

Grantor and Nongrantor Trusts: Income Tax Rules, 2026 Developments, and Planning Strategies

Christopher Steele, J.D., LL.M. (Taxation)

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I. Introduction

Every irrevocable trust answers a threshold income tax question before any planning can begin: who pays the tax on the trust's income? Subpart E of Subchapter J (IRC Section 671 through Section 679) answers that question by asking whether the grantor, or in some cases a third party, has kept enough power or benefit to be treated as the owner of the trust property for income tax purposes. If so, the trust is a grantor trust and its income, deductions, and credits flow to the deemed owner.¹ If not, the trust is a separate taxpayer under Subparts A through D, taxed under a compressed rate schedule and a distribution regime built around distributable net income (DNI).

The choice between the two regimes is rarely neutral. Grantor trust status lets a client pay the trust's income tax with dollars that would otherwise be in the taxable estate, and it lets the client transact with the trust without recognizing gain. Nongrantor status creates a separate taxpayer that can claim its own deductions, exclusions, and state residency, but at the price of reaching the top federal bracket at only \$16,000 of taxable income in 2026.²

The One Big Beautiful Bill Act (OBBBA), enacted July 4, 2025, sharpened these trade-offs.³ It made the individual rate structure permanent, raised the basic exclusion amount to \$15 million, increased the state and local tax (SALT) deduction cap through 2029, expanded Section 1202, and replaced former Section 68 with a new limitation on itemized deductions that, on one reading, reaches the distribution deduction of every nongrantor trust. This paper reviews the core rules, the mechanics of nongrantor trust taxation, the 2026 developments, and the planning strategies that follow.

II. The Grantor Trust Rules

A. Who Is a Grantor

A grantor includes any person who creates a trust or who directly or indirectly makes a gratuitous transfer of property to a trust.⁴ A person who funds a trust for fair market value consideration is not a grantor as to that transfer, and a person who funds a trust indirectly (for example, through a third party acting as a nominal settlor) remains a grantor. A trust may itself be a grantor of another trust, with look-through rules that can treat the owner of the first trust as the grantor of the second.⁵

¹IRC § 671. All section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations under it, unless otherwise stated.

²Rev. Proc. 2025-32, § 4.01 (2026 rate table for estates and trusts under § 1(j)(2)(E)).

³Pub. L. No. 119-21 (July 4, 2025).

⁴Treas. Reg. § 1.671-2(e)(1).

⁵Treas. Reg. § 1.671-2(e)(5).

B. The Operative Triggers

Sections 673 through 677 describe the powers and interests that cause the grantor to be treated as owner. Section 672 supplies the definitions that make them work: an adverse party is a person with a substantial beneficial interest that would be adversely affected by the exercise or nonexercise of the power;⁶ a related or subordinate party includes the grantor's spouse (if living with the grantor), parents, issue, siblings, and employees, and certain employees of entities the grantor controls, and such a party is presumed subservient to the grantor unless shown otherwise.⁷ Under Section 672(e), the grantor is treated as holding any power or interest held by a person who was the grantor's spouse when the power or interest was created, or who became the spouse afterward, for periods after the marriage.

