

# Practical Tax Strategies



## Trusts and Trust Taxation

Estate Tax: Section 6166

## Editorial Board

**Carl W. Duyck, CPA**  
PricewaterhouseCoopers LLP  
Jersey City, N.J.

**Howard M. Esterces, Esq.**  
Meltzer, Lippe, Goldstein  
& Breitstone, LLP  
Mineola, N.Y.

**Carina C. Federico**  
Steptoe & Johnson LLP  
Washington, D.C.

**Ira S. Feldman, CPA**  
Phoenix Tax Workshop  
Phoenix, Arizona

**James R. Hamill, CPA, Ph.D.**  
Reynolds Hix & Co., P.A.  
Albuquerque, NM

**Yair Holtzman, CPA, MBA, MS,  
CGMA**  
Anchin Block & Anchin LLP  
New York, NY

**Louise Jackson, CPA**  
The Jackson Group, P.C., CPAs  
Atlanta, Georgia

**Gary Johnson, CPA**  
Ronald S. Litvak & Co.  
Los Angeles, California

**Sidney Kess, JD, LLM, CPA**  
Of Counsel to Kostelanetz & Fink  
Senior Consultant, Citrin Cooperman  
New York, N.Y.

**Richard M. Lipton, Esq.**  
Baker & McKenzie  
Chicago, Illinois

**Michael S. Melbinger, Esq.**  
Winston & Strawn  
Chicago, Illinois

**Ken Milani, MBA, Ph.D.**  
Mendoza College of Business  
University of Notre Dame  
Notre Dame, Indiana

**Robert F. Reilly**  
Willamette Management Associates  
Chicago, Illinois

**Jeff Schragg, Esq., CPA**  
Newton Grange Consulting  
McLean, Virginia

**William R. Swindle, Esq.**  
Shumaker, Loop & Kendrick LLP  
Tampa, Florida

**D. John Thornton**  
Thornton Byron LLP  
Boise, Idaho

**Stefan F. Tucker, Esq.**  
Venable  
Washington, D.C.

## Editorial Staff

**Managing Editor**  
Daniel J. Reilly, III  
Washington, D.C.

**Executive Editor**  
Vance J. Jandacek

**VP, Editorial**  
Kathleen S. Schmitt  
Washington, D.C.

**Advertising Representative**  
Kathy K. Grier  
Phone: (714) 344-1724  
E-Mail: kathy.grier@thomson.com

**Marketing Manager**  
Michelle B. Gendron

**Subscription**  
(800) 431-9025

**Practical Tax Strategies Website**  
http://www.thomson.com/practicaltax

PRACTICAL TAX STRATEGIES (ISSN 1523-6250) is published monthly by Thomson Reuters/Tax & Accounting, Subscriptions: \$455 per year. Call: (800) 431-9025. Also available on the Internet on Thomson Reuters Checkpoint®; one-license user fee for one year renewal: \$455.

© 2021 Thomson Reuters/Tax & Accounting. Thomson Reuters, Checkpoint, and the Kinesis logo are trademarks of Thomson Reuters and its affiliated companies. All Rights Reserved. No part of this Journal may be reproduced in any form—by microfilm, xerography, or otherwise—or incorporated into any information retrieval system without the written permission of the copyright owner. Requests to reproduce material contained in this publication should be addressed to Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, FAX: (978) 646-8600. Requests to publish material or to incorporate material into computerized databases or any other electronic form, or for other than individual or internal distribution, should be addressed to Thomson Reuters Tax & Accounting P.O. Box 115008 Carrollton, TX 75011-5008.

POSTMASTER: Send address changes to PRACTICAL TAX STRATEGIES, P.O. Box 115008 Carrollton, TX 75011-5008. Periodicals postage paid at Hoboken, NJ and at additional mailing offices. This publication is designed to provide accurate and authoritative information on the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If expert assistance is required, the services of a competent professional person should be sought. The views expressed in our columns may not be concurred in by editors or members of our editorial board.

Send correspondence relating to subscriptions and all other business matters to Thomson Reuters Tax & Accounting P.O. Box 115008 Carrollton, TX 75011-5008.



THOMSON REUTERS®

# A PRIMER ON ESTABLISHING A TRUST AND ITS TAXATION

SIDNEY KESS AND EDWARD MENDLOWITZ

**Trusts are not necessary in most estate plans, but when they are used properly, they provide significant benefits. This article is an overview of trusts and their taxation.**

Trusts are an effective mechanism to provide for transfers of assets, protect assets from eventual or potential creditors, enable assets to be used in situations where the person establishing the trust is not able to act for themselves, provide for distributions of income and assets to different groups of people including charities, allow assets to remain in a family's bloodline for generations, avoid probate, and save gift and/or estate taxes.

