

Grantor Trusts Plus! (Again?!)

presented by
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NORMAL RULE FOR TRUSTS

- “Normal” rule for trusts – the tax consequences “*follow the money*”:
 - Income retained in the trust is taxed to the trust.
 - Income that the trust distributes to trust beneficiaries is taxed to them.

GRANTOR TRUST: RULE BREAKER

- When the grantor trust rules are triggered, the normal “follow the money” rule is not followed.

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TOO MANY STRINGS ATTACHED

- The grantor trust rules apply when the person that created the trust (i.e. the “*settlor*” or “*grantor*”) or some other person retains too many “strings” with respect to the trust assets:
 - an ongoing interest in the trust assets; OR
 - a power over the trust assets.
- If the grantor trust rules apply, the person who retained “too many strings” over the trust assets will be treated as owning the trust assets and taxed on the trust’s income.

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REVOCABLE v. IRREVOCABLE

- A trust that is *revocable* will always be a “grantor trust” for tax purposes.
- However, in referring to a “grantor trust,” practitioners typically mean a trust is *irrevocable* and therefore fully respected for state law purposes but whose existence is disregarded solely for federal income tax purposes.

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HOW IT STARTED

- The Grantor Trust rules were developed many years ago in order to thwart taxpayers’ use of trusts to shift income into lower tax brackets.
- When the Grantor Trust rules were first developed, tax rates were higher, there were more tax brackets, and trust income tax rates graduated at the same rate as individual income tax rates.
- So it made sense at that time for wealthy grantors to fund trusts that benefitted their offspring solely for the purpose of utilizing the trust’s lower income tax brackets.

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BUT NOW ... Trust tax rates graduate more quickly

- As part of the Tax Reform Act of 1986, the tax rates applicable to trusts were completely revised.
- Under the law today, the trust income tax rates graduate much more *quickly* than individual income tax rates.
- In 2025, the federal government taxes trust income at four levels :
- \$0 – \$3,150: 10%
- \$3,150 – \$11,450: 24%
- \$11,450 – \$15,650: 35%
- \$15,650 + : 37%

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Compare to Personal Income Tax Rates

Tax rate	Single	Married filing jointly	Head of household	Trusts
10%	\$0 to \$11,600	\$0 to \$23,200	\$0 to \$16,550	\$0 to \$3,150
12%	\$11,601 to \$47,150	\$23,201 to \$94,300	\$16,551 to \$63,100	
22%	\$47,151 to \$100,525	\$94,301 to \$201,050	\$63,101 to \$100,500	
24%	\$100,526 to \$191,950	\$201,051 to \$383,900	\$100,501 to \$191,950	\$3,150 to \$11,450
32%	\$191,951 to \$243,725	\$383,901 to \$487,450	\$191,951 to \$243,700	
35%	\$243,726 to \$609,350	\$487,451 to \$731,200	\$243,701 to \$609,350	\$11,450 to \$15,560
37%	\$609,351 or more	\$731,201 or more	\$609,351 or more	\$15,650 or more

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- For that reason, it is harder, but still possible, to shift income to lower tax brackets.
- But the grantor trust rules nevertheless remain part of the tax code
- The existence of grantor trust tax rules can still be advantageous

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APPLICATIONS – HOW GRANTOR TRUSTS CAN BE USEFUL:

- Asset protection
- Gift planning
- Tax planning

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WHO IS THE “GRANTOR”?

- The “grantor” is the person who provides the *funds* or other property that become the trust corpus.
- The “grantor” is not necessarily the person *identified* as the grantor in the trust agreement

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MULTIPLE GRANTORS

- It is possible for a trust to have more than one grantor.
- If more than one person funds the trust, then each of those persons will be treated as grantors in proportion to the value they contributed.

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TYPES OF GRANTOR TRUSTS

- **Type #1: “Grantor-Owned” Trusts** – The *grantor* is the person who is the deemed owner and is therefore taxed on the trust’s income. [IRC §§673-677.]
- **Type #2: “Beneficiary-Owned” Trusts** – A person *other* than the grantor is treated as the owner and is therefore taxed on the trust’s income. [IRC §678.]
 - We will return to Beneficiary-Owned Trusts later!

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OVERVIEW OF GRANTOR TRUST RULES (IRC §§671 THROUGH 678)

- **§671 (General Principle)** – If the grantor (or other person) is treated as owner, then the trust’s income, deductions, credits, etc. will be attributed to him/her.
- **§672 – Definitions / Terms**
- **§§673 through 677 (Specific Powers/Interests)** – determine when the *grantor* will be treated as owning the trust assets.
- **§678 (Specific Powers/Interests)** – determine when persons *other* than the grantor will be treated as owning the trust assets.