- **Reversionary interests (Section 673).** The grantor is treated as owner of any portion in which the grantor holds a reversionary interest in corpus or income whose value at inception exceeds 5% of that portion. A reversion that takes effect only on the death before age 21 of a lineal descendant beneficiary who holds all present interests is disregarded.
- **Power to control beneficial enjoyment (Section 674).** The general rule treats the grantor as owner when the grantor, a nonadverse party, or both can control beneficial enjoyment without the consent of an adverse party. The exceptions do most of the work: Section 674(b) protects eight categories of powers regardless of who holds them (including powers exercisable only by will, other than certain powers over accumulated income, and powers to distribute corpus limited by a reasonably definite standard); Section 674(c) protects broad sprinkle powers held by independent trustees, no more than half of whom are related or subordinate; and Section 674(d) protects powers to distribute income limited by a reasonably definite external standard held by trustees other than the grantor or spouse.
- **Administrative powers (Section 675).** Grantor status arises if the grantor or a nonadverse party can deal with trust property for less than adequate consideration (Section 675(1)); if the grantor can borrow without adequate interest or security, except from a trustee other than the grantor under a general lending power (Section 675(2)); if the grantor has actually borrowed trust funds and has not completely repaid the loan and interest before the beginning of the taxable year, unless the loan was adequately secured and bore adequate interest and was made by a trustee other than the grantor or a related or subordinate trustee (Section 675(3)); or if any person holds, in a nonfiduciary capacity and without the consent of a fiduciary, a power to vote closely held stock, control investments in closely held entities, or reacquire trust corpus by substituting property of equivalent value (Section 675(4)).
- **Power to revoke (Section 676).** A power in the grantor, a nonadverse party, or both to revest title in the grantor makes the grantor the owner. This is the rule that governs every revocable living trust.
- **Income for the grantor's benefit (Section 677).** The grantor is treated as owner of any portion whose income is, or in the discretion of the grantor or a nonadverse party may be, distributed to the grantor or the grantor's spouse, accumulated for them, or applied to pay premiums on insurance on the life of the grantor or spouse (other than policies irrevocably payable to charity). Section 677(b) excludes income that may be applied to support a beneficiary whom the grantor is legally obligated to support, except to the extent it is so applied.

⁶IRC § 672(a).

⁷IRC § 672(c).

- **Foreign trusts with U.S. beneficiaries** (Section 679). A U.S. person who transfers property to a foreign trust is treated as owner of the portion attributable to the transfer for any year in which the trust has a U.S. beneficiary, subject to statutory exceptions.

Two drafting points recur. First, because the Code treats a spouse's powers and interests as the grantor's, a spousal lifetime access trust (SLAT) is ordinarily a grantor trust under Section 677(a) for as long as the marriage lasts. Second, former Section 682, which shifted income from a grantor to a former spouse after divorce, was repealed for divorce or separation instruments executed after 2018.⁸ Under current law a divorced grantor can remain taxable on income from a SLAT that benefits the former spouse, which is a reason to include a mechanism to turn off grantor status or to provide for reimbursement.

C. Section 678: Third-Party Owners

Section 678(a) treats a person other than the grantor as owner of any portion over which that person has a power, exercisable solely by himself or herself, to vest corpus or income in himself or herself, or has partially released or modified such a power while retaining control that would make a grantor the owner under Sections 671 through 677. Section 678(b) gives priority to the grantor: if the grantor is treated as owner under Sections 671 through 677 with respect to income, Section 678(a) does not apply to a power over that income.⁹ These rules support the treatment of Crummey withdrawal powers, beneficiary defective inheritor's trusts (BDITs), and beneficiary deemed owner trusts (BDOTs). Because the application of Section 678 to lapsed powers and to post-lapse periods remains the subject of genuine practitioner disagreement, planners should treat those structures as a separate topic and document their analysis carefully.

D. Reporting

A grantor trust generally reports under one of the methods in Treas. Reg. § 1.671-4. A trust wholly owned by one grantor may furnish the grantor's taxpayer identification number to payors and avoid filing a Form 1041, or may file a Form 1041 with an attached grantor statement, or may use the Form 1099 method.¹⁰ The grantor then reports all items on his or her own return. A trust that is partly grantor and partly nongrantor must allocate items between the portions.

III. Consequences of Grantor Trust Status

A. Transactions Between Grantor and Trust

In Rev. Rul. 85-13, the Service ruled that a grantor who is treated as owner of a trust is treated as owner of its assets for federal income tax purposes, so that a transfer between the grantor and the trust is not a sale or exchange.¹¹ The ruling is the foundation of the installment sale to an intentionally defective grantor trust (IDGT): the grantor sells appreciated assets to the trust for a note, recognizes no gain, and receives interest that is not income to the grantor. The same ruling supports substitution of assets under a Section 675(4) swap power without gain recognition.

