GRANTOR TRUSTS

LEARNING OBJECTIVES

- Recognize a trust that will be treated as a grantor trust
- Understand the uses of grantor trusts
- Understand the filing options for a grantor trust

A special category of trusts are those described in IRC §§671-679, trusts generally referred to as "grantor" trusts. While originally created as a set of rules to prevent the use of trusts to take advantage of lower income tax brackets by spawning a bunch of trusts over which the taxpayer retained full control, the trusts are now often intentionally formed.

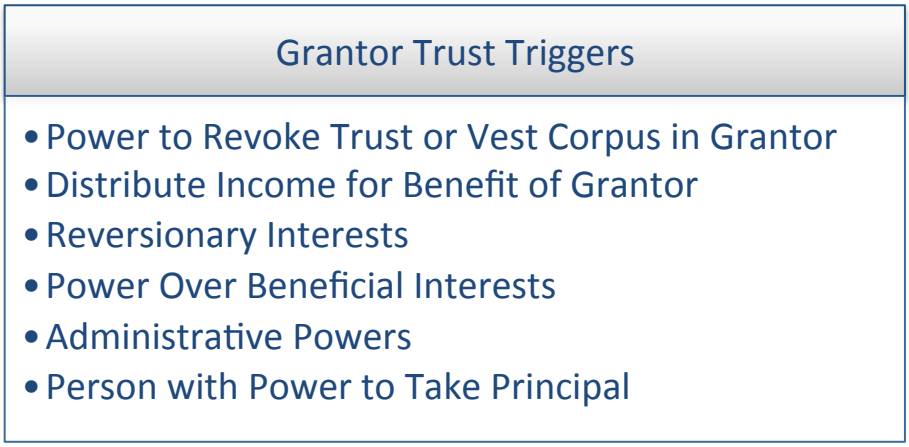
CPAs most often see grantor trusts in one of two contexts. The first major category that many CPAs see are revocable living trusts which are popular in many states as primary estate planning vehicles. Second, CPAs may see intentionally defective grantor trusts (including many irrevocable life insurance trusts) that are designed to be recognized for transfer tax purposes but disregarded for income tax purposes.

In this chapter we'll look at what features will cause a trust to be treated as a grantor trust, the tax implications of grantor trust status and grantor trust filing obligations.

I. GRANTOR TRUST TRIGGERS

Subpart E of Subchapter J governs the treatment of grantor trusts. IRC §671 has the general rule for taxation of grantor trusts, §672 has definitions and rules that apply for grantor trusts, §§672-677 provide for specific situations that will result in a trust being treated as a grantor trust, §678 deals with situations where someone other than the grantor will be treated as a substantial owner and §679 handles foreign trusts.

Below we will consider the various triggers found in Subpart E that cause the trust to subjected to the grantor trust rules. Being aware of these rules is important both to assure that a trust does not accidentally become a grantor trust, but also to recognize the use of such provisions (even if never actually expected to be used) to create grantor trust income taxation (the intentionally defective grantor trust).



When testing a trust for grantor status the CPA must be aware that if the trusts meets *any* of the conditions below for being treated as owned by the grantor, the rules are triggered. So any attempts to design a trust that is meant not to be ensnared by the grantor trust rules must take care when designing provisions to avoid one classification that it does not end up causing problems under a second classification.

A grantor, under Reg §1.671-2(e), is a person who either creates a trust or, directly or indirectly, makes a gratuitous transfer to a trust. A gratuitous transfer is a transfer for other than fair market value. This is true even if the transfer is not treated as a gift for gift tax purposes.

If an intentionally defective grantor trust is desired care must be taken to insure that the power retained is not one that will trigger inclusion in the grantor's estate. That is, while it is possible to grant powers that will trigger the grantor trust rules for income purposes without triggering inclusion in the grantor's estate, not all (or, in fact, even most) of the powers cited below will achieve this effect.

A. Power to Revoke the Trust or Return Corpus to the Grantor [IRC §676]

This variant of the grantor trust is the one that most CPAs are immediately aware of, as revocable living trusts will fall into this category.

Specifically, IRC §676(a) states that "[t]he grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both."

The power in question is simply taking ownership back, but also, per Reg. §1.676(a)-1, "a power to revoke, to terminate, to alter or amend, or to appoint." So a grantor (or nonadverse party) who has the right to appoint beneficiaries is holding a proscribed power that will trigger treatment of the trust as a grantor trust.