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DEFINITIONS (§672)

- “Adverse Party”
- “Non-Adverse Party”
- “Related” or “Subordinate”

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“ADVERSE PARTY”

An “Adverse Party” = any person that has a substantial beneficial interest in the trust that could be adversely affected by the exercise (or non-exercise) of a power that the grantor (or other person) has over the trust.

- **Example:** A person who has no interest in the trust principal or income is not an adverse party.
- **Example:** A person who has the potential to receive income or principal from the trust, and would be affected by a distribution, is an adverse party.
- A “Non-adverse Party” = any person that is not an adverse party.

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SPECIFIC GRANTOR TRUST “TRIGGERS”

- Reversionary Interests (IRC §673)
- Power to Control Beneficial Enjoyment (IRC §674)
- Administrative Powers (IRC §675)
- Power to Revoke (IRC §676)
- Income for the Benefit of the Grantor (IRC §677)

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REVERSIONARY INTERESTS (IRC §673)

- Five Percent (5%) Rule – the Grantor will be treated as trust owner if:
 - The grantor (or spouse) retains a reversionary interest; and
 - If the value of the reversionary interest exceeds five percent (5%) of the value of the trust assets
- The value of the reversionary interest is determined at the trust’s inception.

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REVERSIONARY INTERESTS (*continued*)

- How to Apply the 5% Rule? -- Apply time “*value of money*” principles:
 - Determine the applicable *interest rate* (based on monthly federal mid-term rate).
 - Go to the applicable IRS Table set forth in the Treasury Regulations. **Table B** (for a reversionary interest following a *term* interest) or in **Table S** (for a reversionary interest following a *lifetime* interest).
 - The IRS table will set forth a discount factor, based on the length of *time* (before the reversionary interest takes effect) and the *interest rate*.
 - Apply the discount rate to determine the value of the reversionary interest.

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POWER TO CONTROL BENEFICIAL ENJOYMENT (IRC §674)

- **General Rule** – A grantor will be treated as owning trust assets if the grantor (or a non-adverse party) has the power to affect the beneficial *enjoyment* of the trust *assets* or *income*, without having to obtain the approval of an adverse party. [§674(a).]

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POWER TO CONTROL BENEFICIAL ENJOYMENT (continued)

EXCEPTIONS

- There are several *exceptions* to the general rule.
- Under these exceptions, certain persons are permitted to exercise powers over the beneficial enjoyment of the trust assets without causing the grantor to be treated as the owning the trust assets.

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POWER TO CONTROL BENEFICIAL ENJOYMENT (continued)

2 CATEGORIES OF EXCEPTIONS:

- Powers that are exempt (from the grantor trust rules) without regard to who holds those powers (i.e., anybody can hold the powers); and
- Powers that are exempt (from the grantor trust rules) only if they are held by an “Independent” Trustee.”

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Any Portion of the Trust

- Income or Principal Interest
- Fractional or Pecuniary Interest
- Specific Asset Allocation

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POWER TO CONTROL BENEFICIAL ENJOYMENT (continued)

POWERS THAT ARE EXEMPT WITHOUT REGARD TO WHO THE
HOLDER IS:

- Power to Apply Income to Support a Dependent
- Power to Allocate Income Among Charitable Beneficiaries
- Power to Distribute Corpus Limited by a Standard
- Power to Withhold Income Temporarily
- Power to Withhold Income during the beneficiary's Minority or Disability

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POWER TO CONTROL BENEFICIAL ENJOYMENT (continued)

POWERS THAT ARE EXEMPT ONLY FOR AN INDEPENDENT TRUSTEE

- The power to *sprinkle income* among specified beneficiaries
- The power to *accumulate income* for future distribution to beneficiaries (without having to ultimately pay the income over to the beneficiaries from whom it was withheld)
- The power to *invade corpus* for the benefit of specified beneficiaries (including persons who are not income beneficiaries)

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ADMINISTRATIVE POWERS (IRC §675)

- General Rule: A grantor will be treated as the owner of a trust if he (or she) possesses certain administrative powers which are exercisable for the grantor's *own benefit* rather than for the beneficiaries.