⁸Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11051(b)(1)(B) (2017); see id. § 11051(c) (effective date).

⁹IRC § 678(b).

¹⁰Treas. Reg. § 1.671-4(a), (b).

¹¹Rev. Rul. 85-13, 1985-1 C.B. 184.

B. Payment of the Trust's Income Tax

Rev. Rul. 2004-64 addresses three situations.¹² When the grantor pays income tax on trust income as required by law, the payment is not a gift to the trust beneficiaries, because the grantor is discharging his or her own liability. When the governing instrument or applicable state law requires the trustee to reimburse the grantor, the grantor is treated as having retained the right to have trust property applied to his or her legal obligation, and the trust is included in the grantor's gross estate under Section 2036. When the instrument gives an independent trustee discretion to reimburse, the discretion alone does not cause inclusion, provided there is no understanding or pre-arrangement regarding its exercise and state law does not allow the grantor's creditors to reach the trust. The practical result is the "tax burn": each year the grantor pays tax on income the trust keeps, the taxable estate shrinks without any use of exemption.

C. Swap Powers and Estate Tax

In Rev. Rul. 2008-22, the Service concluded that a grantor's nonfiduciary power to reacquire trust corpus by substituting property of equivalent value does not by itself cause inclusion under Section 2036 or Section 2038, provided the trustee has a fiduciary obligation to ensure that the substituted property is of equivalent value and the power cannot be exercised to shift benefits among beneficiaries.¹³ A companion ruling reached a similar conclusion for life insurance under Section 2042.¹⁴

D. No Basis Adjustment at Death Without Estate Inclusion

Rev. Rul. 2023-2, released March 29, 2023, concludes that assets of an irrevocable grantor trust that are not included in the grantor's gross estate do not receive a basis adjustment under Section 1014 when the grantor dies, because the assets were not acquired or passed from a decedent within any category of Section 1014(b).¹⁵ The ruling reframes the long-term economics of an IDGT: estate tax savings on appreciation come at the cost of carryover basis. The swap power becomes a basis management tool. A grantor can reacquire low-basis assets before death, replacing them with cash or high-basis assets, so that the low-basis assets are in the gross estate and receive a basis adjustment.

E. Turning Grantor Status Off, and Death

The termination of grantor trust status during the grantor's life is treated as a transfer of the trust's assets from the grantor to the trust. If the trust holds property subject to liabilities in excess of basis, the grantor recognizes gain.¹⁶ This matters most when an IDGT still owes the grantor on a note or holds leveraged partnership interests. By contrast, the Chief Counsel's office has concluded that converting a nongrantor trust into a grantor trust is not a transfer for income tax purposes, and it observed that the rule of *Madorin* and Rev. Rul. 77-402 addresses inter vivos lapses and not the termination of grantor status caused by the owner's death.¹⁷ The income tax treatment of an unpaid installment note at the grantor's death remains unsettled, and practitioners disagree about it. Planning to retire or restructure notes during life avoids the question.

¹²Rev. Rul. 2004-64, 2004-2 C.B. 7.

¹³Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

¹⁴Rev. Rul. 2011-28, 2011-49 I.R.B. 830.

¹⁵Rev. Rul. 2023-2 (released Mar. 29, 2023).

¹⁶Treas. Reg. § 1.1001-2(c), Ex. 5; Rev. Rul. 77-402, 1977-2 C.B. 222; *Madorin v. Commissioner*, 84 T.C. 667 (1985).

¹⁷CCA 200923024 (Dec. 31, 2008); see also PLR 201730012 (conversion of nongrantor trust to grantor trust not a transfer under any income tax provision). Chief Counsel advice and letter rulings may not be cited as precedent. IRC § 6110(k)(3).