Normal managerial powers granted to the trustee will not be deemed to trigger this rule. [*Lowenstein v. Commissioner*, 3 TC 1133, *acq*.] In the *Lowenstein* case the grantor served as trustee and had the right to invest trust property, determine distributions, etc. Since his ability to do so was given to him as trustee and had to be exercised in favor of the beneficiaries under state law, the fact that he was given broad discretion did not amount to an indirect power to reinvest principal in himself.

In the *Estate of Preston*, (1950) 14 TC 1931, *affd*, (1951, CA2), 40 AFTR 304, that was true even where the trustee had power to lend money to the grantor, since the trustee had to only exercise that power in favor of the beneficiaries under state law. However, a power of grantor, not acting as trustee, to borrow without security or to require the trust to purchase assets was deemed to be, effectively, a power to withdraw. [*Mather v. Commissioner*, 5 TC 1001]

IRC §672(b) defines any party is not an *adverse* party as a nonadverse party. While that definition may seem a bit circular, the point is that any party who has any of restricted powers must be shown to possess an adverse interest. The fact that an individual has a fiduciary responsibility to other beneficiaries (due to being a trustee or co-trustee) will not generally be found sufficient to show an adverse interest to the termination of the trust. [See *Witherbee, Mary v. Com*., (1934, CA2) 13 AFTR 1065, 70 F2d 696, 4 USTC ¶1279, *affg Stewart, William*, (1933) 28 BTA 256, *cert den* (1934, S Ct) 293 US 582]

Other factors found not to lead to a finding of an adverse interest include:

- Moral obligation or duty [*Flood v. United States*, (1943, CA1), 24 AFTR 188]

- Interest to continue earning commissions [*Reinecke v. Smith*, (1933, S Ct) 12 AFTR 47]

- Interest as a contingent remainderman [*Savage v. Commissioner*, (1944) 4 TC 286]

Generally there must be a material interest that is adversely affected by the exercise of the power to place the corpus back in the grantor's hands in order for the existence of that power not to trigger the grantor trust rules. As the above summary suggests, showing that adverse interest is not a simple task, so any trust which allows property to be transferred back to the trustor is greatly at risk to be treated as a grantor trust.

Similarly, a grantor who had the power to appoint an individual under who could terminate the trust and receive the corpus was found to have a power to invest corpus in himself. In the case of *Pulitzer v. Commissioner*, 36 BTA 964, the Court noted that the taxpayer could enter into a contractual arrangement with that person as a condition of appointment that would require the person to turn the assets over to the grantor. Thus, the grantor retained a vehicle via which he could, at any time, get the corpus back by simply appointing a willing person to step into the role of terminating the trust.

A grantor is treated as holding any power held by his/her spouse. That includes the person who was the spouse at the time of the creation of power or interest or who later becomes a spouse of the grantor after creation of the power (for periods after that person becomes the spouse). [IRC §672(e)(1)]

As should be clear, any trust that is structured in a manner in which the grantor has direct or indirect access to the trust corpus is going to run afoul of this provision.

B. Power to Distribute Income to or for the Benefit of the Grantor [IRC §677]

IRC §677(a) provides that a trust shall be treated as owned by the grantor if the income of the trust, without the approval or consent of an adverse party, or in the discretion of the grantor or a nonadverse party may be:

- Distributed to the grantor or the grantor's spouse;

- Accumulated for future distribution to the grantor or the grantor's spouse or

- Applied to payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

Such a distribution need not be directly to the grantor or the grantor's spouse—if the grantor may direct payment be made to another party such the constructive receipt is treated as enough to trigger this rule. [Reg. §1.677(a)-1(c)]

There is somewhat conflicting guidance with regard to conditional distributions. In the case of the *Estate of Wadewitz*, (1959) 32 TC 538, the fact that the income would be distributed to the grantor only if she survived to a date in future was a proscribed accumulation. However, the Eighth Circuit reversed the Tax Court in the later case of *Johnson v. Commissioner*, (1999, CA8), 84 AFTR 2d 99-5306 where the earnings of funds held in trust would either be used to pay a liability of the grantor or, if not used for that, then not returned to the grantors. The Eighth Circuit found that the grantor never had and would never receive this income. The opinion did not comment on the fact that a payment of income that may be directed to discharge the grantor's debt is considered a triggering right for use of income under Reg. §1.677(a)-1(d).

