Grantor Trust Income Tax Reporting Requirements

A Primer

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As estate and tax planners, we are very much aware of the virtues of grantor trusts, but how often do we consider the mechanics of reporting the income of a grantor trust? Although grantor trusts are ignored for the purpose of calculating taxable income, they are not ignored for the purpose of reporting such income. There are complex reporting requirements that we, as advisors, should understand when advising clients to use grantor trusts.

What is a grantor trust? The most common form of a grantor trust is a revocable trust funded by the grantor during his or her lifetime. Grantor trusts, however, can arise in a number of common planning techniques including irrevocable life insurance trusts, intentionally defective grantor trusts, and grantor retained annuity trusts. A grantor trust is a trust to which at least one of the provisions of IRC §§ 671–679 applies. If any of IRC §§ 671–677 or 679 applies, then the "grantor" is required to include all items of the trust's income, deduction, and credit on his or her personal income tax return. If IRC § 678 applies and a beneficiary is deemed to be the grantor of the trust for income tax purposes, that beneficiary must similarly report the items taxed to the trust on his or her personal income tax return. The goal of this article is to provide a primer on grantor trust income tax reporting. This article will not delve into the ways to create a grantor trust but will assume that the advisor has already made a determination that the trust in question is a grantor trust.

Taxable Year

IRC § 644(a) requires all trusts to use a calendar year for reporting purposes. But a wholly owned grantor trust (that is, the entire trust is deemed to be owned by one person) is exempt from this requirement and must use the same taxable year and accounting method of its grantor. Therefore, a wholly owned grantor trust may use a fiscal year for its tax return filings if the grantor is on a fiscal year.

General Reporting—Form 1041

Grantor trusts are subject to the same reporting requirements as nongrantor trusts. IRC §§ 6012(a)(4)–(5) require trusts with taxable income of any amount, gross income of $600 or more, or one or more nonresident beneficiaries, to file an income tax return within three and one-half months of the end of its taxable year. For most trusts (that is, those that report on a calendar year) this deadline is April 15.

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Notwithstanding the general rule, grantor trusts are eligible for simplified reporting procedures. If the trust is a wholly owned grantor trust, the trust's tax return, if required at all, need include only minimal information. If a wholly owned grantor trust files a Form 1041, it is using the "Traditional Method" of reporting. In the Traditional Method of reporting, only the entity information on the Form 1041 need be completed. Treas. Reg. § 1.671-4(a) provides that the activity of the trust that is reportable by the grantor is shown on an attachment giving the following: the name, Social Security number, and address of the grantor; the income of the trust that is taxable to the grantor; and any deductions or credits that apply to the income. This filing gives notice to the IRS that the income of the trust is being reported by the grantor.

If a trust is not owned entirely by one person (that is, a partial grantor trust), the portion of the trust's income, deduction, and credit that is allocable to the nongrantor portion of the trust is reported on the 1041 under normal reporting rules, and the amounts allocable to the grantor are shown only on an attachment to the form as described above. In all events, if an attachment is used, the trustee must provide a copy of the attachment to the grantor.

General Reporting—Taxpayer Identification Numbers

Treas. Reg. § 301.6109-1(a)(ii)(A) states that an individual must use a Social Security number as his or her taxpayer identification number (TIN). Treas. Reg. § 301.6109-1(a)(ii)(C) states that generally a trust must use an employer identification number as its TIN. Treas. Reg. § 301.6109-1(a)(2), however, provides an exception to the general rule for grantor trusts. A trust that is a wholly-owned grantor trust does not need to obtain a TIN if the trust reports under Alternative Method One (described below). But, if the trust uses the Traditional Method of reporting or Alternative Method Two (also described below), the trust will be required to obtain a TIN under this Regulation.

Alternative Methods of Reporting for Grantor Trusts

There are two alternative methods for reporting the income, deduction, and credit of a wholly-owned grantor trust that allow the trustee to avoid filing Form 1041. Treas. Reg. § 1.671-4(b)(1) allows the trustee of the trust to choose one of the alternative reporting methods.

