Taxation - Income, Estate and Gift

Income tax reduction strategies using non-grantor trusts.

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The passage of the 2017 Tax Cuts and Jobs Act (TCJA) changed the nature of planning for many individuals. Many expenses that taxpayers were able to deduct on their annual income tax returns prior to the TCJA have been permanently eliminated, suspended, or limited until 2026. Changes brought by the TCJA include:

- The mortgage interest deduction is limited to $750,000 of mortgage indebtedness.
- The deduction for state and local income, sales and property taxes is limited to $10,000.
- The standard deduction increased to $24,000 for married couples filing jointly, and $12,000 for individual taxpayers.
- The applicable exclusion amount is temporarily increased (in 2020, the exclusion is $11,580,000).

Changes to the tax code as a result of the TCJA impacted the tax returns for many individuals. In fact, according to the IRS, only 14.6 million returns were itemized in 2019, compared with 42.1 million in 2018.

As a result of the TCJA, the focus of many individuals has shifted from estate tax planning strategies to income tax planning strategies.

How non-grantor trusts can help

A non-grantor trust is an irrevocable trust that pays taxes on its income. For income tax purposes, non-grantor trusts have some, but not all, of the tax attributes of an individual. For example, both a non-grantor trust and an individual can deduct property, state and local taxes.

However, unlike an individual, a non-grantor trust does not have a standard deduction; a non-grantor trust can deduct "distributable net income" (DNI); and a non-grantor trust has an unlimited amount of charitable deductions.

Some income tax reduction strategies that many advisors are focusing on as a result of the TCJA include:

- Shifting taxable income to beneficiaries in lower tax brackets.
- Avoiding state income tax.
- Basis step-up optimization.
- Exchanging ordinary income tax rates for capital gains tax rates.
- Creating tax-free income.
- Maximizing deductions.

Although non-grantor trusts can assist with many of these techniques, this article focuses on maximizing available deductions.

State and local tax deductions

Under pre-TCJA law, some individuals justified the economic cost of owning a vacation home based on the benefit of being able to deduct mortgage interest and property taxes on the property. However, as described above, the TCJA limited the deduction for state and local income tax to $10,000 per year. To compensate for the reduction in deductible state and local taxes, some individuals may consider transferring their vacation home to one or more non-grantor trusts so as to maximize their state and local tax deduction.

Non-grantor trusts can enable an individual to maximize state and local income tax deductions because the new $10,000 limit on deductions applies per taxpaying entity. Since non-grantor trusts are their own taxpaying entity, each trust funded with real estate is eligible to deduct up to $10,000 for state and local taxes (provided the trust has enough income to offset the deduction).

Example 1

In 2020, a husband and wife incur $40,000 of property taxes and other state and local taxes.

- Under prior law, if husband and wife itemized their deductions, they could generally deduct all state and local taxes.
- Under current law, their itemized deduction for state and local taxes would be limited to $10,000 (resulting in no tax deduction for $30,000 of incurred state and local taxes).
- If, however, two separate non-grantor trusts each own 25% of the property that generates the state and local taxes, each trust could deduct $10,000 of property taxes and husband and wife could include $10,000 of state and local income tax in their itemized deduction (reducing the wasted deduction for taxes incurred from $30,000 to $10,000).

Example 2

Assume, instead, property taxes and other state and local taxes on the residence are $50,000 a year.

- Husband and wife could create five non-grantor trusts, one for each of their five children, and transfer 20% of the real estate to each trust (along with sufficient assets to produce at least $10,000 of taxable income each year). This strategy would likely involve first transferring the property to an LLC and then transferring LLC interests to each trust.
- Each of the five trusts would be able to deduct $10,000 of state and local taxes, completely offsetting 100% of incurred state and local tax.

Though transferring property to a trust usually involves the loss of ownership and use by the transferors, husband and wife can preserve access to and use of the trust-owned property by continuing to hold some interest as co-tenants in common. Co-ownership gives each co-tenant the right to use, occupy, and possess each part of the property, with an undivided right of possession.

Deductions for charitable contributions

Individuals are subject to limits on the deductibility of donations to charity based on the individual's adjusted gross income (AGI). Charitably inclined individuals who are unable to fully deduct charitable gifts may benefit from utilizing non-grantor trusts since non-grantor trusts are not subject to the same AGI limits.

