

Chapter 1

Types of Trusts

Income taxation of estates and trusts is governed by provisions contained in subchapter J¹ of chapter 1 of the Internal Revenue Code² that were originally enacted as a part of the general adoption of the Internal Revenue Code of 1954.³ Important amendments to subchapter J were made by the Tax Reform Act of 1969,⁴ primarily in the so-called throwback rules, in the rules for split-interest charitable trusts, and the taxation of income for the benefit of a grantor's spouse. Significant changes were also made by the Tax Reform Act of 1976,⁵ again especially in the throwback rules.⁶ Additional amendments were made by the Revenue Act of 1978;⁷ the Tax Reform Act of 1984;⁸ the Tax Reform Act of 1986;⁹ and the Revenue Reconciliation

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1. I.R.C. §§ 641-92.
 2. EDITORIAL NOTE. The "Code" referred to in this book is the Internal Revenue Code of 1986 as amended. It is cited in the footnotes as "I.R.C." Citations of the preceding Internal Revenue Code of 1939 appear as "I.R.C. __ (1939)."
 3. Before extensive changes to income tax rules governing estates and trusts were made in 1954, the relevant sections in the 1939 Code were 161 to 172. See Kamin, Surrey & Warren, *The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries*, 54 COLUM. L. REV. 1237 (1954).
 4. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.
 5. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.
 6. See generally Cornfeld, *New Laws on Accumulation Trusts Require Practitioners to Take Prompt Action*, 45 J. TAX'N 331 (1976); Howe, *Transaction of Trusts and Beneficiaries Changed by Provisions of Tax Reform Act of 1976*, 17 TAX'N FOR ACCT. 346 (1976); Johnston & Garrett, *Sweeping Changes in Rules of Accumulation Trusts Partially Unscramble Tax Computations*, 4 EST. PLAN. 142 (1977).
 7. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.
 8. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.
 9. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

Act of 1993.¹⁰ The Small Business Job Protection Act of 1996¹¹ made significant changes to rules governing foreign grantor trusts and domestic grantor trusts with foreign grantors or substantial owners. Additional important changes were made to several areas of the income taxation of estates, trusts, and beneficiaries by the Taxpayer Relief Act of 1997.¹²

Trusts and estates can be divided into five general categories:

- (1) "Ordinary trusts," consisting of valid, domestic trusts that do not fall into either the second, third, fourth, or fifth categories. Generally, decedents' estates are treated in the same manner as ordinary trusts.¹³ The provisions of subchapter J, relating generally to trusts and estates in this category, are sections 641–68.¹⁴ Ordinary trusts and estates are discussed in greater detail in chapter 3.
- (2) "Grantor trusts," are trusts in which the grantor retains sufficient dominion and control or beneficial interest to treat the corpus or the income as still belonging to the grantor for income tax purposes.¹⁵ Under these rules, dominion and control or beneficial interest in a person other than the grantor

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10. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 416. *See generally* Early, *Living With the New Fiduciary Income Tax Rates Under RRA '93*, 21 EST. PLAN. 3 (Jan.–Feb. 1994).
 11. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755.
 12. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.
 13. Differences exist between estates and trusts, however. For example, an estate is entitled to a personal exemption of \$600, while a trust is entitled to a personal exemption of either \$100 or \$300. *See* I.R.C. § 642(b).
 14. In *United States v. Cooke*, 228 F.2d 667 (9th Cir. 1955), *aff'g* 115 F. Supp. 830 (D. Haw. 1953), a legal life estate was held not taxable as a trust; thus, the holder of the life estate was not a fiduciary and did not have to report a capital gain. However, the case has been distinguished and is of doubtful value. *United States v. De Bonchamps*, 278 F.2d 127 (9th Cir. 1960); *see also* *Brooke v. United States*, 468 F.2d 1155 (9th Cir. 1972) (guardianship); *Hirschmann v. United States*, 309 F.2d 104 (2d Cir. 1962), *aff'g* 202 F. Supp. 722 (S.D.N.Y. 1962); *Weil v. United States*, 180 F. Supp. 407 (Ct. Cl.), *cert. denied*, 364 U.S. 822 (1960); Rev. Rul. 61-102, 1961-1 C.B. 245; Rev. Rul. 59-154, 1959-1 C.B. 160 (requiring trust treatment of power in trust although legal title was in the beneficiaries); *cf.* *Sher, Recent IRS Successes Taxing Life Tenant on Sale of Principal Residence Are Questionable*, 17 J. TAX'N 30 (1962); *see also* *Morgan v. United States*, 94-1 U.S.T.C. ¶ 50,146 (N.D. Fla. 1994) (CCH) (discussion of consequences of sale of life estate and sale of remainder, suggesting apportionment of capital gain based on actuarial interests of each if all interests sold).
 15. I.R.C. §§ 671–79.