However, the possibility that a grantor might receive an interest back by inheritance or as a surviving spouse under a statutory right of election is not considered a prohibited interest for these purposes. [Reg. §1.677(a)-1(c)]

The insurance provision deserves special attention. If the grantor creates a funded insurance trust, then the income benefit provision is triggered. The only facts that are relevant is the trust is authorized to use income of the trust is used to pay for a policy on the life of the grantor or spouse. The Code does not mention any other factor—so the fact that the trust may be irrevocable, the trustee isn't required to make the payments out of income or that the grantor has not retained any rights to name a beneficiary.

However, the income so taxed is limited to the amount that could have been used to pay current year premiums on policies actually in force—not on policies that "could" have been acquired by the trust. [*Iversen v. Commissioner,* 3 TC 756] So the mere fact that a trustee has the right to acquire insurance policies or accept them as additions to trust corpus and could use income to pay such premiums does not make the income taxable to the grantor.

C. Grantor Retains a More Than 5% Reversionary Interest in Trust Property or Income [IRC §673]

A grantor that retains an "excess" reversionary interest is treated as the owner of the trust under the first of two reversionary trust rules and the one applicable to trusts currently being established.

Under this rule, any portion of a trust is treated as owned by the grantor if the grantor has a reversionary interest in either the principal or income of the that portion of the trust if, as of the inception of that portion of the trust, the value of the interest exceed 5% of the value of the portion in question. [IRC §673(a)] In computing that value, it will be assumed that any exercise of discretion available will be used in a fashion to maximize the amount of that interest by being exercised in favor of the grantor. [IRC §673(c)]

An exception to this rule exists for reversionary interests that take effect upon the death of a minor lineal descendant of the grantor. If a lineal descendant is a beneficiary of the trust who holds all present interests in any portion of the trust, the grantor will not be treated as the owner of such an excess reversionary interest to the extent of a reversionary interest in such portion that takes effect upon the death of the beneficiary before that beneficiary attains age 21. [IRC §673(b)]

The Senate Committee Reports also noted that grantor should not be treated as an improper reversionary interest merely due to the possibility an interest could revert to either the grantor or the spouse due to intestacy. [Senate Report No. 99-313 (PL 99-514), p. 871]

If the grantor postpones the date provided for reacquisition of possession or enjoyment of the property the tests for a 5% interest should be undertaken as if this were a new transfer to the trust. However, income will not be taken into account by the grantor if the income would not have been includable to the grantor had there been no postponement. [IRC §673(d)] The House Committee Report note that this was added to deal with the case where the date of the reversionary interest is after the life of an individual and that date is later postponed. [House Report No. 100-795 (PL 100-647) p. 342]

Note that a similar 5% rule is found in the estate tax provisions at IRC §2037(a)(2) for inclusion of transferred property where an "excess" reversionary interest is retained by the donor. It seems prudent to assume the same valuation methods the IRS uses for these purposes (the IRS valuation tables found in the estate and gift tax regulations) will be used to value a reversionary interest under the grantor trust provisions.

D. Reversionary Interest of 10 Years or Less Retained by Grantor (pre-March 2, 1986 Trusts) [IRC §673]

A different reversionary interest applied to trusts established prior to March 2, 1986. While the number of such trusts is obviously on the decline, advisers may still run into one of these and the adviser needs to recognize such trust.

Under the old "short term reversionary trust" rules, a grantor was treated as the owner of a trust if:

- The grantor retained a reversionary interest in either corpus or income *and*

- As of the inception of the trust, the reversionary interest either did, or was reasonably expected to, take effect within 10 years from the transfer to the trust [IRC §673(a) prior to 1986 amendments]

The 5% rule replaced this rule and any additions to the trust made after March 1, 1986 are tested under the 5% rule—so the fact a trust was established before 1986 does not grandfather it into the short term reversionary interest rule for post 1986 transfers.

Such trusts were used prior to 1986 to shift income to, most often, children who were in lower tax brackets. Obviously, the usefulness of such techniques were dealt a serious blow by the enactment of the "kiddie tax" rules that have income taxed at the parent's marginal tax rates.

E. Power Over Beneficial Interests in the Trust [IRC §674]

IRC §674(a) provides that "[t]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party."

