

Alternative Filing Requirements for a Grantor Trust

By Salvatore M. Di Costanzo

Since the enactment of the Deficit Reduction Act, most of us have turned to the Income Only Trust as a preferential advanced planning technique to protect our clients' assets. Often, the trust is prepared to protect the homestead or other real estate of the client. At times, it may also be prudent to transfer liquid assets to the trust such as cash, money markets or other types of marketable securities. In doing so, the trust may generate income, giving rise to certain tax filing requirements. However, it may not always be necessary to file a tax return if the trustee takes certain actions.

A properly drafted Income Only Trust is usually designed to be a grantor trust for income tax purposes. Having the creator of the trust retain sufficient control over the income and principal of the trust does this. If the trust is a grantor trust, the creator is treated as the owner of the income and/or principal of the trust and consequently, those items of income—deduction, credit, etc., attributable to income and/or principal—are taxable to the creator at the individual level.¹ For instance, if the creator reserves the power to reacquire trust property by substituting other property of equivalent value, the creator will be treated as the owner of all the trust property (e.g., income and principal) and consequently, all the income of the trust will be taxed to the creator.² If husband and wife jointly create an Income Only Trust structured as a grantor trust, they will both be considered owners of the trust in proportion to their contributions.³

Generally, the trustee of a grantor trust must file Form 1041 by the 15th day of the fourth month following the close of its taxable year if the trust (i) generates any taxable income for the year, (ii) has gross income for the year of \$600 or more or (iii) has a non-resident alien beneficiary.⁴ Since the trust is considered owned by the creator for income tax purposes, Form 1041 is merely an informational tax return (also referred to as a skeleton return). Procedurally, a statement detailing the items of income, deduction, and credit that are taxable to the creator accompanies Form 1041. Form 1041 contains no information other than identifying information of the creator and the trust. The front page of Form 1041 usually includes the following statement, "Under the terms of the trust instrument, this is a grantor trust. All income is taxed to the grantor under IRC § 671-678. A statement of income, deductions and credits is attached." A sample Form 1041, page 1 (Appendix A) appears on page 23 and a grantor letter (Appendix B) appears on pp. 24-25.

After January 1, 1996, where a trust is treated as being owned by one creator, the trustee is afforded two alternative reporting methods prescribed by the Treasury Regulations ("Regulations") as simplified alternatives to filing a tax return.⁵ A husband and wife who file a joint tax return are treated as one grantor for tax purposes. If the trustee follows the procedures outlined in the Regulations for one of the following optional reporting methods, the trustee is not required to file Form 1041. The two alternative options are discussed below.

Option One⁶

The trustee must furnish the name and taxpayer identification number of the person treated as the owner of the trust and the address of the trust to all payors of income. The trustee obtains the creator's information by having the creator complete Form W-9. When each payor files its respective Form 1099s with the Internal Revenue Service, such information will be reported under the creator's social security number, not the tax identification number of the trust. Unless the creator is also a trustee, when the trustee receives each Form 1099 from the payors, the trustee is required to deliver these forms to the creator together with a statement that (i) identifies the payor, (ii) shows all items of income, deduction, and credits attributable to the creator, (iii) provides the creator with information necessary to compute the return and (iv) informs the creator that all items of income, deduction, and credits shown on the statement must be reported by the creator on the creator's tax return.

Option Two⁷

The trustee must furnish the trust's name, tax identification number, and address to all payors of income. When the trustee receives Forms 1099, the trustee must file its own Form 1099 with the Internal Revenue Service to report such amounts being received by the trust and paid to the creator from the trust. The trustee then prepares and delivers the same statement as described in Option One (except for (i)) to the creator so the creator can prepare its tax return.

The statement required in both of the above options can be prepared in similar format to the grantor letter and its accompanying statements that appear on pp. 24-25.

The Regulations allow the trustee to switch between filing Form 1041 and electing one of the optional reporting methods.⁸ If this is done, the trustee must file a final Form 1041.