may result in that person being treated as the owner as well.¹⁶ Grantor trusts are discussed in greater detail in chapter 5.

- (3) "Foreign trusts," are trusts that do not meet the definition of a domestic trust and receive special treatment.¹⁷ New foreign trust rules were enacted in 1976,¹⁸ including a new code section for foreign trusts with U.S. beneficiaries.¹⁹ Legislation in 1996 added to the adverse treatment of foreign trusts under U.S. law and eliminated grantor trust status for many trusts, whether domestic (U.S.) or foreign, with foreign grantors.²⁰ The 1996 legislation also expanded the reporting requirements for foreign trusts if there is a U.S. grantor or a distribution is made to a U.S. person. Foreign trusts are discussed in greater detail in chapter 6.
- (4) Trusts that own stock of S corporations are subject to extensive and complex rules governing when a trust or estate may own S corporation stock without voiding the S election. The taxation of these types of trusts may fall under ordinary trust rules, grantor trust rules, or special rules that apply to Electing Small Business Trusts.²¹ Chapter 8 provides an expansive overview of the tax rules applicable to trusts and estates that own stock of an S corporation.
- (5) "Special trusts," are trusts used in particularized situations, such as pension trusts,²² common trust funds,²³ alimony trusts,²⁴ trusts taxable as corporations,²⁵ and Alaska Native

16. I.R.C. § 678.

17. See I.R.C. § 7701(a)(31)(A). Legislation in 1996 provides a trust will be considered domestic (U.S.) if (i) a court in the United States is able to exercise primary supervision over the administration of the estate or trust, and (ii) one or more U.S. fiduciaries have the authority to control all substantial decisions of the trust. I.R.C. § 7701(a)(31)(B). See *infra* section 6:3.

18. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

19. I.R.C. § 679 enacted by Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, § 1013(a).

20. Small Business Job Protection Act, Pub. L. No. 104-188, 110 Stat. 1755, § 1093.

21. See *infra* section 8:7.

22. I.R.C. § 401.

23. I.R.C. § 584.

24. I.R.C. § 682. See also *infra* section 7:2. The tax treatment of alimony trusts was modified by the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 and repealed for tax years beginning after 2018. Pub. L. No. 115-97, 131 Stat. 1244, § 11051(b)(1)(C).

25. Treas. Reg. § 301.7701-4(b). See also *infra* section 7:3.

Settlement Trusts.²⁶ Also included in this category are split-interest charitable trusts—charitable lead and remainder annuity trusts, charitable lead and remainder unitrusts, and pooled income funds—with simplified treatment for noncharitable current beneficiaries.²⁷ Special trusts, including charitable trusts, are discussed in greater detail in chapter 7.²⁸

When a decedent dies, income attributable to the decedent's efforts (services income) does not necessarily end and income generated by the decedent's property continues. In general, only the income received before a decedent dies is reported on the decedent's final or a prior year's return. Similarly, income generated by the decedent's property and received before death is reported on the decedent's final or prior return. When a decedent dies with a right to either type of income, special rules come into play concerning how and when that

