Pennsylvania Recognizes Irrevocable Grantor Trusts – How Does This Impact Pennsylvanians?

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Pennsylvanians can sometimes be known as…let's say traditional…or if you prefer, set in our ways or even stubborn. It is part of the spirit that was needed to colonize a hilly, snowy, and sometimes mountainous terrain. It is the same can-do spirit that sent our forefathers into the coal mines, a resistance to taking the easy path in life. In at least one area, Pennsylvania has agreed to follow the rest of the nation, and the result makes its residents' lives easier. By passing legislation that was effective January 1, 2025, Pennsylvania is no longer the last holdout on how certain trusts are taxed.

Pennsylvania Recognizing Irrevocable Grantor Trusts Under State Law

Pennsylvania now recognizes irrevocable grantor trusts under state law. A grantor trust is a trust where the creator (called a grantor) of the trust remains the owner of the trust assets for income tax purposes. This allows the income and capital gains of the trust to be taxed at the grantor's individual tax rate. Non-grantor trusts are taxed at a top federal income tax rate of **37%** on ordinary income. Additionally, undistributed net investment income may be subject to an extra 3.8% net investment income tax. This is a significant savings at the federal level, since any ordinary income over $16,000 hits the top tax bracket, while individuals only pay the same top tax rate for income over $640,600 (2026 rates).

Understanding the Compliance Nightmare Before Recognizing Irrevocable Grantor Trusts Under State Law

Pennsylvania's reluctance to follow the federal standards created a compliance nightmare for trustees (those who hold the trust assets for the benefit of the beneficiary). Trustees of irrevocable grantor trusts had to track income and distributions two different ways for federal and state tax reporting. Federal income and capital gains were all placed on the grantor's tax return, while Pennsylvania required the trustee to file a tax return for the trust as its own taxpayer, but only on undistributed income and gains. Income and gains that were distributed to beneficiaries were recorded on the *beneficiaries'* state tax returns. This made grantor trusts in Pennsylvania more difficult to administer and increased the cost of trust administration.

How the New Law Makes Things Much Easier For Pennsylvanians

Under the newly effective law, this dual record-keeping requirement disappears. The grantor will pay all taxes on the income in the trust during the grantor's lifetime as long as the trust is a grantor trust, and the beneficiaries will not receive or claim the trust distributions on their own income tax returns during the grantor's lifetime. This is a significant boon for any taxpayer with property that is likely to increase in value over time. There are also other tax benefits of grantor trusts, which are more complex.

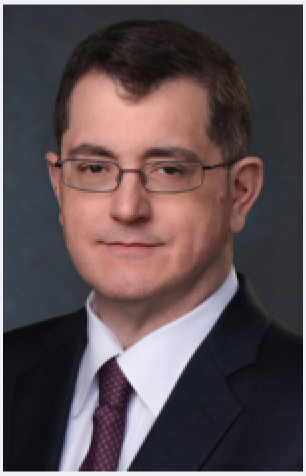
How Does This Affect Your Estate Plan, Grantors, or Beneficiaries of Grantor Trusts?

So, how does this affect your estate planning or your life if you are a grantor or a beneficiary of a grantor trust? There are several considerations to discuss with your tax advisor and estate planning attorney.

1. These changes may impact tax filings for both grantors and beneficiaries. Grantors will see increased reportable income on their income tax returns, while beneficiaries receiving distributions will have lower reportable income. As such, estimated tax payments should be reevaluated.
2. Certain Pennsylvania municipalities tax unearned income, and some include investment income in these taxes. Grantors will now be claiming that unearned income and should inquire if their local income tax obligations will change.
3. If a grantor resides in two different states and files taxes in both states, there may be a new credit available to the grantor. Under the previous law, the trust itself was the taxpayer for income and capital gains in Pennsylvania, while the other state taxed the grantor directly. Since the two taxpayers were not identical, there was no way to offset the tax paid in one state with a credit in the other state. Going forward, a credit may be available to a grantor for the taxes paid in a different state on the same income.
4. Irrevocable trusts in Pennsylvania have been more expensive to administer than other trusts. This change in the law will likely reduce those expenses and permit more residents to access these estate planning tools. The filing and tracking compliance of each irrevocable trust was fairly level, with no meaningful change based on the amount of assets in each trust. Previously, filing an income tax return involved a fixed fee, whether the trust had $500,000 or $50,000,000 in assets; so, as a percentage of the trust assets, the cost of trust administration resulted in the burden falling increasingly on trusts with less assets. The change will reduce these expenses and should result in trusts that are easier to administer as well as less expensive to operate.
5. The final item existing grantors need to evaluate is how this change will impact their existing estate plan. If a grantor established trusts without any consideration of how to pay tax for the trust (because it wasn’t a concern under the old law), the grantor may find that the tax burden is oppressive after a few years under the new law. There are options to address this potential problem, but they will require the advice of an experienced trust practitioner or estate planning attorney.

Speak With a Trusted Pennsylvania Estate Planning Attorney

Grantor trusts are an incredible asset protection tool when used properly. Knox Law’s estate planning team has significant experience with all types of trusts and how they fit into a comprehensive estate plan to achieve clients’ goals. If you have questions about grantor trusts, or any other type of trust, please contact one of our Estate Planning & Administration attorneys or call us at 814-459-2800.



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Brian focuses his practice on business & tax, public finance & bonds, and employee benefits matters for a variety of clients in the private and public sector. His breadth of experience across roles and industries provides clients a 360 degree view of situations, often providing unique but simple solutions while also able to engage in the most complex financial situations.

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