The powers to be exercised include powers of appointment. The fact that a power is subject to a fiduciary duty and can only be exercised in the interests of the beneficiaries also does not keep the power from causing the trust to be treated as owned by the grantor under these rules. [Reg. §1.674(a)-1]

In the case of *Gurich v. Commissioner*, (1961, CA1), 8 AFTR 2d 5663 the Appeals court found that the grantor's right to amend the trust gave him the right to vary income interests and thus run afoul of this provision.

However, the existence of *de facto* control of the trust does not expose the grantor to this rule, as the issue is the rights of the grantor under the trust. In the case of *Estate of Goodwyn v. Commissioner*, TC Memo 1976-238 the fact that the grantor effectively ran the trust with the trustees "rubber stamping" his decisions with minimal oversight did not cause the trust to be treated as a grantor trust. The court found that despite their actions (or lack thereof), the trustees were still legally responsible for the actions of the grantor and the grantor himself did not possess the required rights.

F. Administrative Powers Under Which Grantor Can or Does Benefit [IRC §675]

Under IRC §675 a grantor is treated as the owner of the trust if the grantor has any of the following powers:

- Power to deal with the trust for less than full and adequate consideration – this includes the power to deal with any person, not just the grantor, in this fashion. The power does not trigger grantor status only if the power can only be exercised with the approval and consent of an adverse party. [IRC §675(1)]

- Power to borrow without adequate interest or security – this power will not count if a trustee other than the grantor is authorized under a general lending power to make loans to any person without regard to interest or security. [IRC §675(2)]

- Borrowing of trust funds – if the grantor borrows funds from the trust and does not completely repay the loan before the beginning of the taxable year the trust is treated as owned by the grantor. This power does not trigger inclusion if the loan has adequate interest and adequate security and is made by a trustee other than the grantor and who is not related to the grantor or a subservient trustee of the grantor. For purposes of this rule all references to the grantor include the grantor's spouse. [IRC §675(3)]

- Possession of a specified "general power of administration" exercisable by any person without the approval or consent of any person in fiduciary capacity. The powers covered by this rule include:

    - Power to vote the stock or other securities of a corporation in which the holdings of the grantor are significant from the viewpoint of voting control;

    - Power to control the investment of trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or

    - Power to reacquire the trust corpus by substituting other property of an equivalent value. [IRC §675(4)]

The power to reacquire assets of the trust by substituting property of an equivalent value under IRC §675(4) is one of the most often used powers to create an intentionally defective grantor trust, as including this power, if properly drafted, will not trigger inclusion in the grantor's estate.

Loaning to related entities may not work quite as many CPAs might expect. In the case of *Buehner v. Commissioner,* (1976) 65 TC 723 the Tax Court found that a loan to a corporation 100% owned by the grantor did not trigger this provision. The corporation was found to have existed for many years, the loan was reflected on the corporate books and there was no indication the funds were diverted for the grantor's benefit.

However, in the case of *Bennett v. Commissioner*, (1982) 79 TC 470, the Tax Court found that a loan to a partnership did count as indirect loan to the partners, triggering this provision, although loans to a successor corporation were, like the loans in *Buehner*, not treated as being an indirect loan to the grantor.

G. Trustee, Beneficiary or Other Person Has the Power to Take Principal or Income for Himself [IRC §678]

If a trust is not otherwise treated as grantor trust to the original grantor under the rules noted above, any person who has power to take principal or income for him/herself may be treated as the owner of the trust pursuant to the grantor trust rules unless the person renounces or gives up the tainted power—and, as well, does not retain any of the powers described above that would normally trigger grantor trust treatment.

This provision, found at IRC §678(a), provides that a person will treated as the owner of any portion of a trust if either:

- The person has a power exercisable solely by himself to take principal or income from the trust *or*

- The person has previously partially released or modified the power to take from the trust and retains control which would, under the standard grantor trust rules of IRC §§671-677 discussed above, cause a person to be treated as owner of such a portion of the trust if that person had been the grantor.

IRC §678(b) contains the provision that if another party is treated as the owner of the trust under the other grantor trust rules, then this rule will not apply to this person who has a power over income. In, to phrase it different, a tie goes to the grantor, since only party will actually be subject to tax on the income of the trust.