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ADMINISTRATIVE POWERS (continued)

PROHIBITED POWERS:

- The power to deal with trust property for *less than adequate consideration*
- The power to borrow from the trust *without adequate interest or security*
- Powers that may be exercised in a *non-fiduciary* capacity
 - Power to *vote stock* of a corporation in which the grantor has voting control;
 - Power to *control investment* of trust funds if the trust funds include stock of a corporation over which the grantor has significant voting control; OR
 - Power to *reacquire corpus* by substituting property of *equivalent* value.

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THE POWER TO REVOKE (IRC §676)

- General Rule: The grantor will be treated as owning any part of a trust over which the grantor (or a *non-adverse* party) holds the power to re-vest title to trust assets in the grantor.

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THE POWER TO REVOKE (*continued*)

- **NOTE**: The grantor will be treated as the trust owner even if the power of revocation is held by a person *other than the grantor unless* that person's interest is adverse to that of the grantor.

Exception:

- If the power to revoke is *held* by an adverse party (OR if it the *approval* of an adverse party is required in order to exercise the power), then the power will *not* cause the grantor to be treated as owning the trust assets.

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INCOME FOR THE BENEFIT OF THE GRANTOR (IRC §677)

- **General Rule**: The grantor will be treated as owning a trust if the trust income is or may, at the discretion of the grantor (or a non-adverse party) be:
 - distributed to the grantor or to the grantor's spouse; or
 - accumulated for future distribution to the grantor or the grantor's spouse.

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INCOME FOR THE BENEFIT OF THE GRANTOR (continued)

- **Exception:** The grantor will not be treated under §677 as trust owner if the grantor's (or the non-adverse party's) power to distribute income to the grantor (or the grantor's spouse) must be approved by an **adverse** party.

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Non-Grantor Owned Trusts



PERSONS OTHER THAN THE GRANTOR TREATED AS OWNER (IRC §678)

- **General Rule:** Under IRC §678, a person other than the grantor (such as, for example, a trust *beneficiary*) will be treated as owning the trust assets if that person has:
 - The right to unilaterally withdraw the trust corpus or income; or
 - Retained “grantor trust” – type powers (under IRC §§673-677) over trust assets after having released a power to withdraw trust corpus or income.

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PERSONS OTHER THAN THE GRANTOR TREATED AS OWNER (*continued*)

POWER TO WITHDRAW TRUST PRINCIPAL OR INCOME

- A person (ordinarily, a trust beneficiary) will be treated as owning any part of a trust over which he has the power (solely exercisable by himself) to withdraw the corpus or the income.
- Thus, a withdrawal power over principal or income will cause the beneficiary to be treated as the trust owner of the principal or income, respectively; even if the principal or income is paid to someone else.

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PERSONS OTHER THAN THE GRANTOR TREATED AS OWNER

POWER TO WITHDRAW TRUST PRINCIPAL OR INCOME

(Continued)

- The holder of the withdrawal power will only be treated as owner if he can exercise the withdrawal power **solely** by himself and without consent or approval of any other persons.
- So, for example, if a trust beneficiary owns a withdrawal power that can only be exercised with the consent of his spouse, children, or parents, etc., then the beneficiary will **not** be treated as owning the trust assets.

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PERSONS OTHER THAN THE GRANTOR TREATED AS OWNER (IRC §678)

PARTIALLY RELEASED WITHDRAWAL POWERS

- Even if a beneficiary no longer holds a withdrawal power, the beneficiary can still be treated as owning the trust assets if:
 - The beneficiary **previously** held and released a withdrawal power; and if,
 - After releasing the withdrawal power, the beneficiary still **retains** such control over the trust as would cause a grantor of the trust to be treated as the owner under one of the other grantor trust rules (§§673 – 677).

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PERSONS OTHER THAN THE GRANTOR TREATED AS OWNER (IRC §678)

PARTIALLY RELEASED WITHDRAWAL POWERS

(Continued)

- For example, a beneficiary who releases a power of withdrawal over trust assets will still be treated as owning the trust assets if, after the release:
 - The beneficiary has a reversionary interest that is worth more than 5% of the value of the trust assets (IRC §673); or
 - The beneficiary (or a non-adverse party) has the power to control the beneficial enjoyment of trust assets (IRC §674); or
 - The beneficiary (or his spouse) has the power to deal with trust funds for less than full and adequate consideration or without adequate interest and security (IRC §675); or
 - The beneficiary or his spouse may receive income from the trust (IRC §677).

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2 TYPES of NON-GRANTOR OWNED TRUSTS

- **Beneficiary Defective Inheritor's Trust (BDIT)**
- **Beneficiary Deemed Owner Trust (BDOT)**

- In both cases, the beneficiary retains certain powers that causes tax attributes to be allocated to *the beneficiary*.
- BDITs and BDOTs are used to achieve different goals.

