Transferring Investment Property to a Trust: What You Need to Know

Suppose you own real estate properties for investment purposes. Further assume that you would like to achieve the following:

1. You no longer want to manage the real estate properties.

2. You want your heirs to avoid probate after you die.

3. You want to save on taxes, if possible.

One option to consider is transferring the property to a trust -- either revocable or irrevocable.

Achieving Your Goals

If you transfer the real estate to a revocable trust and list one of your children or a trusted adviser as the trustee, you achieve two of your goals -- avoiding probate and having someone else manage the assets. Property in a revocable trust allows for the assets to transfer ownership without the need for probate.

However, the property will remain as part of your estate. If you are fortunate enough to have the amount of assets above the federal tax exemption amount (currently $5.49 million for an individual or $10.98 million for a married couple), you may still have to pay federal estate taxes (as well as any state estate taxes) because property in a revocable trust stays in your estate (in 2016 these figures were $5.45 million and $10.90 million respectively).

The third goal of potentially reducing taxes would be achieved by gifting the properties outright or to an irrevocable trust. There would be federal gift tax if the gift amount is above the exemption amount when the gift is made. So, if the transfer was above $5.49 million, there would be a gift tax above the federal exemption amount. The grantor would have to complete a gift tax return. The appraisal could be based on the fair market value at the time of the transfer. The IRS can always challenge the appraisal if it is deemed to be too low. The gift tax return is due on April 15th following the year in which the gift is made. A gift tax return should be prepared even if there are no gift taxes to pay.

There is an analysis that you would need to do to determine if you want to gift the assets with regard to tax savings. You would want to compare estate and gift tax liability with income or capital gains tax liability. (Your estate planning adviser can assist you with this.) Once you gift the assets, they would no longer be subject to estate taxes. Therefore, you would no longer have to pay an estate tax on the property but you would have to pay gift tax. The benefit, though, is that if they are revenue-producing assets, then they could appreciate outside your estate and without you paying estate taxes on the money.

There could be a cost to your heirs. So, an analysis could be helpful. The cost could be in the federal capital gains tax your heirs may have to pay. If you hold on to the real estate, when you die, there would be a stepped-up basis in the property. So, if you bought the property at $200,000 twenty years ago and now the property is worth $1 million, the basis for federal capital gains tax purposes would be $1 million, not $200,000. This would be good news for the heirs since if they sell, the basis would be $1 million. However, this would not be true if you gift the property because there would not be a stepped up basis.

Yet some see the benefit of gifting property because the accumulated amount of income would be excluded for estate tax purposes. The estate tax rate would most likely be higher than the capital gain tax rate, resulting in an overall tax savings.

It could be possible to get the best of both worlds when the property is transferred to what is known as an intentionally defective irrevocable trust (IDIT). This way, you may be able to limit estate taxes and also limit capital gain taxes.

With an IDIT, the grantor sells the assets to the trust in exchange for a promissory note or installment note, as opposed to gifting the property into the trust. So, the beneficiaries of the trust could obtain the stepped up basis since the value of the assets freeze when sold to the trust, allowing for the avoidance of a capital gains tax. Also, the grantor pays the income taxes on the income earned in the trust.

Speak with your attorney about these complicated issues if you own investment property and you would like to achieve the goals described above.

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