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Trusts
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Trusts and Trust Taxation

TYPES OF TRUSTS AND HOW THEY'RE TAXED

- A. Revocable v. Irrevocable
- B. Simple v. Complex Trusts
- C. Intervivos v. Testamentary
- D. Grantor Trust Status and Reporting (Obtaining Status, Toggling, Federal, State)
- E. Trust Asset Valuation and Tax Consequences

Introduction

Every person who has any assets should have a trust, even if it is a simple management trust. And every person with assets should also have a will. It is not a matter of which avenue is appropriate, but rather an analysis of the purposes / uses of each document in an estate plan.

I was not adamant about this recommendation — that every person should have a trust — until 2013, when I became aware of the Texas supreme court decision of *Finance Commission v. Norwood*.¹ The reason is that the decision prompted many financial institutions to refuse to honor powers of attorney. However, the decision applies only to the agency relationship created by a power of attorney. It does not apply to the legal title held by the trustee of a trust. The result is that custodians of assets -- financial institutions -- which will not accept the authority of an agent named in a power of attorney typically will accept a trustee's authority.

“We also hold that Section 50(a)(6)(N),² which provides that a loan may be ‘closed only at the office of the lender, an attorney at law, or a title company’, precludes a borrower from closing the loan through an attorney-in-fact under a power of attorney not itself executed at one of the three prescribed locations. We reasoned that executing a power of attorney is ‘part of the closing process’, and that not to restrict the use of a power of attorney would impair the undisputed purpose of the provision, which is ‘to prohibit the coercive closing of an equity loan at the home of the owner.’”³

¹ 418 S.W.3d 566 (Tex. 2013).

² Tex. Const. art. XVI, § 50(a)(6)(E).

³ *Finance Commission v. Norwood*, 418 S.W.3d 566 (Tex. 2013). The provision limiting validity of the homestead transactions was enacted after unscrupulous persons convinced people, in their homes — at the kitchen table, so to speak — to “sign away” their homesteads in overreaching transactions.

The decision applies only to transactions involving home equity financing. However, the result of the decision is that many custodians of assets refuse to honor powers of attorney, regardless the type of transaction. Even if the document was, indeed, signed at one of the three locations, the place of signing still could be asserted to be incorrect, leading to a finding that the agent named in the power of attorney had no authority and therefore the transaction is invalid.

The statute respecting powers of attorney was changed effective September 17, 2017, with the goal of making it more likely that powers of attorney be accepted. However, the statute provides many exceptions to the general rule of acceptance. None of this applies to the authority of a trustee.

A. Revocable v. Irrevocable

First, the basics on trust formation.

The Internal Revenue Service describes a trust as a relationship in which one person (which can be a corporation as long as it has trust powers) holds title to property, subject to an obligation to keep or use the property for the benefit of another.⁴

A trust is formed under state law.⁵ The general rule under federal law is that federal courts must look to state law to determine property rights.⁶ This general rule is subject to many exceptions, particularly in situations in which the relief sought by the federal government would not be consistent with recognition of state law on property rights.⁷

Under Texas law, a trust may be created by: (1) a property owner's declaration that the owner holds the property as trustee for another person; (2) a property owner's inter vivos transfer of the property to another person as trustee for the transferor or a third person; (3) a property

⁴ <https://www.irs.gov/charities-non-profits/definition-of-a-trust>.

⁵ IRS Publication 557.

⁶ *Aquilino v. United States*, 363 U.S. 509 (1960) (both federal and state courts must look to state law, for it has long been the rule that, "in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property . . . sought to be reached by the statute), *citing Morgan v. Commissioner*, 309 U.S. 78, 82.

⁷ *See, e.g., United States v. Craft*, 535 U.S. 274 (2002) (federal tax lien could attach to property in which delinquent taxpayer held certain rights, notwithstanding state law providing that the taxpayer held no individual ownership interest in the property).

owner's testamentary transfer to another person as trustee for a third person; (4) an appointment under a power of appointment to another person as trustee for the donee of the power or for a third person; or (5) a promise to another person whose rights under the promise are to be held in trust for a third person.⁸ Notice that a piece of paper describing the terms of the trust is not necessarily required (although it is definitely recommended) to create a trust.

A trust is created only if the settlor manifests an intention to create a trust.⁹ Consideration is not required for the creation of a trust. However, a promise to create a trust in the future is enforceable only if the requirements for an enforceable contract are present.¹⁰

A trust consisting of personal property, however, is enforceable if created by: (1) a transfer of the trust property to a trustee who is neither settlor nor beneficiary if the transferor expresses simultaneously with or prior to the transfer the intention to create a trust; or (2) a declaration in writing by the owner of property that the owner holds the property as trustee for another person or for the owner and another person as a beneficiary.¹¹ A trust cannot be created unless there is trust property.¹²

Typical property ownership consists of fee simple ownership, in which one or more persons own all aspects of title. Trusts trifurcate that title into legal title, beneficial title, and remainder interest. One person can hold two of the three in a trust and still retain the trust existence.

However, if one person holds all three titles, then the trust fails under the doctrine of merger. If a settlor transfers both the legal title and all equitable interests in property to the same person or retains both the legal title and all equitable interests in property in himself as both the sole trustee and the sole beneficiary, with no remainderman, a trust is not created and the transferee holds the property as his own.¹³

⁸ TEX. PROP. CODE § 112.001.

⁹ TEX. PROP. CODE § 112.002.

¹⁰ TEX. PROP. CODE § 112.003.

¹¹ TEX. PROP. CODE § 112.004.

¹² TEX. PROP. CODE § 112.005.