An individual could gift a portion of their non-qualified securities portfolio to a non-grantor trust. The trustee could use income generated from the portfolio to either (i) make distributions to the children/grandchildren of the individual who created and funded the trust, or (ii) make distributions to charitable entities.

For distributions made to children/grandchildren, the income tax liability resulting from the distributed income would flow through to the recipient child/grandchild's tax return. If the child/grandchild is in a lower income tax bracket than the individual who created and funded the trust, less tax liability will result. For distributions to charity, the trust is eligible to fully deduct the charitable distribution, thereby offsetting income tax associated with the distributed income.

Example 3

Husband and wife are charitably inclined, but their deductions are unlikely to ever exceed the new standard deduction amount ($24,000 for married couples).

- Husband and wife could gift $250,000 of marketable securities to a non-grantor trust. The trust would name husband and wife's children as well as charities that husband and wife regularly donate to as trust beneficiaries.
- Assume that the $250,000 portfolio generates $10,000 of taxable income a year. The trustee can distribute $5,000 to charity and $5,000 to the children. The trust can deduct $5,000 for the charitable distribution, and $5,000 of taxable income passes through to the children's tax returns.
- The trust would pay $0 in taxes.
- The trust also could have paid all income to charity and then made discretionary distributions of other trust assets to the children. In this instance, the children would have no taxable income as a result of distributions from the trust.

Other deduction enhancement opportunities

Other deduction enhancement opportunities with non-grantor trusts are described below.

TAX PREPARATION FEES. While these fees are no longer deductible by individuals, trusts can continue to deduct tax preparation fees in full.

INVESTMENT AND ADVISORY FEES. As with individuals, investment advisory fees for trusts are not deductible. However, trusts can deduct expenses "not commonly incurred by individuals," such as trustee fees and other trust administration costs. If a trustee also provides investment advisory services, he or she may be able to "unbundle" these fees and provide extra deductions.

SECTION 199A DEDUCTION FOR PASS THROUGH ENTITIES. A pass-through entity owned by a non-grantor trust may assist business owners in obtaining full use of this deduction.

SECTION 1012A QUALIFIED SMALL BUSINESS STOCK DEDUCTION (QSBS). Each non-grantor trust can claim its own $10 million QSBS gain exclusion, separate from any QSBS that the investor retains.

Caveats

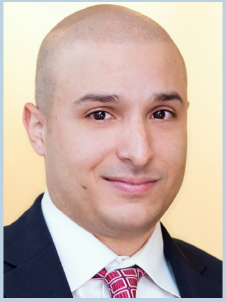
Using these strategies is not without disadvantages.

- A trust will need enough income to offset any deduction for which it is eligible. Ideally, the nature of a trust's income is ordinary (as opposed to long term capital gain or qualified dividends). Furthermore, the transfer will require coordination between the amount of income and the deduction because non-grantor trusts are subject to the highest tax bracket of 37% at $12,500 of income. Thus, to the extent there is no 100% income offset, the strategy may only work if the clients are already in the highest tax bracket.
- Property transferred to a non-grantor trust will not be eligible for the step-up in cost basis upon death of the individual who created and funded the trust. A step-up in cost basis is beneficial to an individual's heirs to the extent they may desire to sell the property in the future (since a step-up in basis would reduce the income tax liability an heir would be subject to when the asset is sold).
- A transfer to a non-grantor trust could result in the loss of IRC Section 121 home sale exclusion and homestead protection.
- If real estate is subject to debt, the transfer may accelerate payment of the debt unless consent of the debt holder is obtained.

Conclusion

These complex trusts that pay income tax contrast with the pervasive use of grantor trusts that was the standard in planning for many years. Today, non-grantor trusts may be ideal in helping to reduce income tax, especially for individuals who own vacation properties, are charitably inclined, or who are otherwise capped in terms of deductions.

Setting up non-grantor trusts is not without cost, however, and even though most individuals will no longer benefit from itemizing deductions, this may not be a wise strategy for everyone. An individual should always work with professional advisors when undertaking any tax reduction or estate planning strategies.



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