a family member with a disability, the dominant topics are ongoing asset management and preservation of eligibility for government benefits. However, an important component is often neglected in considering the choice of the appropriate type of trust—the taxation of the different trust arrangements.

Two Categories of Trusts: Revocable and Irrevocable

Revocable Trusts

A revocable trust is a trust which can be revoked or amended by its creator at any time and without anyone's consent. Of course, the trust's creator retains unrestricted control of the trust assets as long as he or she is competent. The trust usually continues after the creator's death for traditional estate planning purposes.

When planning for a family member with special needs, his or her parent(s) or other relatives often create a revocable special needs trust (SNT) but expect to delay funding until the creator's death. The trust creator may declare the trust irrevocable at any time and may even provide for an automatic shift to irrevocable status under a specific circumstance, such as funding by someone other than the trust creator. Revocable trusts give the creator significant flexibility to address changes in the lives of those expected to be involved in the future administration of the trust. A revocable trust is not recognized for tax purposes until the death of the creator. While the trust is revocable, the income earned by the trust is reported under the creator's social security number. (See Trust Taxation below.)

Irrevocable Trusts

Irrevocable trusts are the other (and more common) category of trusts used in special needs estate planning. The primary characteristics of an irrevocable trust are that the creator cannot amend the provisions of the trust and cannot spend trust funds for the benefit of anyone other than the beneficiary unless the terms of the trust document specifically authorize it. Sometimes the trust document grants the trustee a limited right to amend certain provisions if changes in the beneficiary's life justify or require an amendment. For example, this need could be triggered by the beneficiary moving to another state with different laws or policies, or by changes in trust, tax, or public benefits law.

SNTs created by and funded with the assets of the parents, grandparents, or other relatives are called "third-party" SNTs, whether they are irrevocable at the time of creation or become irrevocable later. SNTs funded with assets of the beneficiary are called "first-party," "self-settled," or "Medicaid payback" trusts and must be irrevocable from the beginning. First-party trusts can receive and hold any assets of the beneficiary, such as his or her injury settlement funds and gifts and inheritances left directly to the beneficiary.

Whether a first- or third-party irrevocable SNT, the creator is prevented from accessing the funds unless those funds are to be spent for the benefit of the trust beneficiary according to the trust's terms.

Irrevocable trusts are recognized as a separate legal entity for tax purposes. The trustee will need to obtain an identification number (TIN) from the IRS. The trust must file a tax return to report income earned by the trust. (See Trust Taxation below.)

Trust Taxation

Family members should understand the basic income tax rules that will apply to the trusts they create for their loved ones. Where is the trust's income reported? Who is responsible for the payment of tax on the trust's income? The remainder of this article addresses questions like these.

Revocable Trusts

Revocable trusts are the simplest of all trust arrangements from an income tax standpoint. Any income generated by a revocable trust is taxable to the trust's creator (who is often also referred to as a settlor, trustor, or grantor) during the trust creator's lifetime. This is because the trust's creator retains full control over the terms of the trust and the assets contained within it. Typically, during the creator's lifetime, the taxpayer identification number of the trust will be the creator's Social Security number. All items of income, deduction, and credit will be reported on the creator's personal income tax return, and no return will generally be filed for the trust itself. Revocable trusts are considered "grantor" trusts for income tax purposes. One could think of them as being invisible to the IRS and state tax authorities. Grantor trusts are discussed in more detail below.

Irrevocable Trusts

Generally, irrevocable trusts have their own separate tax identification numbers, which means that the IRS and state taxing authorities have a record of the existence of these trusts. Income of a trust that has a tax identification number is reported to that tax identification number with a Form 1099, and a trust reports its income and deductions for federal income tax purposes annually on Form 1041. There are two primary taxation categories of irrevocable SNTs: (1) grantor trusts and (2) non-grantor trusts.

Grantor Trusts

If a trust is considered a grantor trust for income tax purposes, all items of income, deduction and credit are not taxed at the trust level but rather are reported on the personal income tax return of the individual who is considered the grantor of the trust for income tax purposes.