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BDIT

- The beneficiary has the power to withdraw all contributions (principal) to the Trust
- The trust is usually funded with only \$5,000 initially
- The withdrawal power lapses if not exercised within a specific period
- After this period lapses, the trust has other terms which satisfy the release of power requirement
- Primarily used for asset freezing / leveraged gifting

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BDIT Example

- Jimmy creates a trust that gives his daughter, Delaney, the right for sixty days, to withdraw a \$5000 contribution. After which, the right to withdraw lapses and the trust agreement provides no other rights to Delaney.
- Delaney is the owner of the trust income and principal earned during the sixty days, but not before or after.

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BDIT Example

- Jimmy creates a trust and grants Savanna, Sarah, and Cameron power to withdraw trust contributions in equal amounts within sixty days of the contribution. In the initial year, Jimmy contributes \$30,000. The trust provides that the Trustee can distribute to Savanna, Sarah, and Cameron for their best interest.
- How is income and principal taxed?

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BDIT Example, continued

- Not enough information.
- If Trustee is independent, but none of the beneficiaries have “grantor trust powers” =
 - Complex trust; except principal and income earned during the sixty days is owned equally by Savanna, Sarah, and Cameron.

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BDIT Example, continued

- If Trustee is Savannah’s spouse and no beneficiary has “grantor trust powers” =
 - Savannah is the owner of 1/3 of the income and principal
 - Sarah and Cameron own the income and principal earned during the 60 day withdraw period
 - The remainder of the trust is a complex trust

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BDIT Example, continued

- Same scenario, but the power to withdraw only lapses after sixty days to the extent of \$5000 or 5% of the trust property.
 - Savannah is still 1/3 owner of income and principal;
 - Sarah and Cameron each own 1/6 of the income and principal and
 - 1/3 of the trust is a complex trust.

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BDIT Example, continued

- Same scenario, but Sarah and Cameron have 671-677 powers.
 - Each Savanna, Sarah, and Cameron own 1/3 of the income and principal.

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BDOT

- The beneficiary has the power to withdraw all taxable income (including capital gains) of the Trust.
- The initial funding is typically not limited to \$5,000 because there is no principal access for the beneficiary.
- If the beneficiary fails to withdraw the taxable income in any year, the withdrawal power lapses partially or fully.
- BDOT's have significant tax planning opportunities and, in many cases, can provide the same asset protection.

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BDOT Example

- Carmon Miranda funds a trust at her death for her friend Louis L'Amour, with \$1mm of her investment account and names the trust as the beneficiary of her \$1mm IRA.
- The Trust grants Louis the right to withdraw the taxable income (including capital gains) from the trust each year.
- The trust is a “see through” trust so the IRA must pay out within ten years. The Trustee withdraws \$100,000 in year one.
- \$100,000 of taxable income is allocate to Louis regardless of whether he exercises his withdrawal power.
- After ten years, the trust has \$3mm of investment and all income was taxed at Louis' individual tax rate.

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Asset Protection Versus Income Tax Planning



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Asset Protection

- Keep assets in trust to prevent beneficiary access
- Maximizing asset protection can include NOT distributing income to beneficiaries

Income Tax Planning

- Best tax result = taxing trust income at the lowest possible rate
- Usually involves income TO the beneficiary, since trust rates are higher than individual tax rates

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Pennsylvania Spendthrift Statute

- A judgment creditor or assignee of the beneficiary may reach the beneficiary's interest by attachment of present or future distributions to or for the benefit of the beneficiary or other means to the extent the beneficiary's interest is not subject to a spendthrift provision.

20 Pa. C.S 7741.

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Pennsylvania Spendthrift Statute

- Creditors can reach assets subject to a power of withdrawal during and after the right has lapsed whether or not subject to a spendthrift provision.

– 20 Pa. C.S. 7748

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Pennsylvania Spendthrift Statute

- The withdrawal exception to the spendthrift provision does not apply to amounts that are equal to or less than the greater of:
 - \$5,000;
 - 5% of the aggregate value of assets out of which the withdrawal could be satisfied (this includes all assets of the trust, not just the assets subject to withdrawal); and
 - The annual exclusion for federal gift tax (\$19,000 – 2025).

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BDIT Example

- Frank Bama creates a trust for his girlfriend Trevor Kane and contributes \$5000. Frank retains no grantor trust powers. Trevor has the right to withdraw \$5,000 and 5% of the trust assets that lapses sixty days after the contribution, but Trevor possess ongoing grantor trust powers. Trevor is the owner of the income and principal because
- Trevor's trust buys a \$10mm company for a note payable. The note is paid by the profits of the company over time.
- The trust agreement contains a spendthrift clause, so the trust assets are protected from Trevor's creditors.