IV. Taxation of Nongrantor Trusts

A. The Trust as a Separate Taxpayer

A nongrantor trust computes taxable income in the same manner as an individual, except as Subchapter J provides otherwise.¹⁸ In place of a standard deduction, it receives a small exemption: \$300 for a trust required to distribute all income currently and \$100 for other trusts, with a larger inflation-adjusted amount for a qualified disability trust.¹⁹ Costs that are paid or incurred in connection with the administration of the trust and would not have been incurred if the property were not held in trust are deductible in arriving at adjusted gross income.²⁰ Final regulations confirm that Section 67(e) deductions, the Section 642(b) exemption, and the Sections 651 and 661 distribution deductions are not miscellaneous itemized deductions.²¹

B. The Compressed Rate Schedule

The rate schedule for estates and trusts reaches 37% at a fraction of the individual thresholds. Table 1 shows the 2026 schedule.²²

Table 1. 2026 federal ordinary income tax brackets, estates and trusts

Taxable income over	But not over	Marginal rate
\$0	\$3,300	10%
\$3,300	\$11,700	24%
\$11,700	\$16,000	35%
\$16,000	No limit	37%

By comparison, the 37% bracket begins above \$640,600 for a single individual and above \$768,700 for married individuals filing jointly.²³ For long-term capital gain and qualified dividends, a trust's 0% rate ends at \$3,300 and its 15% rate ends at \$16,250.²⁴ The 3.8% net investment income tax (NIIT) applies to a trust on the lesser of its undistributed net investment income or the excess of its adjusted gross income over the dollar amount at which the highest bracket begins, which is \$16,000 for 2026.²⁵

Table 2. 2026 federal ordinary income tax on \$100,000 of taxable income (illustrative; computed by the author from the Rev. Proc. 2025-32 tables)

Taxpayer	Regular tax	Top marginal rate reached
Nongrantor trust	\$34,931	37%
Single individual	\$16,712	22%

¹⁸IRC § 641(b).

¹⁹IRC § 642(b).

²⁰IRC § 67(e); *Knight v. Commissioner*, 552 U.S. 181 (2008); Treas. Reg. § 1.67-4.

²¹T.D. 9918, 85 Fed. Reg. 66,219 (Oct. 19, 2020); Treas. Reg. § 1.67-4(a)(1).

²²Rev. Proc. 2025-32, § 4.01.

²³Rev. Proc. 2025-32, § 4.01; IRS, IRS releases tax inflation adjustments for tax year 2026, including amendments from the One, Big, Beautiful Bill (Oct. 9, 2025).

²⁴Rev. Proc. 2025-32, § 4.03.

²⁵IRC § 1411(a)(2).

Taxpayer	Regular tax	Top marginal rate reached
Married filing jointly	\$11,504	12%

If the trust's \$100,000 were entirely undistributed net investment income, the NIIT would add \$3,192 (3.8% of the \$84,000 excess over \$16,000), while the individuals in Table 2 would owe none because their income is below the individual NIIT thresholds. The table explains why income that a trust accumulates is usually taxed at the highest available rate.

C. Distributable Net Income and the Distribution Deduction

DNI does three jobs. It caps the trust's distribution deduction, it caps the amount beneficiaries must include in income, and it carries the character of the trust's income (tax-exempt interest, qualified dividends, ordinary income) out to the beneficiaries.²⁶ DNI starts with taxable income, adds back the distribution deduction and the personal exemption, adds tax-exempt interest net of allocable expenses, and generally excludes capital gains allocated to corpus.

Capital gains are included in DNI only if they are allocated to income under the governing instrument or local law, or allocated to corpus but consistently treated as part of a distribution, actually distributed, or used to determine the amount distributed.²⁷ Because most instruments allocate gains to principal, a trust that sells a concentrated position will often pay tax on the gain at the trust level even if it makes large distributions, unless the instrument or a consistent practice brings gains into DNI. Drafting that grants the trustee discretion to allocate gains to income, and a documented exercise of that discretion, can move the gain to lower-bracket beneficiaries.