Getting a client to understand the tax complexities of an Income Only Trust can sometimes be a daunting task. However, if you can effectively communicate the tax filing requirements to your clients and or their accountant and then offer one of the alternative options, you will most likely save the clients money on an annual basis and avoid unnecessary penalties and interest for clients who undoubtedly are less than diligent in filing tax returns. Initially, it may be difficult for the trustee to understand and implement. However, once an option is chosen and identification numbers are provided to the payors, a template grantor letter can be created and utilized each year.

In my opinion, providing the payors with the creator's social security number and delivering a grantor letter to the creator each year is the easiest option for the trustee. Regardless of the option chosen, since the trustee of an Income Only Trust is usually a child of the creator, carrying out the procedures of one of the alternative options should not be too difficult of a task, or is it?

Endnotes

1. Treasury Regulation § 1.671-4(a).
2. I.R.C. § 674(4)(c).
3. Treasury Regulation § 1.671-4(b)(8).
4. I.R.C. § 641.
5. Treasury Regulation § 1.671-4(b)(2).

6. Treasury Regulation § 1.671-4(b)(2)(i)(A).
7. Treasury Regulation § 1.671-4(b)(2)(i)(B).
8. 1.67104(g).

Salvatore M. Di Costanzo is a partner with the firm of McMillan, Constabile, Maker & Perone, LLP. Mr. Di Costanzo is an attorney and accountant whose main areas of practice include Trusts and Estates, Tax Law and Elder Law. Prior to being a partner with McMillan, Constabile, Maker & Perone, LLP, Mr. Di Costanzo was an attorney with Ernst & Young, LLP in its estate and business succession planning group, where he provided estate planning and income tax services for individuals, corporate executives, and closely held business owners, as well as estate and trust taxation and administration services. Prior to practicing law, Mr. Di Costanzo was an auditor with Deloitte & Touche, LLP in Stamford, CT. He earned a B.B.A. in accounting from Siena College and a J.D. from Pace University School of Law. Mr. Di Costanzo is a member of the National Academy of Elder Law Attorneys and is active in the Real Property, Elder Law and Tax Sections of the New York State Bar Association. He is also the current co-chair of the Elder Law Committee of the Westchester County Bar Association. He is licensed to practice law in New York, Connecticut, the United States District Court for the Southern District of New York and the United States Tax Court. Mr. Di Costanzo is a regular contributing author for the *Elder Law Attorney* on various tax matters affecting the practice of elder law. He can be reached at (914) 834-3500 or via e-mail at smd@mcmillanconstabile.com.

A Type of entity (see instr): For calendar year 2007 or fiscal year beginning _____, 2007 and ending _____

Decedent's estate
 Simple trust
 Complex trust
 Qualified disability trust
 ESBT (S portion only)
 Grantor type trust
 Bankruptcy estate — Chapter 7
 Bankruptcy estate — Chapter 11
 Pooled income fund

The Sally Jones Income Only Trust
 Julie Stevens
 Trustee
 2180 Boston Post Road
 Larchmont, NY 10538

C Employer identification number
 26-3872910

D Date entity created
 4/15/2007

E Nonexempt charitable and split-interest trusts, check applicable boxes (see instr):
 Described in section 4947(a)(1)
 Not a private foundation
 Described in section 4947(a)(2)

B Number of Schs K-1 attached (see instructions): _____

F Check applicable boxes:
 Initial return Final return Amended return
 Change in fiduciary Change in fiduciary's name Change in fiduciary's address