¹³ TEX. PROP. CODE § 112.034(a).

A trust terminates if the legal title to the trust property and all equitable interests in the trust become united in one person¹⁴; however, if a beneficiary's interest is protected in accordance with spendthrift provisions in a trust, then a court is required to appoint a new trustee or co-trustee to administer the applicable trust if otherwise all legal and equitable interests in the trust property become united in that beneficiary, other than the settlor.¹⁵

Under Texas law, a settlor may revoke the trust unless it is irrevocable by the express terms of the instrument creating it or of an instrument modifying it.¹⁶ That aside, trust documents should specifically state whether the trusts are revocable or irrevocable. Also, judicial modification and recently enacted decanting statutes result in many "irrevocable" trust terms changing.¹⁷

Most trusts in circulation which I see are revocable trusts. I have been seeing many which involve the parties obtaining forms from the internet and preparing their "plans" from those forms. Those trusts typically are revocable, which makes them grantor trusts. The trust EIN should be the social security number of the grantor. The grantor reports all activity on his own 1040, without the requirement to file a separate Form 1041, U.S. Income Tax Return for Estates and Trusts.

Federal law addresses the tax treatment of a revocable trust. The power to revoke the trust causes grantor status,¹⁸ unless such power cannot be exercised until after a certain event.¹⁹ The right to revoke causes the trust assets to be included in the grantor's estate for estate tax purposes.²⁰

¹⁴ TEX. PROP. CODE § 112.034(b).

¹⁵ TEX. PROP. CODE § 112.034(c).

¹⁶ TEX. PROP. CODE § 112.051(a).

¹⁷ TEX. CONST. ART. XVI, § 52; TEX. ESTATES CODE, chapter 353. Given judicial modification, TEX. PROP. CODE § 112.054, and decanting, TEX. PROP. CODE, chapter 112, subchapter D, no trust is truly irrevocable.

¹⁸ 26 U.S.C. § 676(a); Treas. Reg. § 1.676(a)-1.

¹⁹ 26 U.S.C. § 676(b).

²⁰ 26 U.S.C. § 2038(a)(1).

The main reason I have seen for creating a lifetime irrevocable trust is for exclusion of the trust assets for estate tax purposes. Another reason is asset protection. For these goals to be accomplished, the trust should be created with a third party as grantor. The grantor should have no rights with respect to the trust after the trust is created or otherwise, although the grantor should make the initial gift to the trust. The trust provisions provide that someone other than the grantor (typically the client) is the trustee and primary beneficiary.²¹ The client uses the initial gift to the trust to acquire assets. If drafted correctly, none of the assets comprising the trust will be included in anyone's estate for estate tax purposes, unless that result is desired, such as for the step up in basis for appreciated capital assets. The foregoing trust is typically referred to as "beneficiary grantor trust" or "678 trust," referring to the statute applicable to how the trust is taxed for income tax purposes.²²

[By the way, I've long been of the opinion that no trust is truly irrevocable, given the remedies of judicial modification and, more recently, decanting.]

The trust can be drafted so that the owner for income tax purposes, also called "substantial owner," can relinquish a power. Should the same substantial owner be authorized to reinstate the power, the trust could be determined to be revocable,²³ causing the owner to be

²¹ See 26 U.S.C. § 676(b).

²² 26 U.S.C. § 678.

²³ Treas. Reg. § 1.675-1(a).

deemed to have a general power of appointment²⁴ with respect to the trust assets. If that is not the goal, consider giving to a third party the power to reinstate the trust owner's power which causes grantor trust status.

For assets in a revocable trust which pass to a trust that the surviving spouse can revoke or amend, the nine months for a qualified disclaimer begin running on the date of the first spouse's death.²⁵

B. Simple v. Complex Trusts

Trusts which are taxpayers are called nongrantor trusts. Some trusts are "flow through" trusts in that either the grantor or one or more beneficiaries is treated as the owner for income tax purposes regardless of distributions, similar to the income taxation with respect to limited liability companies and partnerships.

Nongrantor trusts are trusts for which income is taxed to the beneficiary to whom income is distributed, while grantor trusts result in income being taxed to the grantor or beneficiary, depending on the powers set forth in the trust document, even if that income is not distributed to the grantor or beneficiary.

²⁴ The term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that— (A) A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment. (B) A power of appointment created on or before October 21, 1942, which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment. (C) In the case of a power of appointment created after October 21, 1942, which is exercisable by the decedent only in conjunction with another person— (i) If the power is not exercisable by the decedent except in conjunction with the creator of the power—such power shall not be deemed a general power of appointment. (ii) If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent—such power shall not be deemed a general power of appointment. For the purposes of this clause a person who, after the death of the decedent, may be possessed of a power of appointment (with respect to the property subject to the decedent's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the decedent's power. (iii) If (after the application of clauses (i) and (ii)) the power is a general power of appointment and is exercisable in favor of such other person—such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the decedent) in favor of whom such power is exercisable. For purposes of clauses (ii) and (iii), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate. 26 U.S.C. § 2041(b)(1).

²⁵ 26 C.F.R. § 25.2518-2(c)(5).