A simple trust (one that must distribute all income currently, makes no charitable distributions, and does not distribute corpus in the year) deducts the income required to be distributed, up to DNI, and its beneficiaries include that amount.²⁸ A complex trust deducts amounts required to be distributed and amounts properly paid, credited, or required to be distributed, up to DNI.²⁹ Its beneficiaries include distributions under a two-tier system: first-tier beneficiaries (those entitled to mandatory income) absorb DNI first, and second-tier beneficiaries share what remains in proportion to their distributions.³⁰ The separate share rule treats substantially separate and independent shares of different beneficiaries as separate trusts for DNI purposes, so that one beneficiary's distribution does not carry out income earned for another.³¹

D. Timing and In-Kind Distributions

The trustee of a complex trust may elect to treat a distribution made within the first 65 days of the taxable year as made on the last day of the preceding year.³² The election is the most useful tool a fiduciary has for fixing the tax result after the books close: it lets the trustee measure DNI and the beneficiaries' brackets before deciding how much to distribute. For distributions in kind, Section 643(e) generally limits the distribution deduction and the beneficiary's inclusion to the lesser of basis or fair market value, unless the

²⁶IRC § 643(a); IRC §§ 652(b), 662(b).

²⁷Treas. Reg. § 1.643(a)-3(b).

²⁸IRC §§ 651, 652.

²⁹IRC § 661(a).

³⁰IRC § 662(a).

³¹IRC § 663(c); Treas. Reg. § 1.663(c)-1.

³²IRC § 663(b); Treas. Reg. § 1.663(b)-2 (election made on the return, due date including extensions).

trustee elects to recognize gain as if the property had been sold. The election applies to all in-kind distributions for the year.³³

E. Passive Activity Rules and Material Participation

Trusts are subject to Section 469, and whether a trust materially participates affects both the passive loss limits and the NIIT. In *Frank Aragona Trust v. Commissioner*, the Tax Court held that a trust can qualify for the real estate professional exception of Section 469(c)(7) and that the work of individual trustees, including work performed as employees of an entity the trust owned, counts as personal services performed by the trust.³⁴ An earlier district court decision looked more broadly to the activities of the trust's agents and employees.³⁵ The Service has taken a narrower view in rulings, generally looking only to the fiduciary's own activities in that capacity. Trusts that hold operating businesses should document fiduciary involvement and consider naming active family members as special trustees for business matters.

F. Multiple Trusts

Two or more trusts are treated as one trust if they have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a principal purpose of the trusts is the avoidance of income tax.³⁶ Section 643(f) applies for purposes of Subchapter J. Its reach to provisions outside Subchapter J, such as the Section 1202 exclusion, is debated. Distinct beneficiaries, distinct terms, and documented non-tax purposes are the ordinary defenses.

V. 2026 Developments

A. OBBBA's Permanent Framework

OBBBA made the individual rate structure permanent, so the seven-rate system and the trust rate schedule in Table 1 no longer carry a scheduled 2026 sunset. It set the basic exclusion amount at \$15 million per person for 2026, indexed after that. For most clients below twice that amount, the estate tax question has receded and the income tax question, including basis at death, has moved to the front. That shift favors grantor trusts with swap powers, powers to turn off grantor status, and in appropriate cases the ability to cause estate inclusion deliberately to obtain a basis adjustment.

B. New Section 68 and the Distribution Deduction

For taxable years beginning after December 31, 2025, OBBBA replaced the suspended Pease limitation with a new Section 68 that reduces a taxpayer's itemized deductions by 2/37 of the lesser of (i) those deductions or (ii) the amount by which taxable income, determined without regard to itemized deductions, exceeds the threshold for the 37% bracket. OBBBA also repealed former Section 68(e), which had said that Section 68 did not apply to any estate or trust.³⁷

The staff of the Joint Committee on Taxation, in its General Explanation of the legislation, reasoned in a footnote that Section 68 applies to trusts through Section 641(b); that Section 63(d) defines itemized deductions as all deductions other than those allowable in arriving at adjusted gross income and the items

³³IRC § 643(e)(3).