Establishing and using trusts needs to follow very technical rules and should never be established without a plan and understanding the reasons and purposes for doing so and the advice of a knowledgeable and experienced attorney. When saving gift or estate taxes is the reason, knowledgeable financial and tax advisers and possibly valuation specialists and insurance agents should also be part of the team.

This article provides the general rules that are applicable for many and sometimes almost every situation, but with taxes and legal issues

there are very few absolutes and almost everything has exceptions. That is why competent and experience advisors must be used in every situation.

## Trust basics

Trusts are not necessary in most estate plans, but when they are used properly, they provide significant benefits.

Many trusts provide a means of distributing income and principal in an orderly and managed way. Some trusts provide a degree of asset protection, designate groups or classes of beneficiaries, and force the use of professional financial advisors, managers, and trustees. Some trusts are set up to outlive the presently living beneficiaries and need to have appropriate protections and guarantees. Also, some trusts are set up to avoid or circumvent the probate process.

There is a difference between estate planning and estate tax planning. An example of where a trust would be used when estate taxes are not an issue is when a trust would be established to own the parent's assets for a couple with minor children and in the terrible event of both parents getting killed, the trust would provide for a regular periodic "allowance" for the guardians and the remaining principal to

*SIDNEY KESS, CPA, JD, LL.M. is of counsel to Kostelanetz & Fink and a senior consultant to Citrin Cooperman & Co., LLP. He is a member of the NYSSCPA Hall of Fame and was awarded the Society's Outstanding CPA in Education Award. He is also a member of the Practical Tax Strategies Editorial Board.*

*EDWARD MENDLOWITZ, CPA/PFS, ABV is emeritus partner at WithumSmith+Brown, PC, the author of 29 books, and is an Adjunct MBA Professor at Fairleigh Dickinson University. He is also the author of a twice-weekly blog posted at [www.withum.com/partners-network-blog](http://www.withum.com/partners-network-blog).*

be distributed to the children at various stages when they reach majority. Some of these trusts go further to also buy life insurance to increase the amount available and to also provide for greater liquidity.

## Trust document

The trust document contains all of the information and rules governing the activities and purposes of the trust. The trust document is a fully executed, i.e. properly signed and witnessed, agreement establishing the trust. In some instances, the trust does not exist as a separate document but is part of another document such as a decedent's will. Trusts are self-contained units where everything about it is included in the agreement, and any guidance about what to do must be located in the agreement and followed.

## Definition of a trust

A trust is an entity established by a person, called a **grantor**, for the benefit of others, called **beneficiaries**, that is controlled or operated by a third person or entity called a **trustee**.

The beneficiaries can consist of one group that receives the current income, fixed dollar amount, or percentage of assets and another group that will receive the trust principal or corpus at a later time. The principal beneficiaries can also be the same people as the income beneficiaries. The beneficiaries can also be people not living yet, such as children born after the trust is established. Beneficiaries can also be organizations such as a charity.

There is wide flexibility and great leeway in establishing who the beneficiaries are and the distribution terms, but once established, they cannot easily be changed, if at all.

## Trustees and their powers

Trustees can be individuals, or entities such as a bank or trust company. There can be a single trustee or multiple trustees.

Trustees have very broad powers to not only control the distributions in amount and timing and sometimes to whom, but also how to invest the principal. Trustees can also have broad **powers to invade principal** or to make a **distribution to a particular beneficiary** to the exclusion of other beneficiaries, or to refrain from making a distribution. All powers given to trustees are explained and detailed in the

**trust document**. Any power not given in the trust agreement cannot be done, with certain narrow exceptions.

Be aware that some trust documents provide for mandatory distributions at set intervals and at specific periods or dates or when certain events take place. Some might dictate investment conditions and some might permit or require a business to be sold or continued to be managed. Some might even try to influence behavior of its beneficiaries. It is reasonable to assume that most trusts are different, that there are few "cookie-cutter" documents, and that trusts are established to fulfill particular and many times personal reasons and occasionally ethical or religious goals or objectives.

Trustees always need to be designated. It is usual and strongly advisable to also designate alternate trustees and possibly second alternate trustees. This process would be best explained by the attorney that prepares the trust document.

