THE IMPORTANCE OF INCOME TAX IN TRUST AND ESTATE PLANNING

In the last 15 years the federal estate tax exemption amount has tripled to a combined $30 million ($15 million per person as of 1/1/2026) for a married couple. Meaning, heirs can inherit $30 million without the imposition of federal estate taxes. And for estates exceeding the exemption amount, the federal estate tax rate is 40% on the value of assets exceeding the exemption amount. For example, if a married couple's combined estate is $50 million, the federal estate tax liability will be $8 million, which is an effective estate tax rate of 16% ($8 million tax on a gross $50 million estate).

However, for many high net worth individuals and for trusts subject to income taxes, the effective federal income tax rates are much higher than the effective estate tax rate, and when coupled with state income taxes and the Net Investment Income Tax, income taxes can produce an erosive effect on net worth. But, with careful evaluation and planning, income taxes can be mitigated.

BASIS STEP UP PLANNING AND THE COMMUNITY PROPERTY TRUST

The tax code provides a very significant benefit to inheritors – the "step up in tax basis." Under this rule, the income tax basis of inherited assets is adjusted to the fair market value of those assets as of the date of the decedent's death, thereby eliminating any built-in gain and allowing the inheritor to sell the asset without any income taxes.

For those individuals residing in one of the 8 states recognizing community property, surviving spouses receive a special tax benefit – a full step up in basis of all community property inherited from their spouse. For jointly owned non-community property, the surviving spouse will receive a step up in tax basis in only the half of the property owned by the decedent spouse.

For married couples that do not reside in a community property state, they may consider establishing a community property trust and funding it with the low basis asset in order to receive a full basis step up at the death of either spouse – even if the spouse who contributed the property to the trust is the surviving spouse. Tennessee's trust code statutorily allows for the creation of a community property trust (even though Tennessee is not a community property state) so that a married couple who establishes and funds a trust that complies with the statute and that is administered in Tennessee by a Tennessee trustee can take advantage of the community property step up in tax basis rule – even if the trust grantors do not reside in Tennessee or in a community property state.

GRANTOR TRUST INCOME TAX REIMBURSEMENT

Likely the most popular type of irrevocable trust created and funded in this century is the irrevocable grantor trust (IGT). An IGT is an irrevocable trust that is excluded from the grantor's gross estate, but for income tax purposes the trust is disregarded and the grantor reports all of the trust's tax attributes on his or her tax return and is liable for the trust's taxes. From a wealth transfer planning perspective, the IGT supercharges the value of the trust as it does not have a tax liability and the grantor's payment of taxes on the trust's taxable income is not a gift.

For many grantors, there comes a time when continuing to pay the trust's tax liability puts a strain on the grantor's cash flow, or other circumstances cause the grantor to desire to mitigate or eliminate their tax liability for the trust. The options either are to terminate the grantor tax status of the trust (which is generally considered to be irrevocable) or to modify the trust to include a tax reimbursement clause (assuming the trust does not include such a clause). With regard to the first option, the grantor may not want to irrevocably terminate the grantor trust status, or as a result of an outstanding transaction with the trust (generally, an installment sale of assets that is still open) "toggling off" grantor trust status is not desirable. With regard to the second option, as many IGTs do not include a provision that would allow a grantor to be reimbursed from the trust for his or her tax liability on the trust's income, under IRS guidance, modification to a trust to include such a provision could have negative estate tax implications.

In order to address this issue, the Tennessee legislature passed a statute that allows a disinterested trustee administering a trust in Tennessee to reimburse the grantor of an IGT for the grantor's income tax liabilities that are attributable to the trust. This is a permissible power held by the trustee, and so long as the trust does not specifically prohibit reimbursement, the disinterested trustee may exercise this power to either reimburse the grantor or to make payment directly to the taxing authorities. This power is effective on or after December 31, 2025 (meaning it is effective for reimbursement for the grantor's tax liability for the 2025 calendar year) and is applicable to all trusts existing on or before this date.

The Tennessee statute provides a great deal of flexibility for IGTs, as the grantor can be reimbursed intermittently and without toggling off grantor trust status, receive partial or full reimbursement, and the reimbursement can be made at the direction of an independent trust advisor. In situations where the grantor is considering terminating the grantor trust status, because of a lack of reimbursement for his or her tax liability, transferring the trust to Tennessee for administration by an independent/disinterested Tennessee trustee can provide an eloquent solution.

STATE INCOME TAXES

For non grantor trusts, in addition to federal income taxes, trustees need to be cognizant of potential state tax liabilities for the trust. In creating an irrevocable trust and with regard to testamentary trusts funded at a grantor's death, understanding the state income tax impact of a trust is probably not top of mind. But, it can have real and significant implications. In the top income tax states – California, District of Columbia, Hawaii, Massachusetts, Minnesota, New Jersey, New York and Oregon – income tax rates can be in excess of 10%, which is exacerbated by the federal cap on deductions for state taxes paid.

The state income taxation of trusts is admittedly complicated, in particular because each state has a different basis on which it taxes trusts – based on either the residence of the grantor, beneficiaries and/or trustee. Recent cases in several states have found in favor of trusts as taxpayers challenging states taxing trusts on the basis of residence of the grantor and beneficiaries. Therefore, selection of a trustee residing in or administering a trust in a state without an income tax can potentially eliminate the trust's state tax liability. Tennessee does not impose a tax on trusts, so that a trust that is administered in Tennessee may result in an annual saving of significant taxes.

Tennessee continues to be at the forefront of Trust laws, providing many advantages, including these income tax benefits, making it a top jurisdiction for trust administration.

About the authors:

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