The concept of who is the grantor can sometimes be confusing, especially in the context of a first-party SNT. For income tax purposes, the grantor is the individual who contributed the funds to the trust, not necessarily the person who signs the trust as the creator. Generally, all first-party trusts (those funded with the beneficiary's own assets) are considered grantor trusts for income tax purposes and so all the items of income, deduction, and credit will be reportable on the beneficiary's personal income tax return.

Third-party SNTs can also be created as grantor trusts, as sometimes the creator of the third-party SNT wants to remain responsible for payment of the income taxes during his or her lifetime. In those instances, the creator of the trust retains certain rights which cause the trust to be treated as a grantor trust for income tax purposes. At the time the creator of the trust passes away or otherwise relinquishes the rights causing the trust to be a grantor trust, the trust's income will no longer be taxable to the grantor, and the trust will no longer be considered a grantor trust.

Non-Grantor Trusts

When a trust doesn't qualify as a grantor trust for income tax purposes, how is the trust taxed and who pays the taxes on the income?

To the extent the trustee of a non-grantor trust distributes money to the beneficiary or pays expenditures on behalf of the beneficiary of the trust, the trust receives a deduction, and all or a portion of the trust's income will be taxed to the beneficiary. This relates to a provision in the Internal Revenue Code that states distributions to or for the benefit of a non-grantor trust beneficiary carry out income to that beneficiary. For example, if in 2023 a taxable trust generated $3,000 of interest and dividend income, and the trustee made distributions of $5,000 for the benefit of the beneficiary in 2023, all of the $3,000 of income would be treated as having been passed out to the beneficiary and thus taxable to the beneficiary on his or her personal income tax return.

Though at first blush this may not seem ideal, in many cases the result is good because the beneficiary, earning little or no income, is in a low income tax bracket (This treatment does not apply if the beneficiary is subject to the Kiddie Tax which is a topic for another article). In many cases, the standard deduction is available for individual taxpayers ($13,850 in 2023). Unless the beneficiary has other sources of taxable income, the only trust income ultimately taxable to the beneficiary will be the amount of income that exceeds the total of the beneficiary's standard deduction.

By contrast, to the extent that trust income is not distributed to or expended on behalf of the beneficiary in a given year (or by March 5th of the following year), that retained income is taxed to the trust. Using the same example above, if a taxable trust generated $3,000 of income in 2023, and only $1,000 was expended on the trust beneficiary in 2023, $1,000 of income will be passed out and taxable to the trust beneficiary, but the remaining $2,000 of income will be taxable at the trust level.

Dramatic Differences in Trust Tax Rates

Understanding the income tax treatment of taxable trusts is important because trusts have highly compressed tax brackets. For 2023, trusts reach the highest federal tax bracket of 37% at taxable income of $14,451 (except for capital gains, which are taxable at a lower rate). By comparison, the tax rate for single taxpayers on taxable income between $11,000 and $44,725 is only 12%. The highest federal tax bracket of 37% does not apply to most individual taxpayers until their taxable income reaches $578,126. In addition, many states also tax the income of trusts.

Trust Exemptions

A simple trust can take a $300 exemption. A complex trust can take a $100 exemption (and an SNT is always a complex trust). If the third-party SNT and its beneficiary meet certain requirements, the trust can be considered a Qualified Disability Trust (QDT) for federal income tax purposes and allowed a larger exemption.

Conclusion

Family members and the professionals helping them often fail to consider and discuss the various options available in establishing an SNT and how choices affect the taxation of the trust. Being aware of the income tax aspects of these commonly used estate planning tools can help the attorney and client make choices that can minimize the federal and state income taxes payable at different stages of the trust's existence. Failing to consider these consequences may result in unintended contributions being made to the IRS. As one can glean from this article, trust taxation is a complex but very important topic. Families and trustees need to work with a practitioner who has both knowledge and experience with SNTs and trust taxation.

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