## How trusts are established

Trusts can either be established by **someone that is living** or **through a will**. Trusts are formed under the laws of the **jurisdiction** where they are set up. The different states have their own rules, as do foreign countries. Some states and countries are particularly useful in creating trusts for specific purposes. When establishing a trust, it is necessary to use an attorney familiar with the different jurisdictions and purposes for that particular trust.

STARTING your practice?      GROWING your practice?

**\$1 BILLION+  
IN DEALS CLOSED**

WHATEVER STAGE YOU'RE IN...  
OUR PROGRAMS AND SERVICES  
WILL HELP YOU ACHIEVE YOUR GOALS

DELIVERING RESULTS - ONE PRACTICE AT A TIME

**APS** ACCOUNTING PRACTICE SALES  
THE GLOBAL LEADER IN PRACTICE SALES

888-632-1040  
www.APS.net

Trusts set up during the lifetime of the grantor are called **inter vivos** trusts. Trusts that are established pursuant to a will are referred to as **testamentary** trusts. Trusts can be set up as a **separate document or within a will or other trust**. Trusts set up in a will have no meaning or effect until the testator dies, and the will is probated.

### Irrevocable trusts

Trusts with an independent trustee and where absolute title to the assets is transferred to the trust are **irrevocable trusts**. Lifetime, i.e. *inter vivos*, transfers made to an irrevocable trust are subject to **gift tax**. Trusts where the grantor can make changes whenever they want for whatever purposes are **revocable**.

Trusts established in a will that becomes effective upon the death of the testator are always irrevocable, in that the grantor is not able to make any changes. However, a trust established in a will does not become operable or effective until assets are transferred to it and that would be done by the executor or personal representative designated in the will. This would also depend on the probate process and the administrative management of the estate and could take a period of time.

**Trusts set up during the lifetime of the grantor are called inter vivos trusts. Trusts that are established pursuant to a will are referred to as testamentary trusts. Trusts can be set up as a separate document or within a will or other trust.**

A person without a will cannot have trusts established in that manner after their death; but they could have a trust document prepared and executed prior to their death that will become effective upon or after their death [see next section for revocable trusts]. An *inter vivos* trust can have assets immediately transferred to it.

### Revocable or living trusts

A trust set up by a grantor where they are the sole trustee is usually revocable and is popularly called a **living trust**. Living trusts are always **revocable** since the grantor can make any changes they want as long as they are able, including terminating the trust. To serve the purpose for which they are created, assets must be **legally transferred** to the trust and the ownership change must be made

and recorded if applicable for the assets that are transferred.

**Living trusts become irrevocable upon death of the grantor.** At that point, the alternate trustee(s) immediately becomes the trustee and assumes complete control of the trust. Living trusts are occasionally considered and used as substitute wills, but this should not negate preparing a will.

Living trusts do not need to file tax returns, or use taxpayer identification numbers. They use the grantor's Social Security number and the transactions are reported on the grantor's individual income tax return. *All transactions in the living trust are disregarded for any tax purposes — income, gift, and estate* — and are not recognized for any tax purpose. Transfers to a living trust are not subject to gift taxes, and the full value of the assets would be included in the estate of the grantor.

### Grantor trusts

This is where trust taxation gets confusing, and we strongly recommend discussing this with a knowledgeable attorney or accountant. Following are the basic rules for grantor trusts.

**Grantor trusts** are a type of trust that are **irrevocable** but where the **grantor has certain rights** as defined in Code Sections 671 – 679. Because of these rights, the trust's income is reported on the grantor's individual income tax return, and the grantor pays the income tax instead of the trust or beneficiaries that receive income or income distributions. The grantor pays the tax regardless of whether he or she receives any income or distributions from the trust. Note that the payment of this tax does not constitute a taxable gift to the beneficiaries. This is an anomaly in the tax code and if used properly can create an added asset transfer benefit and is not covered here.

However, while the trust has certain income tax attributes, it is an irrevocable trust and is subject to the gift tax transfer rules. Therefore, *inter vivos* transfers to grantor trusts are subject to **gift taxes**, and the trust principal is not includible in the estate of the grantor.

A common grantor trust is an irrevocable life insurance trust. Gifts to the trust are taxable gifts and the life insurance owned by the trust and which premiums are paid for by the trust are not included in the estate of the grantor. However, any income earned by the trust during the lifetime of the grantor is included in the

grantor's individual tax return. The grantor in this instance has no rights to the policy, its cash value, or its eventual proceeds.

Grantors do have a right where they could act to terminate the **grantor trust status** of the trust. That would change the income taxability, but nothing else in the trust.