Trusts which require that all income be distributed each year are called simple trusts. A simple trust must pass all three criteria in a taxable year in order to be considered as a simple trust: (a) it must distribute all income to the beneficiaries; (b) it cannot distribute principal; and (c) it cannot make distributions to charity.²⁶ Such trusts cannot accumulate income, distribute from corpus, or pay money for charitable purposes. Simple trusts get a deduction for the amount of income that must be distributed in the current year. The beneficiaries of a simple trust must include in their gross incomes the amount of the income required to be distributed currently, whether or not it is actually distributed.²⁷

A complex trust is a trust that does any one of the following in a taxable year: (i) it accumulates income or (ii) it distributes principal or (iii) it makes charitable distributions. If a trust distributes corpus during a year, as in the year it terminates, the trust becomes a complex trust for that year.²⁸

Trusts which do not meet the requirements of simple trusts — those which accumulate income, make distributions to charitable organizations, or distribute corpus in addition to income — are called complex trusts and are taxed, for income tax purposes, as are individuals, with some exceptions²⁹ and with tax brackets that reached the highest applicable tax at \$16,000. The focus of the difference is the manner of deductions for distributions to beneficiaries.

I almost never draft complex trusts, because trusts as income taxpayers reach the highest income tax bracket — 37 percent — at only \$16,000.³⁰

In general, a grantor trust is a trust where the grantor retains control or ownership of the trust's assets for income tax purposes. This means the grantor is taxed on the trust's income, even

²⁶ 26 CFR § 1.651(a)-1.

²⁷ 26 U.S.C. § 651(a).

²⁸ 26 U.S.C. §§ 651-652.

²⁹ 26 U.S.C. § 641, 661. Grantor trusts are governed by sections 671 through 671 of Title 26.

³⁰ Up to \$3,300, 10 percent; \$3,300 to \$11,700, 24 percent; \$11,000 to \$16,000, 35 percent; \$165,000 and more, 37 percent. Instructions to form 1041. Meanwhile, the income tax bracket for an individual doesn't reach the highest bracket until \$640,601 -- 10 percent up to \$12,400, 12 percent from \$12,401 to \$50,400, 22 percent from \$50,401 to \$105,700; 24 percent from \$105,701 to \$201,775; 32 percent from \$201,776 to \$256,225; 35 percent from \$256,226 to \$640,600; and the highest income tax bracket — 37 percent — at \$640,601.

if the income isn't distributed. In some situations, the trust is a *beneficiary* grantor trust, meaning a beneficiary or beneficiaries are considered the owners for income tax purposes. The income, even undistributed income, is attributed to the beneficiary(ies), in a manner similar to a limited liability company.

There is an exception to my tendency to avoid complex trusts, being trusts for which a beneficiary is a taxpayer in a jurisdiction that taxes individuals a very high rates.³¹ I have drafted trusts as taxpayers to avoid a beneficiary having to include income, the source of which is a transaction in the US, which if taxable to the individual would be taxed at high rates in that beneficiary's home jurisdiction.

With a grantor trust, the grantor or such other person must include on his 1040 all items of "income, deductions, and credits against tax of the trust" attributable to the portion of the trust over which the grantor or such other person is treated as the owner. Such grantor or other person is taxed to the same extent as if he or she had received the item directly, even if the person never receives the item at all.³²

For a simple trust's 1041, all income is reported and also deducted. The trust pays tax only on capital gains.³³

A complex trust's distributions can include ordinary income, dividends, capital gains and principal, if the distribution provisions so provide. A complex trust may have income that is not distributed and deductions for distributions to charities. In theory, the allocation of the tax and any deductions to and among beneficiaries can be more "complex" for a complex trust.

For a complex trust, distributions will be treated as comprised of, first, ordinary income to be distributed before dividends; then all dividends before capital gains; and all capital gains before principal. The trust deducts any income distributed to beneficiaries. Income and certain deductions must be allocated "equitably" among the trust and the beneficiaries, requiring calculation of Distributable Net Income ("DNI"). DNI, if not distributed to beneficiaries, is taxed

³¹ *E.g.*, Denmark, 55.9 percent; France, 55.4 percent; Austria, 55 percent.

³² 26 U.S.C. § 671; Treas.Reg. § 1.671- 2(d).

³³ Some states allow treatment of capital gains as income if permitted by the trust document, in which case capital gains should be distributed to the beneficiaries.

to the trust.

Non-grantor trusts, whether simple or complex, should each have its own EIN. A trust may be a simple trust for one year and a complex trust for another year.³⁴ Form 1041 allows the trustee to check the box as to whether the trust is a simple or complex trust for that particular tax year. The 1041 is required if the trust has any taxable or gross income of \$600 or more.

Distributions to beneficiaries should be reflected on K-1s, included with the 1041 and also sent to each distributee, who is to claim the revenue on his 1040. The trust has a higher tax rate than an individual.

Creditors of a beneficiary of a simple trust should be able to attach distributions which are required to be made from the trust. As such, I prefer complex trusts for asset protection, but with the beneficiary(ies) being the owner(s) for income tax purposes, to reduce applicable income tax.

C. Intervivos v. Testamentary

As previously indicated, under Texas law, a trust may be created by: (1) a property owner's declaration that the owner holds the property as trustee for another person; (2) a property owner's inter vivos transfer of the property to another person as trustee for the transferor or a third person; (3) a property owner's testamentary transfer to another person as trustee for a third person; (4) an appointment under a power of appointment to another person as trustee for the donee of the power or for a third person; or (5) a promise to another person whose rights under the promise are to be held in trust for a third person.³⁵ Notice that a piece of paper describing the terms of the trust is not necessarily required (although it is definitely recommended) to create a trust.

Of course, a testamentary trust is one created in a will. However, a will has no effect unless and until it is admitted to probate.³⁶ Therefore, a testamentary trust for a will that is not admitted to probate has no effect. I could see issues, in many courts, refusing to probate a will after four years from the testator's date of death. All the benefits of a trust — gone.

³⁴ 26 C.F.R. § 1.651(a)-1.

³⁵ TEX. PROP. CODE § 112.001.