G Check here if the estate or filing trust made a section 645 election: _____

Income	1	Interest income	1	
	2a	Total ordinary dividends	2a	
	b	Qualified dividends allocable to: (1) Beneficiaries (2) Estate/trust		
	3	Business income or (loss). Attach Schedule C or C-EZ (Form 1040)	3	
	4	Capital gain or (loss). Attach Schedule D (Form 1041)	4	
	5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5	
	6	Farm income or (loss). Attach Schedule F (Form 1040)	6	
	7	Ordinary gain or (loss). Attach Form 4797	7	
	8	Other income. List type and amount	8	
9	Total income. Combine lines 1, 2a, and 3 through 8	9		
Deductions	10	Interest. Check if Form 4952 is attached <input type="checkbox"/>	10	
	11	Taxes	11	
	12	Fiduciary fees	12	
	13	Charitable deduction (from Schedule A, line 7)	13	
	14	Attorney, accountant, and return preparer fees	14	
	15a	Other deductions not subject to the 2% floor (attach schedule)	15a	
	b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
	16	Add lines 10 through 15b	16	
	17	Adjusted total income or (loss). Subtract line 16 from line 9	17	
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	
19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19		
20	Exemption	20		
21	Add lines 18 through 20	21		
Tax and Payments	22	Taxable income. Subtract line 21 from line 17. If a loss, see instructions	22	
	23	Total tax (from Schedule G, line 7)	23	
	24	Payments: a 2007 estimated tax payments and amount applied from 2006 return	24a	
	b	Estimated tax payments allocated to beneficiaries (from Form 1041-T)	24b	
	c	Subtract line 24b from line 24a	24c	
	d	Tax paid with Form 7004 (see instructions)	24d	
	e	Federal income tax withheld. If any is from Form(s) 1099, check <input type="checkbox"/>	24e	
	f	Other payments: Form 2439; g Form 4136; Total	24h	
	25	Total payments. Add lines 24c through 24e, and 24h	25	
26	Estimated tax penalty (see instructions)	26		
27	Tax due. If line 25 is smaller than the total of lines 23 and 26, enter amount owed	27		
28	Overpayment. If line 25 is larger than the total of lines 23 and 26, enter amount overpaid	28		
29	Amount of line 28 to be: a Credited to 2008 estimated tax; b Refunded	29		

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Sign Here

Signature of fiduciary or officer representing fiduciary _____ Date _____ EIN of fiduciary if a financial institution _____

May the IRS discuss this return with the preparer shown below (see instrs)? Yes No

Paid Preparer's Use Only

Preparer's signature: Salvatore M. DiCostanzo, Esq. Date _____ Check if self-employed Preparer's SSN or PTIN: P00078485

Firm's name (or yours if self-employed): MCMILLAN, CONSTABILE, MAKER & PERONE, LLP EIN: 13-3751918

address, and ZIP code: 2180 BOSTON POST RD LARCHMONT, NY 10538-3616 Phone number: (914) 834-3500

2007 Federal Grantor Information

The Sally Jones Income Only Trust
Julie Stevens
2180 Boston Post Road
Larchmont, NY 10538

Grantor Name and Address Sally Jones 2180 Boston Post Road Larchmont, NY 10538	Trust Tax ID: 26-3872910 Grantor ID/SSN: 976-54-5348 % Ordinary Income: 100.000000 % Capital Gain/Loss: 100.000000
<p>The following income, deductions and credits are to be reported on the income tax return of the above named grantor.</p>	
<p><u>Income</u></p>	
Ordinary Dividends (Enter on Line 9a, Form 1040)	(See Statement 1) 875.
Qualified Dividends (Enter on Line 9b, Form 1040)	(See Statement 2) 654.
Capital Gain Distributions (Enter on Line 13f, Schedule D, Form 1040)	(See Statement 3) 7,436.
Interest (Enter on Line 1, Schedule B, Form 1040)	(See Statement 4) 6,875.
<p>FIFL0213L 07/15/03</p>	

Client 6007

The Sally Jones Income Only Trust

26-3872910

5/02/08

04:01PM

Statement 1
Income
Ordinary Dividends

Merrill Lynch.....	\$ 875.
Total	<u>\$ 875.</u>

Statement 2
Income
Qualified Dividends

Merrill Lynch.....	\$ 654.
Total	<u>\$ 654.</u>

Statement 3
Income
Capital Gain Distributions

Merrill Lynch.....	\$ 7,436.
Total	<u>\$ 7,436.</u>

Statement 4
Income
Interest

Wachovia.....	\$ 6,875.
Total	<u>\$ 6,875.</u>