First State TRUST COMPANY WOMEN & WEALTH

THE TAXATION OF TRUSTS

You have a trust and it's getting closer to April 15th. You know you have to get a document related to the trust to file your return, but what exactly is this document and how does the taxation of a trust work? Below is a quick breakdown in basic terms to help understand what you need to know for April 15th.

WHAT IS A TRUST AND HOW ARE THEY TAXED?

A Trust is a legal agreement in which there is at minimum a grantor (the one who funds a trust), a trustee (the person or corporation legally responsible for administering the trust) and a beneficiary (the individual who benefits from the trust). Assets are placed in a trust for various reasons. A few reasons are to grow funds for future generations, the protection of funds from creditors and lawsuits, protecting against spendthrift beneficiaries, estate planning, etc.

As a trust fund receives income, the income is typically reported to a trust on an IRS report called a 1099. However, some investments (such as private equity limited partnerships or LLCs) will report the taxation on a K-1 report, which is sent to the trustee from the private equity limited partnership or LLC fund. 1099's are usually received by mid February however, due to the complexities of some investments, 1099s will often not become available until around March 15th. If income is reported on a K-1 (IRS form 1065), many times the K-1 will not be delivered until after April 15th. In this case, the trust return is put on extension.

There are different types of trusts, but from a tax perspective there are two types that we focus on. A grantor trust and a non-grantor trust.

TAXATION OF GRANTOR TRUSTS

A grantor trust from a tax perspective is where the IRS views the trust and the grantor as the same taxable entity. The tax due from a trust flows to the grantor and is reported on their individual tax return (Form 1040- IRS individual tax return).

A few examples of how a trust can be a grantor trust:

- A trust is a revocable trust, a trust that can be changed during the grantor's lifetime.
- The grantor or grantor's spouse currently receives trust income, or has the ability to.
- The grantor has the ability to exchange trust assets for their own assets.

Essentially if the grantor has a certain amount of control or benefit over the trust, the trust can be deemed a grantor trust. The grantor is taxed on everything in the trust, even if the beneficiaries receive distributions.

To file one's individual return (Form 1040) a grantor of a grantor trust needs a grantor tax letter, which is prepared and sent by the trustee of the trust. A grantor tax letter reflects all of the taxes earned within the Trust. This information is entered in the Grantor tax letter and given to the Grantor. All the taxes earned by the trust flow out to the Grantor and they are the ones who pay tax.

TAXATION OF NON-GRANTOR TRUSTS

A non-grantor trust is where the trust fund is a separate entity from the grantor. It has its own tax identification number, and from an IRS perspective, is completely separate from the individual who funded the trust.

Since the trust is a separate entity, a separate trust return is completed to cover all of the income earned within the trust. This separate tax return for non-grantor is called an IRS form 1041. If a beneficiary receives distributions in that tax year, those distributions can carry out taxation and be passed out on an IRS form called a K-1. Those distributions to the beneficiary are then reported on the beneficiary's tax return.

SUMMARY

To sum things up very simply, to file one's individual return (IRS Form 1040) a grantor of a grantor trust needs a grantor tax letter from the trustee of the trust. A beneficiary of a non-grantor trust needs a K-1 from their trustee, if they have received distributions during the year from their trust fund. These are created when a tax preparer completes the trust's tax return (IRS form 1041). After receipt of a grantor tax letter or a K-1, the document can be forwarded to an accountant for the preparation of the individual tax return.

Please don't hesitate to contact your Trust Officer with any questions or call First State Trust Company at (800)554-1364.