³⁶ TEX. ESTATES CODE § 301.001.

With limited exceptions, a will may not be admitted to probate after the fourth anniversary of the testator's death -- the applicant must prove that the applicant was not in default in failing to present the will for probate on or before the fourth anniversary of the testator's death.³⁷ However, the will may be admitted to probate if the application for probate was filed on or before the fourth anniversary of the testator's death.³⁸

Exception: A will can be admitted to probate as a muniment of title after four years if the applicant is not at fault for failing to offer the will before the four-year limitations.³⁹

Exception: Probate of foreign wills.⁴⁰

Exception: The four year limitations does not apply if administration is necessary to: (1) receive or recover property due a decedent's estate; or (2) prevent real property in a decedent's estate from becoming a danger to the health, safety, or welfare of the general public and the applicant for the issuance of letters testamentary or of administration is a home-rule municipality that is a creditor of the estate.⁴¹

Every person who has any assets should have a trust, even if it is a simple management trust. And every person with assets should also have a will. It is not a matter of which avenue is appropriate, but rather an analysis of the purposes / uses of each document in an estate plan.

I was not adamant about this recommendation — that every person should have a trust — until 2013, when I became aware of the Texas supreme court decision of *Finance Commission v. Norwood*.⁴² The reason is that the decision prompted many financial institutions to refuse to honor financial powers of attorney. However, the decision applies only to the agency relationship

³⁷ TEX. ESTATES CODE § 256.003(a). With exceptions, an application for the grant of letters testamentary or of administration of an estate must be filed not later than the fourth anniversary of the decedent's death. TEX. ESTATES CODE § 301.002(a).

³⁸ TEX. ESTATES CODE § 256.003(b).

³⁹ Under Section 256.003(a), when an applicant seeks late-probate of a will in the applicant's individual capacity, only the applicant's conduct is relevant to determining whether the applicant "was not in default". *Ferreira v. Butler*, 575 S.W.3d 331 (Tex. 2019).

⁴⁰ TEX. ESTATES CODE §§ 256.003(a); 301.002(a).

⁴¹ TEX. ESTATES CODE § 301.002(b).

⁴² 418 S.W.3d 566 (Tex. 2013).

created by a power of attorney. It does not apply to the legal title held by the trustee of a trust. The result is that custodians of assets often will accept a trustee's authority but not the authority of an agent under a power of attorney.

“We also hold that Section 50(a)(6)(N),⁴³ which provides that a [home equity] loan may be ‘closed only at the office of the lender, an attorney at law, or a title company’, precludes a borrower from closing the loan through an attorney-in-fact under a power of attorney not itself executed at one of the three prescribed locations. We reasoned that executing a power of attorney is ‘part of the closing process’, and that not to restrict the use of a power of attorney would impair the undisputed purpose of the provision, which is ‘to prohibit the coercive closing of an equity loan at the home of the owner.’”⁴⁴

The decision applies only to transactions involving home equity financing. However, the result of the decision is that many custodians of assets refuse to honor powers of attorney, regardless the type of transaction. Even if the document was, indeed, signed at one of the three locations, the place of signing still could be asserted to be incorrect, leading to an invalid power of attorney and therefore an invalid transaction.

The statute respecting powers of attorney was changed effective September 17, 2017, with the goal of making it more likely that powers of attorney be accepted. However, the statute provides many exceptions to the general rule of acceptance.⁴⁵

My experience in discussing the situation with financial institution employees is that powers of attorney still would not be accepted, notwithstanding the change in the law. Title companies, on the other hand, often will accept the agency relationship created by the power of attorney, no questions asked, likely because the title company will not be paid the title insurance policy premium unless the transaction closes.

That's for powers of attorney. I have never had an experience for which a financial institution has refused to honor a trustee's authority to act on behalf of a trust, if a copy of the

⁴³ Tex. Const. art. XVI, § 50(a)(6)(E).

⁴⁴ *Finance Commission v. Norwood*, 418 S.W.3d 566 (Tex. 2013). The provision limiting validity of the homestead transactions was enacted after unscrupulous persons convinced people, in their homes — at the kitchen table, so to speak — to “sign away” their homesteads in overreaching transactions.

⁴⁵ See TEX. ESTATES CODE § 751.201 & 751.203.

trust agreement is provided, although recently some financial institutions have been requiring a certificate of trust. The difference: an agency relationship (power of attorney) versus legal title held by the trustee (trust).

The foregoing illustrates that the trust is a superior vehicle for the grantor, *during the grantor's lifetime*. Especially given the will has no legal effect until it is admitted to probate, after the testator's death.

D. Grantor Trust Status and Reporting; Toggling, Federal, State Requirements

As previously described, trusts, ordinarily, are taxpayers which reach the highest income tax bracket at \$16,000.⁴⁶ However, the tax attributes of trust activity can pass through to the grantor or another person, who is / are treated as owners of the trust for income tax purposes only. These types of trusts are called grantor trusts. Depending on how the trust is drafted and funded, the assets comprising the trust can be excluded from any person's gross estate for estate and generation skipping transfer tax purposes.

A grantor trust is a trust under which the grantor or someone other than the grantor is treated as the "substantial owner" of the trust assets for income tax purposes under sections 671 through 679 of the Internal Revenue Code.⁴⁷

This means the grantor or such other person, one or more of the beneficiaries, must include on the 1040 all items of "income, deductions, and credits against tax of the trust" attributable to the portion of the trust over which the grantor or such other person is treated as the owner. Such grantor or other person is taxed to the same extent as if he or she had received the item directly, even if the person never receives the item at all.⁴⁸

Under grantor trust rules, trust income is taxed to the person creating and/or funding the trust if he or she retains power over trust corpus and/or income, such as determining the allocation of income or revoking the trust. All trust income is reported on the grantor's tax return and not the trust income tax return. Most grantor trusts file Form 1041, *U.S. Income Tax Return for Estates and Trusts*, containing the basic trust information (name, address, taxpayer

⁴⁶ Instructions to form 1041.

