Irrevocable Trusts: Who Is the Taxpayer?

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In establishing and funding an irrevocable trust, a common question is who is responsible for the income tax liabilities associated with the trust? Many individuals assume that the trust is a separate and independent taxpayer, requiring the trustees to file income tax returns for the trust. However, that is not always the case.

Irrevocable trusts are either classified as "grantor trusts" or "non-grantor trusts." When an irrevocable trust is classified as a grantor trust, the trust is treated as identical to the settlor or the donor, requiring the settlor to report all matters of income and deduction with respect to the trust on his or her own individual income tax returns. When an irrevocable trust is classified as a non-grantor trust, the trust is deemed to be a separate taxpayer, requiring the trustees to file annual income tax returns for the trust (known as fiduciary income tax returns) reporting all matters of income and deduction with respect to the trust.

Generally, whether an irrevocable trust will be classified as a grantor or non-grantor trust depends on certain powers that may have been retained by the settlor with respect to the trust, who are the beneficiaries of the trust, and certain provisions in the trust. For instance, if the settlor retained the power of substitution (also known as a swap power), if the trustees have the power to use trust income to pay premiums on a life insurance policy insuring the life of the settlor or if the settlor's spouse is a permissible beneficiary of the income of the trust, the irrevocable trust will be deemed to be a grantor trust. As a general rule, although not always the case, an irrevocable life insurance trust (holding a life insurance policy insuring the life of the settlor) or a spousal lifetime access trust ("SLAT") will almost always be deemed a grantor trust during the settlor's lifetime.

At first blush, a grantor trust may be seen as a harmful result given that the settlor is transferring property to an irrevocable trust (of which the settlor is generally not a beneficiary and no longer has access to the property) but the settlor remains liable for the income tax bill. However, establishing an irrevocable trust as a grantor trust can have significant transfer tax benefits. By establishing a grantor trust, each year the settlor will report and pay any associated income tax liabilities with respect to the trust. Under current law, the payment of tax liabilities that would otherwise be paid by the trust is, in essence, a tax-free gift to the trust each year. As such, the payment of the trust's tax liabilities by the settlor will permit the settlor to further deplete the assets in his or her own name (that will be subject to estate tax at his or her death) without using any of the settlor's gift/estate tax exemption.

With respect to grantor trusts, of course, once the settlor dies, the trust will generally cease to be a grantor trust and convert to a non-grantor trust. It may also, however, be possible to convert the trust from a grantor trust to a non-grantor trust, and vice versa, during the settlor's lifetime, if that would be desirable.

Irrevocable trusts are further subclassified under the Internal Revenue Code as either foreign or domestic trusts. As a general rule, domestic trusts are subject to U.S. income tax on their world-wide income, while foreign trusts are subject to U.S. income tax on only their U.S.-sourced income. The implications of each such classification and the tests to determine such classifications will be addressed in an upcoming cross-border estate planning series.

National Law Review, Volume XIII, Number 114