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BDOT Example

- Warren creates two testamentary trusts: one for each: Rudy Breno and Desdemona.
- Rudy's Trust gives him the ability to withdraw all taxable income. The right to withdraw will lapse to the extent of the greater of \$5000 and 5% of the trust balance each year.
- Desdemona's Trust requires the trustee to distribute all income to her.
- Warren dies and leaves real property (\$1,000,000), non-qualified investments (\$1,500,000) and Roth IRA (\$500,000) and Traditional IRA (\$1,000,000) to the trusts.

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BDOT Example, continued

- Each Trust has \$1,500,000 of trust principal comprised of \$750,000 of inherited traditional IRA and \$750,000 of other assets. In the first year each trust receives \$75,000 IRA distribution and earns \$25,000 of interest, dividends, and capital gains.
- Rudy is taxable on \$100,000 of income and gains. Rudy's trust has no taxable income.
- Desdemona is taxable on \$25,000 of income. Desdemona's trust is taxable on the \$75,000 IRA distribution. All of Desdemona's trust assets remain protected by her trust but is reduced by \$52,750 (the \$25,000 distributed and \$27,500 tax on the trust's income.)

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BDOT Example, continued

- Assuming Rudy is in the 25% tax bracket and exercises his withdrawal power to withdraw enough funds (\$25,000) to pay the income tax on the income he did not receive, the remaining \$75,000 remains in his trust. The amount that can lapse without being considered a taxable gift is \$76,250 (5% of the value of the trust assets: \$1,500,000 initial principal plus \$25,000 of income).
- Further, this amount is not considered an amount subject to withdraw under Pennsylvania's spendthrift statute, so it is protected from his creditors.

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Grantor Trust Tax Reporting



Overview

- There are THREE methods of tax reporting for Grantor Trusts
- The method will depend on the features of the Trust



Traditional Method

- The items of income, deduction, and credit attributable to the grantor are not reported on the trust's Form 1041.
- Instead, these items are shown on a separate attachment to Form 1041 and identifies the grantor as the owner of these items.

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First Alternative Method

- The trustee gives all “payors” the name and TIN of the grantor and the address of the trust.
- Unless the owner is also the trustee or co-trustee, the trustee must furnish the owner with a statement that:
 - Shows all items of income, deduction, and credit of the trust for the tax year.
 - For each item of income, identifies the payor.
 - Gives the owner the needed data to take these items into account when computing the owner's income and informs the owner that these items must be included in computing taxable income.

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First Alternative Method, continued

- Under this method there is no requirement to file any type of return with the IRS, but the trustee must get a Form W-9 from the owner.
- This method is only permitted where there is one single owner of the trust.
- The first alternative method is the most common manner of reporting for revocable trusts.

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Second Alternative Method

- The trustee must provide to all payors throughout the tax year the name, TIN, and address of the trust.
- The trustee must file the proper Forms 1099 with the IRS, reporting the income or gross proceeds paid to the trust during the tax year. These forms will indicate that the trust is the payor and the owner is the payee.

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Second Alternative Method, continued

- In addition, the trustee must file Form 1096, to provide a summary and transmittal of informational returns.
- Unless the owner is also the trustee or co-trustee, the trustee must furnish the owner with the same statement required under the first alternative method.
- This method is available where the trust either has a single owner or multiple owners

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Review of Reporting Methods

	Traditional	First Alternate	Second Alternate
Who Reports?	Grantor	Trustee	Trustee
TIN?	Grantor	Grantor	Trust
Trust Owners?	One Owner	One Owner	One or Multiple Owners
Additional Forms?	Attachment to 1041	W2 from Owner(s) + Statement	1099



No Longer A Grantor Trust?

- Upon the death of the owner, the trust (or portion of the trust) is no longer a grantor trust and may no longer be reported as a grantor trust.
- If the trust was owned entirely by the deceased owner, the trust must obtain a new TIN if the trust will continue.

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No Longer a Grantor Trust

- Traditional = the due date for filing the final Form 1041 for the trust as a grantor trust will be the same due date as the deceased owner's final tax return.
- First Alternative = the trustee is required to provide to all payors a new Form W-9 with the trust's new TIN.
- Second Alternative = the trustee must file Form 1096 for the tax year ending with the death of the owner and indicate that it is the final return.

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Thank You!

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