⁴⁷ 26 U.S.C. § 671.

⁴⁸ 26 U.S.C. § 671; Treas.Reg. § 1.671- 2(d).

identification number). The amount that must be reported by the deemed owner of the trust is presented in a grantor tax information letter. In some situations, the grantor trust may file a Form 1099 instead of a Form 1041, which may simplify tax reporting if the trust does not have many types of income. On the other hand, filing a tax return begins the statute of limitations, while not filing returns does not.⁴⁹

Under a beneficiary grantor trust, one or more beneficiaries are considered "substantial owners" if they have certain rights with respect to the trust. The rights are the right to vest corpus in himself, and, after that right lapses, retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof. I include the power to reacquire the trust corpus by substituting other property of an equivalent value, per section 675(4).

A grantor trust offers several tax advantages. The taxes due from the individuals are lower, because of the different applicable tax brackets. It can own subchapter S stock, if it contains the appropriate provisions, and gain from sale of a personal residence may qualify for the exclusion from capital gain.⁵⁰ The assets comprising the trust likely would be included in the grantor's estate for estate and generation skipping transfer tax purposes, if the grantor is the substantial owner. The assets likely could be excluded if the grantor retains no rights, and likely excluded from the substantial owner's estate if that person(s) is / are the beneficiary(ies) of the trust.

Funding a grantor trust can be accomplished without recognition of capital gain. For example, an individual who is considered the owner of the trust for income tax purposes can sell assets to the trust without recognizing the gain on the sale. Because the seller as grantor is the owner of the trust for income tax purposes, the seller for tax purposes is selling the assets to himself. The transaction therefore has no income tax consequences. No gain or loss is recognized. For example, the sale of a business with a low basis and appreciated value will not result in a capital gain or other tax. In addition, the grantor is not taxed on the note interest

⁴⁹ 26 U.S.C. § 6501.

⁵⁰ Excluding from gross income gain from the sale of a principal residence, owned two or more years, in the amount of \$250,000 for a single taxpayer and \$500,000 for married taxpayers. 26 U.S.C. § 121.

payments. The grantor (or beneficiaries, if those persons are the substantial owners) is subject to tax on any income of the trust. All appreciation in the value of the assets is owned by the trust and insures to the benefit of the beneficiaries, typically the grantor's descendants.

An individual can also loan money to the trust, and although the trust must pay the individual at least a minimum IRS-prescribed interest rate (called the applicable federal rate, or AFR), the interest income is not taxable to the individual, and the transfer does not constitute a gift, if the only owner for income tax purposes is the same individual. In addition, the trust's income tax, paid by the individual as the grantor, is not considered an additional gift to the trust. Basically, the trust assets can grow for the benefit of the beneficiaries, without the economic burden of paying income tax. In essence, this is a tax-free gift.

Toggling Owner for Income Tax Purposes

A transaction involving a grantor trust for which the termination and subsequent recreation of the trust's grantor trust status and which results in a tax loss to the grantor exceeding actual economic loss or to avoid "inappropriately" the recognition of gain, is considered a "transaction of interest" which must be reported to the IRS. A transaction of interest is a transaction which the IRS and Treasury Department believe has the potential for tax avoidance or evasion, but for which the government has insufficient information to label the transaction one of tax avoidance. That grantor status is terminated and not reinstated is not a transaction of interest.⁵¹ Owners for income tax purposes can be changed calendar year to calendar year, but not within any calendar year.

All the assets and liabilities of a trust are treated as having been transferred from the grantor to the trust when during the grantor's life the grantor is no longer owner for income tax

⁵¹ Transactions of Interest, [irs.gov/businesses/corporations/transactions-of-interest](https://www.irs.gov/businesses/corporations/transactions-of-interest), Notice 2007-73; *see* form 8886.

purposes,⁵² causing recognition of gain,⁵³ except as to assets and/or liabilities acquired for fair market value.⁵⁴ Any liabilities between the grantor and trust are disregarded.⁵⁵

The trust can be drafted so that the owner for income tax purposes can relinquish a power. Should the same owner be authorized to reinstate the power, the trust could be determined to be revocable,⁵⁶ causing the owner to be deemed to have a general power of appointment with respect to the trust assets. Consider giving the power to reinstate the trust owner's power which causes grantor trust status to a third party. Again, consider it must be reported to the IRS.

When the Grantor Dies

The trust ceases to be a grantor trust with the grantor as owner for income tax purposes when the grantor dies. The revenue code does not address the consequences. Some believe that termination of grantor trust status constitutes transfer of the assets and liabilities from the grantor to the trust. However, this should not be the result should assets have been purchased by the trust for fair market value.

The IRS addressed a transaction for which a non grantor trust was converted to a grantor trust during a grantor's lifetime. The IRS specifically said lapse of grantor trust status caused by the death of the grantor is not treated as an income tax event.⁵⁷ When grantor trust status terminates during the grantor's lifetime, the grantor is deemed to have transferred to the trust all of the assets in the trust and all of the liabilities of the trust.⁵⁸

⁵² Treas. Reg. § 1.1001-2(c), (5); *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222.

⁵³ Treas. Reg. § 1.1001-2(a)(1).

⁵⁴ Treas. Reg. § 1.1001-2(a)(3).