³⁴*Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).

³⁵*Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

³⁶IRC § 643(f). Spouses are treated as one person for this purpose.

³⁷IRC § 68, as amended by Pub. L. No. 119-21, § 70111. See Ed Zollars, *The Application of New Section 68 to Trusts and Estates: Analyzing JCT Footnote 102 and Unresolved Ambiguities*, Current Federal Tax Developments (June 6, 2026).

listed in Section 63(b); and that the Section 642(b) exemption and the Sections 651 and 661 distribution deductions are therefore itemized deductions for Section 68 purposes. It treated the statement in Treas. Reg. § 1.67-4(a)(1)(ii) that these deductions are not itemized deductions as limited to Section 67.³⁸ The consequence is striking. A trust that distributes all of its DNI could lose part of its distribution deduction and pay tax on income its beneficiaries also report.

A simple illustration follows commentary on the issue. A trust with \$116,000 of ordinary income distributes all of it. The excess over the \$16,000 threshold is \$100,000, and 2/37 of that is \$5,405. On the JCT reading, the distribution deduction falls to \$110,595, and the trust owes tax at 37% on \$5,405 (about \$2,000) while the beneficiary reports the full \$116,000.³⁹

The professional bodies have pushed back. The New York State Bar Association Tax Section described the double taxation and the circularity the reading creates in computing DNI.⁴⁰ The American College of Trust and Estate Counsel recommended a technical amendment limiting Section 68 to deductions computed in the same manner as for individuals and excepting the Section 642(c) charitable deduction.⁴¹ The AICPA asked Treasury and the IRS to provide that the limitation does not apply to the Sections 642(b), 651, and 661 deductions or to administration expenses, and to confine it to income that is not taxed at preferential rates.⁴² As of this writing, the author has not located IRS guidance or an enacted technical correction resolving the issue, and the General Explanation is not binding authority. Fiduciaries should model 2026 estimated tax payments under both readings and decide, with the return preparer, what position to take and whether disclosure is appropriate.

C. The SALT Cap and Nongrantor Trusts

OBBBA raised the Section 164(b) limitation on state and local tax deductions to \$40,000 for 2025 and \$40,400 for 2026, increasing by 1% annually through 2029, with a phase-down of 30% of modified adjusted gross income above \$505,000 for 2026 (never below \$10,000). The limitation returns to \$10,000 in 2030.⁴³ Because each nongrantor trust is a separate taxpayer, each can claim its own limitation, which has renewed interest in funding separate nongrantor trusts with real estate or pass-through interests that generate state and local tax. The strategy runs directly into Section 643(f), into Treas. Reg. § 1.643(f)-1 (the multiple-trust regulation finalized with the Section 199A regulations), and into the short window before 2030. For owners of pass-through businesses, a state pass-through entity tax election will often accomplish more with less complexity.⁴⁴

D. Section 1202 After OBBBA

For qualified small business stock issued after July 4, 2025, OBBBA raised the per-issuer cap to the greater of \$15 million (indexed) or 10 times basis, raised the gross asset test to \$75 million, and added partial

³⁸Staff of the Joint Committee on Taxation, General Explanation of Public Law 119-21, Part 11 (Limitation on Tax Benefit of Itemized Deductions), n.102, as described in Zollars, *supra*.

³⁹See Patricia Giarratano, Tax Law Changes in OBBBA May Require New Planning Strategies for Non-Grantor Trusts, Estates and Their Beneficiaries (2026); the tax figure is computed by the author.

⁴⁰N.Y. State Bar Ass'n Tax Section, Report No. 1517 (Dec. 1, 2025).

⁴¹ACTEC, Comments (Nov. 10, 2025).