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26. I.R.C. § 646. Alaska Native Settlement Trusts are not discussed in this book. Priv. Ltr. Rul. 200733013 discusses the legislative history of I.R.C. § 646 and the issues and relevant law applicable to trusts that qualify and elect to be taxed under I.R.C. § 646. *See also* Priv. Ltr. Ruls. 200835029, 200927022, 201523017, and 201527004. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. Program Manager Technical Advice Memorandum 2016-06 takes the position that property received by an Alaska Native Settlement Trust from an Alaska Native Corporation takes a fair market value basis. *See generally* Bruce N. Edwards, *Understanding and Making the New Section 646 Election for Alaska Native Settlement Trusts*, 18 ALASKA L. REV. 217 (Dec. 2001). Section 139G was added by the 2017 tax legislation to provide that Alaska Native American Corporations do not recognize income for certain payments assigned to Settlement Trusts and can deduct contributions to Settlement Trusts. Pub. L. 115-97, 131 Stat. 1244, § 13821(a)(1).
27. I.R.C. § 664 added by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.
28. Pension trusts, real estate investment trusts, and other special purpose trusts (*e.g.*, Environmental Remediation Trusts) are not discussed in this book. *See generally* Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165 (1997). Trusts wholly for charity may be tax exempt under I.R.C. § 501(c)(3) and, if so, are not subject to the rules of subchapter J. Certain other trusts are particularly concerned with the special rules that apply to the charitable contributions of nonexempt trusts. These special rules, which apply to ordinary trusts, are discussed in § 3:2.1. *See* I.R.C. §§ 170(f) and 508(d)(2) for limitations, enacted in 1969, on charitable deductions for gifts of trust interests, or for gifts to trusts insufficiently restricted. Gift and estate tax charitable deductions relating to remainder interests committed to charity are also in certain circumstances tied to the charitable remainder trusts defined in the text. *See* Appert, *Nonexempt Charitable Trusts Under the Tax Reform Act of 1969*, 25 TAX LAW. 99 (1971).

income is reported. Thus, these reporting issues must be resolved before the income of the decedent's estate may be determined and before the taxation of the estate's beneficiaries is calculated. The decedent's final return and the decedent's right to income at death are discussed in chapter 2.

Revocable trusts are sometimes created to achieve certain estate, financial, and management objectives.²⁹ In recent years, the principal use of revocable trusts has been to avoid the so-called probate process by holding property during the grantor's lifetime pursuant to the terms of a revocable trust and then at the grantor's death the property passes in accordance with the trust's terms rather than pursuant to the grantor's will.³⁰ Other reasons for creating a revocable trust include greater confidentiality than is possible by owning assets directly and at death disposing of them by will, providing an arrangement for property management (especially during a time of legal incapacity of the grantor), and avoiding delays in starting and completing the administration process to transfer ownership of property after a grantor's death.³¹ Revocable trusts are discussed in chapter 9.

In 1981, the Internal Revenue Service began an audit program in its North Atlantic region for audits of U.S. fiduciary income tax returns (Form 1041). The audit issues considered by this program are outlined in chapter 10.

In two Revenue Rulings,³² the Service concluded that land trusts that hold title to real estate and will transfer title at the direction of the true owners are not trusts. In those situations, the trustee is agent to hold title and transfer title. Revenue Ruling 92-105 concerned an Illinois land trust, and Revenue Ruling 2013-14 concerned a Mexican land trust. In Revenue Ruling 2004-86, however, the Service concluded that a Delaware statutory trust, as described in the ruling, is an investment trust that is classified as a trust for federal tax purposes.³³ For a discussion of when a trust may be classified as an association under the check-the-box regulations, see section 7:3, *infra*, Trusts Taxable As Corporations.

29. See generally A. James Casner, *Estate Planning—Avoidance of Probate*, 60 COLUM. L. REV. 108 (1961).

30. Frederick R. Keydel, "Funding" the Revocable Trust—Pros, Cons and Caveats, ACTEC NOTES Fall 1988, Vol. 14-98; *How to Take Title to Trust Property Including a Simple Way to Convert Joint Property into Revocable Trust Property*, 13 ACTEC NOTES 230 (Spring 1988).

31. See generally R. Covey, *Revocable Trusts*, PRAC. DRAFTING, July 1993, at 3244.

32. Rev. Rul. 92-105, 1992-2 C.B. 204; Rev. Rul. 2013-14, 2013-26 I.R.B. 1267.

33. Rev. Rul. 2004-86, 2004-2 C.B. 191.