Alternative Method One—Available Only for Trusts Treated as Wholly-Owned Grantor Trusts

Alternative Method One, set forth in Treas. Reg. § 1.671-4(b)(2)(i)(A), requires that the trustee identify all the payors of income and proceeds of the trust in any given taxable year and provide those payors the name and taxpayer identification number of the grantor and the address of the trust. Treas. Reg. § 1.671-4(b)(4) defines "payor" as any person required to make any type of information return to the trust in the taxable year. If a trustee chooses this option, the trustee must obtain a Form W-9 from the grantor to confirm the grantor's TIN, which under the rules described above will be the grantor's Social Security number. There are no further filing requirements with the IRS. Once the trustee receives the Forms 1099, it passes them on to the grantor, who will attach the forms to his individual tax return. If the trustee is someone other than the grantor, however, then the trustee has one more duty. Under Treas. Reg. § 1.671-4(b)(2)(ii) the trustee must prepare for the grantor an information statement (1) containing all of the income, deductions, and tax credits of the trust, the payor of each item of income,

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and any other information the grantor may need in calculating the grantor's taxable income, and (2) informing the grantor that all items of income, deduction, and credit shown on the statement must be included on the grantor's income tax return. Alternative Method One is the most frequent method of reporting income of revocable trusts.

Examples of Alternative Method One Reporting

Example 1: G creates a trust ("Trust 1") and serves as trustee. Trust 1 is treated as wholly-owned by G. G gives all payors his name and Social Security number, along with the trust's address. G reports the income, deduction, and credit of Trust 1 on his income tax return.

Example 2: G creates a trust ("Trust 2") with X serving as trustee. Trust 2 is treated as wholly-owned by G. X gives G's name and Social Security number to all payors of Trust 2 along with the trust's address. The payors send 1099s to the trust's address and X passes them along to G. X also gives G an information statement. G reports the income, deduction, and credit of Trust 2 on his income tax return.

Alternative Method Two—Available for Single or Multiple Owners

Alternative Method Two, described in Treas. Reg. § 1.671-4(b)(2)(i)(B), allows the trustee to provide all of the payors with the name, TIN, and address of the trust. A trust using this method must have its own TIN. Alternative Method Two imposes additional requirements on the trustee beyond those of the Traditional Method or Alternative Method One. First, the trustee receives Forms 1099 from payors listing the trust as payee. Then, under Treas. Reg. § 1.671-4(b)(2)(iii), the trustee must file Forms 1099 with the IRS showing the income or proceeds received by the trust during the year and showing the trust as the payor and the grantor as the payee. If the trustee fails to file a correct Form 1099, the trustee is subject to penalties under IRC §§ 6721 and 6722. The trustee must file a Form 1099 for each type of income in the aggregate and list each item of gross proceeds separately as described in Treas. Reg. § 1.671-4(b)(2)(i)(A). The trustee only has to file Forms 1099 for items for which the trust received a Form 1099. But, if income is reported to the trust through a form other than Form 1099—for instance, a K-1—the trustee does not have to file a Form 1099 for that income. Under Treas. Reg. § 1.671-4(b)(2)(i)(B), however, the trustee must furnish an information statement to the grantor that shows all items of income, deduction, and credit for the trust in the taxable year, and that statement must include any information necessary to take those items into account when computing the grantor's income and inform the grantor that the information shown on the statement must be included on the grantor's tax return.

Example of Alternative Method Two Reporting

Example 3: Same facts as Example 2 except that X chooses Alternative Method Two. X provides the payors of Trust 2 with Trust 2's name, address, and TIN. The payors provide Forms 1099 to X showing Trust 2 as the payee. X aggregates the Forms 1099 received and files the necessary Forms 1099 showing Trust 2 as the payor and G as the payee. X also provides G with an information statement.

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Special Rules When Both Spouses Are Settlors of a Trust

The first challenge when married individuals are the joint settlors of a trust is determining whether one spouse or both spouses should be treated as the grantor of the trust. The grantor of the trust is a function of substantive state law. In a community property state, both individuals are typically considered grantors of the trust. In a common-law state, both individuals are considered grantors of the trust only if the trust is funded from a joint account. If the trust is funded from one spouse's separate account, that spouse is treated as the grantor, even if the other spouse agrees to "gift-split" for gift tax purposes.

When only one spouse is the grantor of the trust, no additional issues need to be considered merely because the grantor is married. The items of income, deduction, and credit are attributable to that individual and are subject to standard reporting obligations, conditioned on whether the couple lives in a community property or common-law state and whether the couple files jointly or separately. When both spouses are treated as owners of the trust, the filing of a joint return facilitates the reporting of attributed items of income, deduction, and credit. Treas. Reg. § 1.671-4(b)(8) provides that both spouses will be treated as one grantor for purposes of the alternative methods if all of the trust is deemed to be owned by both spouses and if both spouses file a joint income tax return for that year. If the spouses file separately, it is necessary to determine in what proportion each spouse is treated as the owner of the trust. This will be a function of the value of the assets that each has transferred to the trust, which may need to be determined on a year-to-year basis as additional assets are transferred. The items of income, deduction, and credit can then be allocated to each spouse in proportion to his or her ownership of the trust.

