

PRESENTED AT

**20th Annual Changes and Trends Affecting
Special Needs Trusts**

February 15-16, 2024

Austin, TX

A Quick Trust Tax Tutorial

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I. What this paper is, and isn't

Income tax law can be fiendishly complex, and even the portions relevant to trusts are startlingly broad in scope. A law school course in Fiduciary Income Tax is typically two credits, or about 30 hours of instruction from a several-hundred-page coursebook. We're going to cover what we can in 45 minutes and about 11 pages.

So this presentation will not be a treatise on trust income tax, or even really a technical discussion. Instead, it's a boiled-down explanation of the basics for non-tax-oriented special needs trust lawyers. After absorbing this presentation you'll still need to get outside tax advice where appropriate – my goal isn't to make you a tax expert – but you should be better able to spot issues and thoughtfully apply the advice you get.

II. The different types of trusts for income tax purposes

Generally, trusts fall into three categories for income tax purposes:

- *The trust may be ignored, with the grantor treated as the "owner" of its income.* I.R.C. § 671. This is known as a "grantor trust." Distributions from a grantor trust are irrelevant for income tax purposes; the grantor is taxed on the trust income whether it is distributed or not.

A revocable trust is one type of grantor trust. I.R.C. § 676(a).

- *The trust may be ignored, with a beneficiary treated as the "owner" of its income.* I.R.C. § 678(a). This is known by various names, including a "beneficiary-grantor trust." Distributions from a beneficiary-grantor trust are irrelevant for income tax purposes; the beneficiary is taxed on the trust income whether it is distributed or not.

A Crummey trust may be a beneficiary-grantor trust. I.R.C. § 678(a)(2). If you've never heard of a Crummey trust, don't worry, we'll get to it!

- *The trust may be treated as a separate taxpayer of its own.* I.R.C. § 641(a). This is known as a "nongrantor trust." A nongrantor trust generally is taxed on its income. Distributions from a nongrantor trust *sometimes* cause trust income to be "carried out" to a beneficiary for income tax purposes, so that the beneficiary (rather than the

trust) is taxed on the distributed income, but the rules for determining when income is carried out by a distribution are surprisingly complicated.

A testamentary trust is one type of nongrantor trust. Nongrantor trusts may be further subdivided between “simple” and “complex,” but the differences between those subcategories are less important and for ease of discussion will be largely ignored here. *See* I.R.C. § 651-652 (setting forth rules applicable to distributions from simple nongrantor trusts) and § 661-662 (setting forth rules applicable to distributions from complex nongrantor trusts).

To make matters more complicated, a trust may straddle more than one category. For example, it’s possible for a trust to be classified as a grantor trust with respect to some types of income and as a nongrantor trust with respect to other types of income. That’s fairly uncommon, though, and we’ll largely ignore that complication here.

III. How to identify a grantor trust

Sometimes a trust is *obviously* (?) a grantor trust, but it may be more difficult to identify. We’ll start with the more straightforward cases and escalate from there.

A. Power to revoke

If the grantor has the power to revoke the trust, it’s a grantor trust. I.R.C. § 676(a). That’s the easiest case, the classic revocable trust. It doesn’t matter if the grantor is incapacitated. *See* Treas. Reg. § 1.672(f)-3(a)(1) (explaining that the power may be held by the grantor “or, in the event of the grantor’s incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor’s behalf”).

You may also encounter slightly more nuanced variations. The grantor does not necessarily have to have the power to revoke, directly or through a guardian; it is sufficient that a “nonadverse party” have the power to revoke the trust and restore its assets to the grantor. *Id.* Generally, “nonadverse party” means someone who isn’t a beneficiary, though it’s possible for even a beneficiary to be “nonadverse” if the beneficiary’s interest in the trust isn’t substantial or would not be negatively affected by the revocation. I.R.C. § 672(a), (b).

So, for example, if the grantor’s lawyer has the power to revoke the trust (I’m not recommending that, mind you!), it’s a grantor trust, because the lawyer presumably is not a beneficiary. Likewise, if the grantor’s favorite cousin has the power to revoke the trust, and the cousin is only a remote contingent beneficiary (say, only if the grantor’s two siblings and three children all predecease the grantor), it’s likely a grantor trust.

B. Income for benefit of grantor or spouse

If the grantor *could* receive trust income, in the discretion of the grantor or a nonadverse party, it’s a grantor trust. I.R.C. § 677(a)(1), (2). That’s true even if the income isn’t currently distributable, so long as it may be accumulated for the grantor’s future benefit. *Id.* Further, if the

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First appeared as part of the conference materials for the
20th Annual Changes and Trends Affecting Special Needs Trusts session
"A Quick Trust Tax Tutorial"