However the IRS has privately ruled (see PLR 200603040) that a similar result applies in the case of a Crummey trust for the grantor's wife, where the wife had, under the Crummey power, the right to withdraw both principal and income of the trust immediately following the grantor's contribution. The IRS found that because the trust is a grantor trust under IRC §677 (since all income and corpus were payable to the grantor's spouse for life) all income was taxable to the grantor and not to his spouse. The IRS came to a similar conclusion for a non-spouse beneficiary of a similar trust in PLR 200730011.

A person other than the grantor who has a proscribed power can avoid the provisions of this rule if the person renounces or disclaims the power within a reasonable time after the person becomes aware of the power. [IRC §678(d)]

Another special provision applies so that an unintended consequence doesn't occur when establishing trusts for grandchildren. In such cases the grantor may name his/her child (the grandchild's parent) as trustee for the trust whose beneficiary is that person's child. In such a case the trustee will generally have a legal obligation to support the beneficiary and, since the trust will most likely allow distributions from the trust for the benefit of the beneficiary this creates a situation where the trustee now has a power to take income from the trust that would effectively reduce the amount the trustee would need to pay to support his/her child.

Since, under these rules, the existence of the power and not the use of it is the key, the trustee under the general rule would be treated as the owner of the entire trust and subject to tax as if the person were the owner. This would be true even if the trustee never actually used any of the trust's income to offset his/her legal obligation to support the grandchild.

Section 678(c) provides that in such a case where a trustee has the power to apply the income from the trust to the support or maintenance of an individual the trustee is under a personal obligation to support the rule will not be applied except to the extent that income of the trust is used to provide such support.

The second prong of the tests (release of power with retained interests that would be a grantor trust interest) creates issues for "five or five" power holders. Under a "five or five" power a holder is allowed to withdraw the greater of 5% of the value of the trust corpus or $5,000 each year, with the power lapsing if not used in a particular year. If the power is allowed to lapse, an increasing portion of the trust can be treated as owned by the beneficiary per Revenue Ruling 67-241.

PLR 200022035 gives an example of the application of this rule to such a trust. This case involves a decedent's trust with a spouse beneficiary. The spouse had a "five and five" withdraw right available each year as well as lifetime power to appoint all or any part of trust income. The right was noncumulative, so if not exercised the power would lapse.

The ruling notes that during the time that an annual 5 and 5 power is outstanding, the beneficiary has the right to take trust principal and income for herself. As such, the beneficiary is taxable on the income of that portion of the trust during the period that option is open.

When the power lapses, the spouse's right to appoint trust income became a problem. While she no longer had the right to take the principal, she could distribute income to herself, a power that if retained by a grantor would create a grantor trust under the provisions of IRC §677. Thus, each year the spouse becomes the owner of increasing amount of the trust, equal to the amount she failed to take.

The ruling also held that if she takes a distribution under the 5 and 5 power in a later year, it will be deemed to come from her prorata share of each asset of the trust's corpus she is treated as owning.

The effect of this is that she picks up her proportionate share of all trust income and deductions each year based on her share of trust corpus computing under these rules. Such items will include her proportionate share of capital gains.

IRC §2514(e) provides an exclusion from the gift tax treatment of release of a power of appointment being treated as a taxable gift for lapses of "five or five" powers (with IRC §2041(b)(2) providing a similar estate tax result), thus such options are seen quite often in estate planning trusts. CPAs must remember that although the estate and gift problems are "taken care of" with such a power, they do some with income tax complexity.

In private rulings (see, for example, PLR 9523029) the IRS has attempted to apply similar rules to beneficiaries with Crummey powers. Since often the holder of the Crummey power will be named as a party to which income in the future may be distributed or which the income will be accumulated, the IRS argues that the beneficiary is subject to the grantor trust rules on these amounts.

There is an argument that the IRS is overreaching on the treatment in these cases following the lapse of the power. IRC §678(a) refers to a partial release or modification of a power, but does not refer to a lapse. That is, the law suggests that an action is needed on the part of the person rather than simple inaction.

II. INCOME TAX TREATMENT OF GRANTOR TRUSTS

In some ways grantor trusts were the first "disregarded entity," recognized years before that concept reappeared in the check the box regulations applicable to single member LLCs.

