Ease itemized deduction limitations using a nongrantor trust

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The record-high exemption amount currently in effect means that fewer families are affected by gift and estate taxes. Accordingly, the estate planning focus for many people has shifted from transfer taxes to income taxes. A nongrantor trust can be an effective option to reduce income taxes, and it offers a way around the itemized deduction limitations imposed by the Tax Cuts and Jobs Act ("TCJA").

What's a nongrantor trust?

A nongrantor trust is simply a trust that's a separate taxable entity. The trust owns the assets it holds and is responsible for taxes on any income those assets generate. A grantor trust, in contrast, is one in which the grantor retains certain powers and, therefore, is treated as the owner for income tax purposes.

Both grantor and nongrantor trusts can be structured so that contributions are considered "completed gifts" for transfer tax purposes (thereby removing contributed assets from the grantor's taxable estate). But traditionally, grantor trusts have been the estate planning tool of choice. Why? It's because the trust's income is taxed to the grantor, reducing the size of the grantor's estate and allowing the trust assets to grow tax-free, leaving more wealth for beneficiaries. Essentially, the grantor's tax payments serve as an additional tax-free gift.

With less emphasis today on gift and estate tax savings, nongrantor trusts offer some significant benefits.

How can nongrantor trusts reduce income taxes?

The TCJA places limits on itemized deductions, but nongrantor trusts may offer a way to avoid those limitations. The law nearly doubled the standard deduction to $12,000 for individuals and $24,000 for married couples. (Indexed annually for inflation, the 2019 standard deduction amounts are $12,200 for individuals and $24,400 for married couples.) The TCJA also limits deductions for state and local taxes ('SALT") to $10,000.

These changes reduce or eliminate the benefits of itemized deductions for many taxpayers, especially those in high-SALT states. By placing assets in nongrantor trusts, it may be possible to increase your deductions, because each trust enjoys its own $10,000 SALT deduction.

For example, Andy and Kate, a married couple filing jointly, pay well over $10,000 per year in state income taxes. They also own two homes, each of which generates $20,000 per year in property taxes. Under the TCJA, the couple's SALT deduction is limited to $10,000, which covers a portion of their state income taxes, but they receive no tax benefit for the $40,000 they pay in property taxes.

To avoid this limitation, Andy and Kate transfer the two homes to an LLC, together with assets that earn approximately $40,000 per year in income. Next, they give 25% LLC interests to four nongrantor trusts. Each trust earns around $10,000 per year, which is offset by its $10,000 property tax deduction. Essentially, this strategy allows the couple to deduct their entire $40,000 property tax bill.

Beware the multiple trust rule

If you're considering this strategy, be aware that the tax code contains a provision that treats multiple trusts with substantially the same grantors and beneficiaries as a single trust if their purpose is tax avoidance.

To ensure that this rule doesn't erase the benefits of the nongrantor trust strategy, designate a different beneficiary for each trust. Please contact us for more information.

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