⁵⁵ See Rev. Rul. 85-13, 1985-1 C.B. 184.

⁵⁶ Treas. Reg. § 1.675-1(a).

⁵⁷ Chief Counsel Advice 200923024; *discussing Madorin*, Rev. Rul. 77-402, Treas. Reg. § 1.1001-2, Ex. 5.

⁵⁸ *Madorin v. Comm'r*, 84 T.C. 667 (1985); Treas.Reg. §1.1001-2(c), Ex. (5); Rev.Rul. 77-402, 1977-2 C.B. 222.

If the liabilities deemed transferred to the trust exceed the basis of the assets deemed transferred to the trust, the grantor should recognize gain on the difference.⁵⁹ The “amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.”

If, however, the liability was incurred by reason of acquisition of the property, the liability will not be included in the amount realized.⁶⁰ Furthermore, because transactions between the grantor and the grantor trust are disregarded for federal income tax purposes, any liabilities between the grantor and the grantor trust should be disregarded.⁶¹

Gain on the sale of a capital asset is the excess of the amount realized as compared with the adjusted basis of the property.⁶² If the decedent had a general power of appointment with respect to the capital assets, then the assets should get the step up in basis. The assets also would be included in the grantor’s estate for estate tax purposes, which is basically irrelevant if the value grantor’s gross estate is less than the applicable exclusion amount. Those inheriting capital assets over which the decedent had a general power of appointment do not realize any amount in excess of the adjusted basis, before any applicable step up in basis. As such, an inheritance does not trigger gain.

Consider including in the trust a limited testamentary power of appointment with respect to appreciated capital assets, but only to the extent and with respect to assets which would result in a decrease in out-of-pocket tax due, considering all types of tax.

The Form 1041 for a grantor trust which contains only the trust’s name, address, tax identification number (TIN), and a statement attached to the form.⁶³ The assets owned by the

⁵⁹ Treas.Reg. §1.1001-2(a)(1).

⁶⁰ Treas.Reg. §1.1001-2(a)(3).

⁶¹ See Rev.Rul. 85-13, 1985-1 C.B. 184.

⁶² 26 U.S.C. § 1001(a).

⁶³ 26 CFR § 1.671-4(a).

trust are normally titled so that the earnings are initially reported by the payor (*e.g.*, the brokerage firm, partnership, or, in many cases, an S corporation, etc.) as being taxable to the trust. However, by filing the Form 1041, the trustee is in effect letting the IRS know that the items of income or deductions are instead reportable by the “deemed owner.” The activity that is reportable by the deemed owner is summarized on a separate statement, a grantor tax information letter, which is attached to the otherwise “mostly blank” Form 1041 when filed with the IRS. However, there are two alternative reporting methods that allow some grantor trusts to avoid filing a Form 1041. On the other hand, filing a tax return begins the statute of limitations.

First Alternative

One alternative method allows the trustee of the trust to file Forms 1099 in lieu of a Form 1041.⁶⁴ The income is initially reported as taxable to the trust. However, the taxability of that income is shifted to the deemed owner with the 1099s showing the trust itself as the payor, and the deemed owner as the payee. As a practical matter, though, if there are multiple types of income (dividends, interest, rent, etc.) or multiple sale transactions, this method may not be any easier than filing a Form 1041. Furthermore, as described below, unless the deemed owner is the trustee or a co-trustee, filing Forms 1099 does not negate the trustee’s duty to prepare the grantor tax information letter and send it to the deemed owner to be reported on his or her personal return. In that situation, filing Forms 1099 involves virtually as much effort as filing Form 1041.

Second Alternative

The other alternative, however, is a relatively easy way to avoid filing either a Form 1041 or Forms 1099. This involves changing the way the ownership of the trust’s assets is listed with the payor, available if the grantor trust owner is only one person.⁶⁵ The trustee furnishes to all payors of income (*e.g.*, a brokerage firm, etc.) the following information, so that Forms 1099 or Schedules K-1 (from either a partnership, S corporation, or a trust, etc.) are issued using:

- The owner’s name;
- The owner’s social security number; and
- The trustee’s address.

⁶⁴ 26 CFR § 1.671-4(b)(2)(iii).

⁶⁵ 26 CFR § 1.671-4(b)(2)(i)(A).

In this alternative, the income is reported to the IRS as being taxable directly to the deemed owner; however, the forms are mailed by the payor to the trustee. The goal of this alternative reporting method from the IRS's perspective is to have Forms 1099 and Schedules K-1 issued in a manner that allows the IRS to computer match the income directly against the income shown on the individual's Form 1040.

An often-mentioned concern with this technique, however, is that precise compliance with this alternative would tend to not leave a clear trail that the assets are legally owned by a trust, rather than owned individually, particularly if the trustee's and grantor's addresses are the same. This concern is particularly acute if the trust is irrevocable and the intent is for the assets to be outside of the grantor's taxable estate for estate tax purposes.

However, the assets are legally titled in the trust's name. It is merely changing the method for reporting the trust's income and deductions. Nevertheless, someone who is looking solely at an S corporation Schedule K-1 upon the death of the grantor (showing the grantor's name, SSN, and address) could mistakenly miss that the relevant assets, e.g., stock certificates, would clearly show ownership by the trust. This alternative method might cause the estate planning benefits of the trust to be inadvertently missed.

For the above reason, the best solution (to both comply with the regulation and still "leave a clear trail") is to not give to the payors just the name of the owner for income tax purposes (as suggested by the regulations), but rather to show both his or her name and the trust's name on the payor's records. Thus, if "John Doe" created the trust, the name section of the Form 1099 or Schedule K-1 would contain the following: "John Doe, grantor (or beneficiary) of the Doe Dynasty Trust dated 12/30/2012."