A. Income Treated as That of Grantor

Since the grantor is treated as the owner of that portion of the trust for purposes of income tax (though not necessarily for transfer tax purposes), the grantor ends up reporting his/her share of all income, deductions, credits, etc. that the trust incurs during the grantor's tax year.

Similarly, since the grantor is treated as the owner of the trust assets, no gain or loss is recognized on a sale of assets between the grantor and the trust, nor would income be recognized for payments made to the trust (say for rent of property held by the trust).

If the trust is only partially a grantor trust (that is, the person is treated as the owner of only a portion of the trust), then only that proportion is reported by the grantor and the remainder is reported using standard trust income tax reporting provisions.

If, as is often the case, the trust is treated as a 100% grantor trust (that is, the grantor is treated as owning 100% of trust corpus) the trust itself has no income tax liability.

Note that it is very possible to end up with grantor trust treatment on a trust where the person treated as the owner has no right to withdraw assets from the trust, either currently or in the future—and, in the case of an intentionally defective grantor trust (IDGT), this is often by design. The fact that the person does not have access to funds from which to pay the tax does not prevent the imposition of the tax.

The danger arises if this situation is not one that arose by design in forming an IDGT or similar vehicle, but rather one into which the taxpayer and his/her advisers accidentally run afoul of.

B. Grantor Trust and the Exclusion of Gain on the Sale of a Residence

If a taxpayer is treated as the owner of a trust under the grantor trust rules described above and the trust owns a residence, the taxpayer will be treated as the owner of the residence during the period he/she is treated as owner of the trust holding the residence. [Reg. §1.121-1(c)(3)(i)]

The period will therefore counts as time the residence was owned by the grantor for purposes of qualifying for the gain exclusion under IRC §121 for sale of a principal residence.

Note that any portion of the gain that is not treated as allocable to the beneficiary under the grantor trust rules will not be eligible for any exclusion of gain under §121, since a trust does not have a principal residence and, as well, doesn't "use" the property. IRC Section 121 creates issues whenever ownership is held by one party or entity, but the use as the residence involves a separate party. The grantor trust rules provide an exception to these rules due to looking through the trust and treating the party as the owner of the trust corpus.

C. Tax Planning Logic Behind IDGTs

Intentionally defective grantor trusts are an estate planning tool that CPAs will encounter from time to time. These trusts take advantage of the fact that the transfer tax rules do not perfect dovetail with the grantor trust rules for income tax purposes.

A transfer to a trust may be a completed gift and the asset removed from the trustor's estate even though the grantor trust rules treat the asset as continuing to be owned by the grantor. So even though the asset are long gone from the trustor's estate (and direct control), the trustor will be pay tax on all income generated by those asset and, as well, recognize any gain or loss on sale.

Initially CPAs wonder what insanity would move someone to intentionally volunteer to pay taxes on assets that are outside the individual's reach. But there is a method to this "madness" due to the position the IRS has taken to date on such arrangements.

An IDGT effectively has trust corpus that is allowed to grow without having to either use trust corpus to pay taxes or to require beneficiaries of the trust to use their own assets to pay the tax burden if the items giving rise to trust income flow onto the beneficiary's K-1s. Rather, the grantor effectively "subsidizes" the payment of taxes, resulting in an indirect transfer from the trustor to the trust's beneficiaries.

While there is argument that this represents an indirect gift to the beneficiaries, the IRS has not required recognizing this as a gift for transfer tax purposes.

III. INCOME TAX FILING REQUIREMENTS

Regulation 1.671-4 provides the rules that must be followed by grantor trusts for tax reporting purposes. The regulation provides a "standard" reporting method (which in practice is rarely used for trusts treated as 100% owned by the grantor or another person) as well as two optional methods.

A. Standard Method

Reg. §1.671-4(a) provides the default method for grantor trust reporting. This method is used unless the trustee elects (as they most often do) to use one of the alternative methods.