Separate taxpayer identification numbers ("TINs") for grantor trusts are not required – the grantor's Social Security number (or individual TIN) is used. Some banks, brokers, and insurance companies require separate TINs for the trusts, causing fiduciary tax returns to be filed, but the income is still taxed by the grantor.

Sometimes grantor trusts are called **defective trusts** because they violate "sound" trust drafting rules that cause them to fall under the Section 671-679 traps set up to "catch you." They are "defective" based on tax laws but not for legal purposes. Using grantor or defective trusts can be an effective estate planning tool if used in the proper circumstances.

### Irrevocable trust taxation

Irrevocable trusts that are **not** grantor trusts are taxed on undistributed income at the trust tax rate schedule. Such trusts that distribute income to beneficiaries get a deduction for those distributions, and the beneficiaries pay the tax along with their other income on their individual income tax returns. The filing is done using IRS Form 1041 (U.S. Income Tax Return for Estates and Trusts). The filing requirements are based on the type of trust as defined in the instructions.

Long-term capital gains are not considered as income that can be distributed, so the trust is taxed on this income. The trustee can make certain elections (not covered here) to have the beneficiaries pay the tax on that income. This should be discussed carefully before such elections are made.

The beneficiaries are provided with a Form K-1 to report the income distributed to them.

A trust must use a calendar year for reporting **except** if the trust is created under a will or if a special election is made in certain circumstances. When a fiscal year is permitted, it can elect to use a fiscal year that ends any month through the month before the month of death.

Gifts are subject to gift tax reporting rules.

An estate and two types of trusts have filing requirements and exemptions (when tax is paid by the trust). The instructions spell out the fil-

ing requirements. The two categories of trusts that are the most common are simple and complex trusts.

A **simple trust** is required to distribute all income currently, no charitable contributions are permitted, and amounts allocated to corpus are not distributed. A **complex trust** is a trust that does not qualify as a simple trust. Estates can make distributions as the executor deter-

### **Trusts with an independent trustee and where absolute title to the assets is transferred to the trust are irrevocable trusts. Trusts where the grantor can make changes whenever they want for whatever purposes are revocable.**

mines as long as the estate is kept open. Income retained in the trust or estate is taxed at the trust tax rates. The document creating the trust will determine whether the trust is a simple or complex trust, so the trust document must be read carefully and fully understood.

### Summary of trust tax return filing

- **Irrevocable trust that is not a grantor trust:** Must obtain a TIN and file a tax return if one is required to be filed. Gifts are subject to gift tax reporting rules. The gifts are not included in the grantor's estate.
- **Irrevocable trust that is a grantor trust:** Does not need to obtain a TIN and does not need to file a tax return. All income is reported on the tax return of the grantor. Gifts are subject to gift tax reporting rules. The gifts are not included in the grantor's estate.
- **Revocable or living trust:** Does not need to obtain a TIN and does not need to file a tax return. All income is reported on the tax return of the grantor. Gifts are not subject to gift tax reporting rules. Everything in the trust is included in the grantor's estate.

### Costs

Costs will be incurred in establishing the trust and in trust maintenance, operation, government or beneficiary reporting, and tax return filing. Trustees are entitled to statutory fees that will automatically apply unless the agreement states specifically that there will be no fees, or what the basis of the fees will be.

Trustees may or may not have to obtain a fidelity bond, and this will be determined by what the trust document provides for this. If

there is a desire to forgo obtaining fidelity bonds, it must be stated in the document establishing the trust. Bonds are obtained from insurance companies, and assure the truthfulness and fidelity of the performance of the trustee.

### **Caveat**

Trust documents can be extremely complicated and voluminous. It is cautioned that an experienced attorney be used to prepare the document; and that it either be carefully explained so that the grantor and, more importantly, the trustees, understand all of its provisions or a "plain language" summary be prepared to accompany the trust agreement. Further, an equally experienced attorney should be engaged to assist in the implementation of the provisions

when that time comes, if the original attorney is no longer available or able to be engaged.

### **Conclusion**

Trusts provide a wide range of functions and purposes, and if used properly can be extremely effective. If you have specific needs, requirements, restrictions, obligations, want to assure a smooth and speedy transfer of assets, protect assets, and avoid probate, and potentially save estate taxes, trusts should certainly be considered. It is suggested that the planning include precise goals and descriptions of what you are trying to accomplish, and then you should meet with a knowledgeable estate planner and discuss how a trust, and what type of trust, might help you achieve your goals. ■