GRANTOR VS. NON-GRANTOR TRUSTS

July 23, 2021

During tax season, one of the most common questions we hear is: "what is the difference between a grantor and a non-grantor trust?"

1. What is the difference?

A grantor trust allows the grantor (the trust maker) to maintain some level of control over the assets in the trust. Because of this control, the grantor is considered the "owner" of the trust and any trust income, loss, or deduction is included on the grantor's individual tax return. In effect, the Grantor is paying the taxes for the trust. Grantor trusts may use the grantor's individual Social Security Number to report the activity directly on his or her Form 1040 and avoid having to file a separate tax return. A grantor trust is automatically converted to a non-grantor trust upon the death of the grantor.

A non-grantor trust is considered an entirely separate tax entity. As a result, non-grantor trusts pay their own taxes and are eligible for certain deductions that may not be allowed on an individual tax return. Less flexibility for the grantor of a non-grantor trust can limit the grantor's ability to make changes to the trust in the future. Additionally, tax brackets for trust income are steep. The analysis of the grantor's tax bracket versus the non-grantor trust tax bracket is important in determining whether to opt for the grantor or non-grantor tax structure when such a choice is available.

2. What kind of powers does a grantor maintain with a grantor trust?

Any trust will be treated as a grantor trust if the grantor retains certain powers. The powers are outlined in the Internal Revenue Code §§ 673 - 677. For simplicity's sake, some of the provisions that trigger grantor status can be defined as followed:

- The trust assets will revert back to the grantor after a certain time period or occurrence;
- The grantor controls how the trust assets are distributed without approval;
- The grantor can access the trust assets for his or her own benefit;
- The grantor can take assets out of the trust and retitle the assets in the grantor's own name; or
- The grantor can allocate trust income to himself/herself or the grantor's spouse.

By incorporating any of these features, the Grantor can assume responsibility for the trust's tax burden. The trust assets can compound faster without the drag of the trust incurring additional income tax liabilities. This increases the amount intended for future beneficiary support and acts as a powerful estate planning tool.

3. Why does it matter?

Recently, we worked with a client who asked about the tax liability relating to his grantor trust. Because it was a grantor trust, any income earned by the trust was reported on the grantor's tax return. By paying the taxes on trust income, the client allowed the trust assets to grow outside of his estate without any depletion normally caused by an annual tax bill. We explained to the client that, by paying the taxes for the grantor trust, the grantor in effect made an additional transfer to the beneficiaries that avoided estate and gift taxes. The grantor's payment of

---

About the author:

Abigail Jansen is a rising 3rd year student at the University of Georgia School of Law and legal intern at Pendleton Square Trust Company, LLC, a provider of trustee and estate administration services. Nothing in this article should be construed as providing legal or tax advice regarding your specific situation.