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts 2013 OMB No. 1545-0092
► Information about Form 1041 and its separate instructions is at *www.irs.gov/form1041.*

A Check all that apply:	For calendar year 2013 or fiscal year beginning , 2013, and ending , 20	
☐ Decedent's estate ☐ Simple trust ☐ Complex trust ☐ Qualified disability trust ☐ ESBT (S portion only) ☐ Grantor type trust ☐ Bankruptcy estate-Ch. 7 ☐ Bankruptcy estate-Ch. 11 ☐ Pooled income fund	Name of estate or trust (If a grantor type trust, see the instructions.)	**C** Employer identification number
	Name and title of fiduciary	**D** Date entity created
	Number, street, and room or suite no. (If a P.O. box, see the instructions.)	**E** Nonexempt charitable and split-interest trusts, check applicable box(es), see instructions. ☐ Described in sec. 4947(a)(1). Check here if not a private foundation . . . ► ☐ ☐ Described in sec. 4947(a)(2)
	City or town, state or province, country, and ZIP or foreign postal code	
B Number of Schedules K-1 attached (see instructions) ►	**F** Check applicable boxes: ☐ Initial return ☐ Final return ☐ Amended return ☐ Change in trust's name ☐ Change in fiduciary ☐ Change in fiduciary's name	☐ Net operating loss carryback ☐ Change in fiduciary's address
G Check here if the estate or filing trust made a section 645 election . . . . . ► ☐ Trust EIN ►		

If any of the trust is taxed under the grantor trust rules, the box for "grantor trust" on page 1 of Form 1041. If a portion of the trust is not treated as a grantor trust, then the classification for the "nongrantor" portion of the trust (such as simple, complex, etc.) must also be indicated on page 1—otherwise only the grantor trust box should be checked. [2013 Instructions Form 1041, p. 12]

The portion taxed under the grantor trust rules is not reported on the detailed line forms of Form 1041 or on Schedule K-1. If the trust is treated as entirely owned by a single individual, only the entity information on the front of Form 1041 is filled in. All other IRS form lines are left blank.

If only a portion of the trust is treated as owned by another person under the grantor trust rules (such as a trust with a lapsed 5 and 5 power that runs into the provisions discussed above), the income, deductions, etc. related to the portion of the trust treated as owned by that other person is not reported on the IRS forms, but the income, deductions, etc. related to the portion of the trust not treated as owned by the other person will be reported on the standard trust lines of the IRS forms. [2013 Instructions Form 1041, p. 12]

In either case the trust must attach a separate statement (not on Form 1041 or Schedule K-1) attached to the return the information on income and deductions that will be reported by the grantor. [Reg. §1.671-4(a)] Per the IRS instructions that attachment must show:

- Name, identifying number (normally social security number) and address of the person to be taxed on the income
- Income that is taxable to the person under the grantor trust rules of IRC §671-678 discussed earlier, in the same detail as it would have been reported on that person's return if directly received by that person; and
- Deductions or credits that apply to the income, again in the same detail as would be reported on the return of that person if they had directly paid such expenses or qualified for such credits

Such a statement would look something like this:

John Doe Revocable Trust
99-999999

Grantor: John Doe
999-99-9999
3330 E Indian School Road
Phoenix, Arizona 85018

Income:	
Interest income – Bank of Ajo	$ 34,209
Qualified Dividends – XYZ Corp	22,800
Deductions:	
Investment advisory fees	12,817
Real estate taxes	6,238

This report must be provided to the grantor by the standard due date for a trust tax return (normally April 15). The trustee must maintain a copy of the statement furnished to the grantor or other person for a period of three years from due date for furnishing the statement to that person. [Reg. §1.671-4(d)]

If the trustee fails to provide the requirement statements, the trust is subject to the standard penalties on failure to file information returns (1099s for instance) under IRC §6721 and failure to furnish payee statements under IRC §6722. [Reg. §1.671-4(f)]

Given the potential for mismatching of information by the IRS in these circumstances, many practitioners believe that when filing a return under these procedures additional statements should be included with the return. For instance, *PPC's 1041 Deskbook* suggests a statement that "Pursuant to Reg. §1.671-4(a), all items of income, deduction, and credit attributed to the grantor under IRC Secs. 671-678 are reported on the attached separate schedule" should be placed on page 1 of the Form 1041. [*1041 Deskbook (PPC),* Key Issue 26K]

Most often CPAs will see this form of reporting for trust treated as 100% owned by the grantor when assets are being held by a corporate trust department (such as at a bank or trust company). In this case the trustee's report may simplify issues for the taxpayer, as the information is gathered by the trust department and summarized in a relatively straight-forward report that is based on the accounting the trust company is doing already.

For trusts where the assets are not being held by a trust company but rather being directly managed by the grantor (such as most revocable living trusts), the first alternative method is much simpler to handle.