One of the most common situations in which a trust is settled by two spouses is when an irrevocable life insurance trust is created to own a survivorship policy insuring the joint lives of the spouses. On the death of the first spouse, it may be necessary to determine to what extent the trust continues to be treated as a grantor trust for the surviving spouse. As discussed above, the surviving spouse is the owner of the trust to the extent of his or her pro rata share of contributions to the trust.

Reporting—Multiple Grantors

If a trust is deemed owned by more than one person (other than spouses who file a joint return), the trustee must follow the procedure described in Treas. Reg. § 1.671-4(b)(3). The trustee must give the trust's name, TIN, and address to all payors for the taxable year, and the trustee must file Forms 1099 with the IRS and appropriately attribute the income of the trust among the grantors in proportion to their deemed ownership. The trustee must furnish statements to each of the grantors showing what items of the trust's income, deduction, and credit are attributable to each grantor's portion of the trust, explaining how to take those items into account in computing the grantor's taxable income and informing each grantor that the information shown on the statement must be included on the grantor's income tax return.

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Exceptions to Trustee's Ability to Choose Its Reporting Method

Some trusts are not allowed to report under one of the alternative methods and must report using the Traditional Method. If a trust has its situs in a foreign jurisdiction, has foreign assets, has a single grantor who is not a U.S. person, has multiple grantors at least one of whom is not a U.S. person, or is a qualified subchapter S trust (QSST), the trust must use the Traditional Method. In addition, if the trust is a common trust fund defined in IRC § 554, it must use the Traditional Method.

Change in Reporting Method

A trustee may change from the Traditional Method to one of the alternative methods by filing a final Form 1041 that states, "Pursuant to Treas. Reg. Section 1.671-4(g) this is the final Form 1041 for this grantor trust." The trustee should check the "Final Return" box in item F.

Treas. Reg. § 1.671-4(g)(2) describes the procedure for changing the trust's reporting method from one of the alternative methods to the Traditional Method. If the trustee has previously used Alternative Method One by providing payors with the grantor's name and TIN and wishes to begin using the Traditional Method, the trustee must obtain a TIN for the trust and furnish the payors with the trust's name and TIN. If the trustee was using Alternative Method Two and wishes to begin using the Traditional Method, the trustee must file Form 1096 (Annual Summary and Transmittal of U.S. Information Returns), which indicates that the trust is making its final return by that method.

The trustee also can change which alternative method it uses by changing what it reports to the payors (that is, the trust's information instead of the grantor's information, or vice versa). But, if the trustee is changing from Alternative Method Two to Alternative Method One, it must file Form 1096 and indicate that it is the trust's final return. The choice of reporting method is not irrevocable. Theoretically, a trustee could change reporting methods each year.

Termination of Grantor Status

A trust can cease to be a grantor trust because of the termination of grantor status or the death of the grantor. In the event of the grantor's death, Treas. Reg. § 1.671-4(h) states the trust may no longer report under the Traditional Method or one of the alternative methods discussed in this article. The final taxable year of the grantor trust ends on the grantor's date of death. Thereafter, the trust must follow the general reporting rules applicable to nongrantor trusts. If the trust continues after the death of the grantor, the trust must obtain a new TIN if the trust was a wholly owned grantor trust.

If the trust had been reporting under Alternative Method One, the trustee must provide all of the payors with a new Form W-9 showing the new TIN, the name of the trust, and the address of the trustee, in accordance with Treas. Reg. § 301.6109-1(a)(3)(ii). If the trust had been reporting under Alternative Method Two, the trustee must file a Form 1096 for the tax year ending on the decedent's date of death and note that it is the trust's final return using that method.

Treas. Reg. § 1.671-4(h)(3)(iii) provides that, if the trust had multiple grantors and only one died, the trust may be able to continue reporting in the same manner it did before the deceased grantor's death, using the same TIN, so long as no portion of the trust has a short taxable year because of the decedent's death and the portion treated as owned by decedent terminates on the death of the decedent.

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The Regulations do not clearly state what changes must be made in reporting if a grantor trust terminates by reason other than the grantor's death, but presumably the same rules would apply in those situations.

Conclusion

Grantor trusts are one of the most powerful tools in an estate planner's toolbox. As a result of their effectiveness, grantor trusts have become extremely prevalent in estate planning including common planning techniques such as irrevocable life insurance trusts, intentionally defective grantor trusts, grantor retained annuity trusts, and revocable trusts. When advising clients to use planning techniques that involve grantor trusts, it is important to remember the relevant reporting requirements. The attorney setting up an estate plan with a grantor trust should not assume that the client's other advisors know the rules summarized in this article and should confirm with the client that the grantor trust is being reported correctly for income tax purposes. n

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