

Title Matters – Part 2. Who pays the income taxes?

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This is part 2 of a series of estate planning articles. The first part of this series dealt with the various types of ownership and how property passes at death based on the form of ownership. This article deals with the income tax ramifications of various types of ownership.

Assets Owned Individually

These are assets that have only your name on the title. If these assets produce income, such as interest or dividends, the income will be taxed on your individual tax return. When establishing bank or investment accounts in your name it is important to understand that providing your social security number (as required by law), means that the income from these accounts will be reported to the Internal Revenue Service in your name. If your tax return does not match the information the Internal Revenue Service has, then you will receive a “love letter” from the government asking you to explain the difference.

Joint Tenants

This form of ownership is where property is owned by two persons in equal amounts, i.e. 50% each. The income from these types of assets should be reported by both parties showing their ½ interest. Problems frequently arise where a joint account has been set up at a bank or brokerage institution because they only ask for one social security number for tax reporting purposes. If the joint tenants are married and filing jointly, then 100% of the income will properly end up on the return. Issues arise where the two individuals are not married but own property as joint tenants. The most efficient way to handle this is to report 100% of the income on the tax return whose social security number was provided, and then deduct ½ of that amount on the return with a notation that it is being reported by SS#xxx-xx-xxxx. The other joint tenant should then include ½ of the income on their tax return.

Tenants-in-Common

Tenants-in-common are similar to joint tenants, except that the individual ownership percentages can vary. The income from these assets needs to be reported by each individual on a pro-rata basis. Therefore, if you own 25% of a piece of property as a tenant-in-common, then you need to report ¼ of the income. The individual whose social security number is on the account should report 100% as indicated above, and then subtract out the other owner's percentages to arrive at their own taxable share on the income tax return.

Revocable Trust

A trust is a legal relationship in which the legal ownership of property is separated from the beneficial ownership of the property. In a trust, one person or group of persons (the trustee) holds money or other property (the trust principal) for the benefit of another person or group of persons (the beneficiaries).

The person who creates the trust, by transferring money or property to the trustee, is called the grantor or settlor of the trust. The terms and conditions of the trust are set forth in the trust document.

A revocable trust allows the grantor to alter, amend, or revoke the trust prior to death. Therefore, the trust can be undone if the grantor so chooses.

Generally, when you place cash, stocks, bonds, mutual funds, real estate or other assets into a revocable trust, there is no income tax effect, either favorable or unfavorable. The revocable living trust is basically ignored for income tax purposes and all of the income from the trust is reported on the grantor's income tax return.

Some institutions require the trust to apply for and obtain a separate federal identification number for the trust. If the trust has its own identification number, then a fiduciary income tax return needs to be filed for the trust, and all of the income will "pass-through" to be reported on the grantor's income tax return. There will not be any income tax payable at the trust level.

Irrevocable Trust

An irrevocable trust is permanent. Once the terms and conditions of the trust are written down and the trust is signed, those provisions are fixed. No property can be removed from the trust and nothing can be changed.

There are two types of irrevocable trusts: (1) simple, and (2) complex.

A simple trust requires that all income be currently distributed. This means that the beneficiaries of the trust will pay tax on the income earned by the trust, and the trust itself will not have any income tax obligations.

A complex trust is exactly as it sounds – more complex. The income earned by the trust is split into two categories: (1) ordinary – which includes interest, dividends, pensions, rents etc., and (2) capital – which usually includes capital gains from the sale or exchange of securities.

To the extent that ordinary income is distributed to the beneficiaries, they will pay income tax on the distributed income. If distributions for the year exceed the taxable income for the year, it is considered a return of capital, and is not taxable to the beneficiary.

If the ordinary income is not distributed to beneficiaries during the tax year, then the trust pays the tax on that income, and the beneficiaries do not report anything on their individual income tax returns.

Under trust law, capital gains are treated as additions to corpus, and therefore, cannot be distributed. If an irrevocable trust has capital gains during the tax year, then the trust will pay the income taxes associated with those gains.

Ownership Type	Income Taxed to:
Individual	Individual
Joint Tenants	Pro-Rata
Tenants in Common	Pro-Rata
Revocable Trust	Grantor
Irrevocable Trust	Trust and/or Beneficiaries



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Ms. Aptaker is an attorney licensed to practice law in Rhode Island, Massachusetts and Florida, a Certified Public Accountant, Certified Business Appraiser and a Personal Financial Specialist. Peri Ann has been qualified as an expert witness in Rhode Island state and federal courts. She has written several articles on financial planning and business valuation issues. Peri Ann is a frequent speaker at professional meetings.