B. Trusts Treated as Wholly Owned by One Person

Reg. §1.671-4(b) provides two optional alternative reporting methods for trusts that are treated as wholly owned by one person. [Reg. §1.671-4(b)(1)]

The law allows two optional reporting methods for such a trust. Both are discussed below.

1. Grantor's TIN Option

The first optional method allows the trustee to provide the grantor (or other owner's) TIN to reporting entities rather than the trust's. In such a case the grantor will receive the Form 1099 and report the resultant income on his/her own income tax return.

The grantor is required to provide to the trustee a completed Form W-9. If the grantor fails to provide this form, this method of reporting may not be used for the trust. [Reg. §1.671-4(b)(1)]

Note that if the trustee is not the grantor, the address provided to the payor for each account would generally be that of the trustee. In such a case the trustee must forward the Forms 1099 to the grantor when they are received and provide relevant information on all income. [Reg. §1.671-4(b)(2)(i)(A)]

No forms are filed with the IRS by the trustee if this reporting method is chosen. [Reg. §1.671-4(b)(2)(ii)(B)]

This method is the one most often used when the grantor is trustee, such as the case normally for a revocable living trust.

2. Trust TIN With Issuance of Forms 1099 to Grantor

A second alternative reporting method for a trust 100% owned by a single grantor is to have the trustee provide the trust's TIN (just as the trustee would under the standard method), but then issue Forms 1099 to the IRS reporting the income for the grantor. [Reg. §1.671-1(b)(2)(iii)]

In this case the trustee has the same obligations to file (and is subject to the same penalties) as if the trustee were the original payor of the income in question.

The trustee does not actually technically issue the grantor a Form 1099, but rather must provide an information statement. That statement must contain the following information:

- Shows all items of income, deduction, and credit of the trust for the taxable year;
- Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and
- Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

The trustee does not included any information on a Form 1099 other than information reported to the trustee on a Form 1099. Thus, if the trust owns an interest in a partnership and receives a K-1, the trustee does not include any items on the K-1 on a Form W-2 (including such items as interest income flowing from the partnership that it might seem should be placed on a Form 1099-INT) but rather includes information about the K-1 in the statements given to the deemed owners.

C. Trusts With More Than One Grantor or Other Person

If there is more than one person treated as the owner of the trust, the trustee is not allowed to use the method of providing the grantor's TINs to the payors. However, a modification of the second version, issuing 1099s, may be used in lieu of filing a Form 1041. [Reg. §1.671-4(b)(3)] Again, the trustee provides a statement to each of the deemed owners disclosing the information noted above and then files Forms 1099 with the IRS.

D. Changing Reporting Methods

The trust is allowed to change its methods of reporting. [Reg. §1.671-4(g)]

If the trust had been filing Forms 1041 under the "standard" reporting method, in the year prior to the year in which the trust will start reporting using an optional method the trust must file a Form 1041 marked final. That return must state, on the front of the return, that "Pursuant to §1.671-4(g), this is the final Form 1041 for this grantor trust." [Reg. §1.671-4(g)(1)]

If the trust changes from one of the alternative methods to the standard method (that is, it will start filing Forms 1041) it does so by a) insuring that the trust TIN is provided to all payors and b) if the trustee was filing 1099s as its alternative method, it indicates on Form 1096 for the prior year that this is the final year for the trust to file the Form 1096. [Reg. §1.671-4(g)(2)]

If the trust changes from one alternative method to the other it also generally "just does it" though if changing from filing Forms 1099 the trustee must, as noted for changing to filing a Form 1041, indicate that the Form 1096 for the prior year is the final one. [Reg. §1.671-4(g)(3)]

E. Trusts that May Not Use the Alternative Methods

Certain grantor trusts are prohibited from using the alternative reporting methods. These trusts include:

- A common trust fund
- A foreign trust
- A qualified subchapter S trust (QSST)
- A trust with a single grantor that has a fiscal year end (although the Form 1099 method can be used if there are multiple grantors)
- A trust with a non-U.S. person grantor
- A trust with a single grantor who is an exempt recipient for Form 1099 purposes. As with the fiscal year rule, though, the 1099 alternative method may be used if there are multiple grantors even if one is exempt from information reporting. [Reg.§1.671-4(b)(6) and (7)]

Thus, these trust will need to file a Form 1041 using the "standard" reporting system.