In this way, the Forms 1099 or Schedules K-1 would be issued in the grantor's (or beneficiary's) SSN, and the grantor's (or beneficiary's) name would be the first item in the name section, followed by a reference to the trust. This technique gives the trustee the option to avoid filing either an annual income tax return or Forms 1099. Instead, the taxable income is reported directly on the grantor's Form 1040.

However, at some point the individual who created the trust may realize that the trust has sufficient assets for its intended beneficiaries — usually the grantor's children and grandchildren.

Or the grantor may no longer find it economical to the grantor's personal finances to pay the trust's income taxes. In these circumstances, it may be possible to give up or waive the grantor trust powers, which would then convert the grantor trust to a non-grantor trust, *unless the trust terms provide that on waiver of grantor's powers, a different individual or individuals will have certain powers*. Also, after the death of the grantor, the trust will become a non-grantor trust, *unless the trust provides for different terms*. These possibilities would change the grantor trust to a beneficiary grantor trust, a type of trust which is less known. Beneficiary grantor trusts are not dependent on the death of the grantor, if correctly structured.

With beneficiary grantor trusts, the income is taxed to the beneficiaries rather than the grantor. These trusts require the grantor relinquish rights to the trust, because the provisions which otherwise would make a beneficiary an owner for income tax purposes will nevertheless make the grantor the owner if the grantor has any powers.⁶⁶

In some situations, the taxpayer's situation would call for treating the grantor or some other person as owner of the entire trust, while in other situations, it may be beneficial to have such ownership attributable to only a portion of the trust. In the latter cases, the person treated as owner would include only those items of income, deductions, and credits allocable to that portion.⁶⁷

A qualified subchapter S trust is treated as a grantor trust and therefore considered an eligible S corporation shareholder. To qualify, the trust must contain appropriate provisions, the trust income beneficiary must make a proper and timely election, and the trust must distribute all income to a single individual beneficiary who is a U.S. citizen or resident. If the trust also distributes corpus, it must be allocated to the same income beneficiary. The interest terminates when the trust terminates or the beneficiary dies, and at that point principal and income must be distributed to the beneficiary or the beneficiary's estate.

The tax brackets of the relevant individuals, as well as the types of property involved, factor into a determination of the appropriate type of trust.

While a grantor trust can provide many benefits, the grantor trust status may at some

⁶⁶ 26 U.S.C. § 678(b).

⁶⁷ Treas.Reg. § 1.671-3(a).

point result in a higher tax liability than property ownership in other structures. With a grantor trust, the grantor is the subject of the tax liability created by the trust. At some point, whether resulting from the performance of the trust investments, the potential sale of a highly appreciated asset, or merely due to the lapse of time, it may no longer be financially feasible or tax efficient for the grantor to continue paying the tax. Trusts can be drafted to allow the grantor trust status to be effective or not. This has been nicknamed "toggling" the powers which cause the grantor to be the owner for income tax purposes.

It may be possible to turn off the grantor trust status and the grantor owe no tax, but each situation is different. Consider the case of a sale to what's often referred to as a "defective" trust -- one for which the trust has grantor trust status. If the sale to the trust by the grantor was of appreciated assets in return for a promissory note, and the grantor trust status is no longer applicable, then outstanding obligations on the note could cause (i) interest paid to the payee to be subject to income tax and (ii) a portion of the previously avoided capital gains tax may be due.

In some situations when the trust expects a large capital gain, grantor trust status may need to be switched off so that the grantor would avoid the tax to be generated and allow the trust to pay the capital gains tax out of the transaction proceeds. On the other hand, "turning on" the grantor status may benefit if, for example, the grantor is expecting a large capital loss through other personal investments. Grantor trust status would allow for those transactions to offset against one another.

The IRS has classified certain arrangements involving toggling of ownership as "transactions of interest" requiring disclosure,⁶⁸ with substantial penalties should disclosure not be made.⁶⁹

In Notice 2007-73, the IRS has determined that one type of planning involving grantor trusts has the potential for "abuse." The identified transaction uses the purported termination and subsequent re-creation of grantor trust status to allow the grantor either to claim a tax loss greater

⁶⁸ Treas. Reg. §1.6011-4(e); Transaction of Interest – Toggling Grantor Trust Notice 2007-73.

⁶⁹ Treas. Reg. §1.6011-4; 26 U.S.C. §§ 6707A, 6111, and 6707(a).

than any actual economic loss sustained by the taxpayer or to “inappropriately”⁷⁰ avoid the recognition of gain. This termination and recreation of grantor trust status is sometimes referred to as "toggling." The IRS has initially identified two variations of this transaction.

In both variations, the transactions generally occur within a short period of time during the taxable year. In each case, the grantor claims that the "toggling off" and "toggling on" of the grantor trust status, combined with the events regarding the trust's assets, result in tax consequences that are not achievable without *both* the toggling off and on of the grantor trust status.

The transactions described in Notice 2007-73 *do not* include a situation where a trust's grantor trust status is terminated, *unless* the original grantor trust status for income tax purposes is subsequently reestablished.

As previously indicated, retention of certain powers by a grantor causes a trust to be a grantor trust, with the grantor being treated as owner for income tax purposes.

A trust which provides one or more beneficiaries with certain powers, and with respect to which the grantor has not retained powers, causes a trust to be a beneficiary grantor trust, with one or more beneficiaries being the owner(s) for income tax purposes.

These specific powers are directed at income tax, not estate tax.

E. Trust Asset Valuation and Tax Consequences

The value of trust assets is relevant to gift, estate, and generation skipping transfer taxes when contributions to a trust become completed gifts. It is at that time that the transfer tax is assessed on the value of the particular gift.

The elements of a gift are intent, delivery, and acceptance. Taxation is dependent on whether a gift is or isn't complete and whether a gift is one of a present interest in the gifted assets. Gifts of \$19,000 or less to any one or more persons are within the annual exclusion and not subject to gift tax. Gifts paid directly to the provider of education or medical services are excluded from the gift tax. Gifts of a future interest in property are not within the annual exclusion.

Gift tax returns (Form 709) are due April 15 of the year following the year of the gift, or

⁷⁰ I have not been able to locate a legal definition of “inappropriate tax avoidance” or “abusive tax shelters.”

October 15 if extended. If a gift tax return is filed late, the value of the gift is determined at the time the gift is made or at the time the return is filed, whichever is the higher amount.

The estate tax is a tax on the transfer of property at death.⁷¹ Assets owned or over which the decedent had incidents of ownership, including a general power of appointment, as of the date of death are included in the decedent's gross estate for estate tax purposes.⁷² The tax is assessed on the market value of assets. Assets may include of cash and securities, real estate, insurance, trusts, annuities, business interests, retirement assets.⁷³

Certain deductions are appropriate, including mortgages and other debts, estate administration expenses, and property that passes to surviving spouses⁷⁴ who are U.S. citizens⁷⁵ and qualified charities.⁷⁶ The value of some operating business interests or farms may be reduced for estates that qualify.⁷⁷ The tax is computed on the value of the net estate, then reduced by the available unified credit and possibly other credits.⁷⁸

Estate tax returns are required if the gross estate exceeds the value that can pass free from out-of-pocket tax because of the available credit (applicable exclusion amount, formerly known as exemption equivalent amount), even if deductions will reduce the net value to below that value. That value in 2026 is \$15 million.⁷⁹

⁷¹ 26 U.S.C. § 2001.

⁷² 26 U.S.C. § 2031-2046.

⁷³ 26 U.S.C. § 2031-2046.

⁷⁴ The marital deduction applies only if the assets are included for determining the value of the decedent's gross estate. 26 U.S.C. § 2056(a).

⁷⁵ The unlimited marital deduction does not apply to spouses who are not citizens of the United States. 26 U.S.C. § 2056(d).

⁷⁶ 26 U.S.C. § 2053-2054.

⁷⁷ 26 U.S.C. § 2032A.

⁷⁸ 26 U.S.C. § 2010-2016.

⁷⁹ 26 U.S.C. § 2505; Instructions for Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return; <https://www.irs.gov/businesses/small-businesses-self-employed/whats-new-estate-and-gift-tax>.

Every citizen and resident of the United States has the credit that pays the tax on the first \$15 million from 2026 forward. This is illustrated as follows:

	Gross estate	\$15,100,000												
	Deductions	\$ 100,000												
	Net taxable estate	\$15,000,000												
	Tax due	\$ 5,945,800												
	Estate tax credit	\$ 5,945,800												
	Out-of-pocket tax due	\$ 0												
*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
	Gross estate	\$16,100,000												
	Deductions	\$ 100,000												
	Net taxable estate	\$16,000,000												
	Tax due	\$ 6,345,800												
	Estate tax credit	\$ 5,945,800												
	Out-of-pocket tax due	\$ 400,000												

Taxable gifts made during a decedent's lifetime will use part of the estate tax credit, and therefore the amount which can pass free from the out-of-pocket tax will decrease.

Estate tax returns are due nine months after the date of death. The IRS automatically grants requests for extensions of the due date for the estate tax return for six months; however, the tax still is due by the initial return date by filing Form 4768 on or before the due date of the estate tax return.⁸⁰

Most married people want to provide, first, for the surviving spouse, with assets benefiting the children after the surviving spouse dies. An adequately prepared estate plan involving assets which exceed the applicable exclusion amount provide for a credit shelter trust and marital deduction trust. Most estate plans do not involve estates which exceed \$15 million.

I still prepare estate plans with creditor shelter trusts and marital deduction trusts, even for estates which do not include that amount of value. First, such estate plans are not difficult to operate and maintain. If the assets comprising the estate are less than the applicable out-of-pocket tax amount, the marital deduction will not be funded. Second, the applicable exclusion

⁸⁰ Instructions for Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return.

amount changes from year to year. While the amount has increased, rather than decreased, during the time I have been involved in estate planning, that amount also could decrease.

There's also portability.

The IRS issued “guidance” allowing certain taxpayers an extended amount of time to five years to make a “portability election” regarding estate and gift taxes.⁸¹

Prior to the portability election, without planning, a married couple could lose the application of the unified credit of the first spouse to die. Example. One spouse had an estate exceeding the application exclusion amount; the other’s estate was less than that amount. If the spouse with the lesser estate died first, the entire unified credit would not be used, and it could not transfer to the surviving spouse with the larger estate.

The estate of a deceased, survived by a spouse, can make a portability election which allows the surviving spouse to apply the deceased’s unused exemption amount to the surviving spouse’s transfers during life and at death. Timely filing of the Deceased Spousal Unused Exemption (DSUE) return allows heirs / beneficiaries to utilize the unused tax credit and therefore decrease or eliminate the amount of tax due.

The specifics of portability are beyond the scope of this paper.

Other types of trusts: charitable remainder trusts, charitable lead trusts, grantor retained annuity trusts, qualified personal residence trusts

⁸¹ Revenue Procedure 2022-32 (2022-30 IRB 101), effective July 8, 2022.