⁴²AICPA Tax Executive Committee, comments on guidance for the limitation on itemized deductions (2025). See also Justin T. Miller, The Fate of a Trust or Estate Under New Section 68, Tax Notes Federal (June 2026).

⁴³IRC § 164(b)(6), (7), as amended by Pub. L. No. 119-21, § 70120.

⁴⁴See Notice 2020-75, 2020-49 I.R.B. 1453 (entity-level state taxes deductible by the partnership or S corporation); T.D. 9847, 84 Fed. Reg. 2952 (Feb. 8, 2019) (adopting Treas. Reg. § 1.643(f)-1).

exclusions of 50% after three years and 75% after four years, with a full exclusion after five.⁴⁵ Stock transferred by gift keeps its character and the donor's holding period.⁴⁶ Gifts to separate nongrantor trusts, each a separate taxpayer with its own cap, remain the most common stacking technique. Press reports in 2026 attributed to Treasury officials' skepticism of trust stacking, but the author has seen those remarks only secondhand, and no guidance had been issued as of this writing.⁴⁷ Section 1202(k) authorizes regulations to prevent avoidance of the purposes of the section, which is a more natural foundation for any future limit than Section 643(f).

E. The IRS No-Rule List

For 2026, the Service added to its no-rule list whether the distribution of property from one irrevocable trust to another (a decanting), or a modification of an irrevocable trust that results in a change in beneficial interests, is a taxable distribution or gift.⁴⁸ Planners who expected to decant or modify an older grantor trust to add a tax reimbursement clause or to change its grantor trust status can no longer obtain a letter ruling on those questions.

F. Modifications That Add Reimbursement Clauses

In CCA 202352018, the Chief Counsel's office concluded that a judicial modification of a grantor trust, with the beneficiaries' consent, to add a discretionary power in the trustee to reimburse the grantor for income tax is a taxable gift by the beneficiaries, because they relinquish part of their interests in favor of the grantor. The memorandum added that the result would be the same if the modification occurred under a statute that gives beneficiaries notice and a right to object and they do not object.⁴⁹ The memorandum distinguished Rev. Rul. 2004-64 on the ground that the reimbursement authority there was in the original instrument. The practical lesson is to include a reimbursement clause, and a power to toggle grantor status, in the original instrument rather than relying on later modification.

VI. Planning Strategies

A. Using Grantor Trust Status Deliberately

- **Installment sales to IDGTs.** The sale freezes the value of the transferred asset for estate tax purposes, and Rev. Rul. 85-13 prevents gain recognition. The grantor's payment of tax on trust income adds a further, gift-free transfer each year. Seed funding, valuation, the Section 7520 or applicable federal rate, and the risk of Section 2036 inclusion if the note looks like a retained interest are the recurring issues.
- **Swap powers for basis.** Because Rev. Rul. 2023-2 denies a basis adjustment for assets outside the estate, a grantor with a Section 675(4) power can substitute high-basis assets or cash for low-basis trust assets late in life. The trustee must confirm equivalent value to keep within Rev. Rul. 2008-22.

⁴⁵IRC § 1202, as amended by Pub. L. No. 119-21. See Venable LLP, *QSBS Stacking in the Crosshairs?* (May 28, 2026).

⁴⁶IRC § 1202(h).

⁴⁷See Venable LLP, *supra*. The officials' remarks were reported secondhand and should not be quoted without verification.

⁴⁸Rev. Proc. 2026-3, 2026-1 I.R.B. 143, as described in Ed Zollars, *Annual Procedural Updates: Analyzing the 2026 Revenue Procedures*, Current Federal Tax Developments (Dec. 30, 2025). The author has not reviewed the precise section numbering of the relevant items and recommends confirming them against the published revenue procedure.

⁴⁹CCA 202352018 (Nov. 28, 2023; released Dec. 29, 2023). Chief Counsel advice may not be cited as precedent. IRC § 6110(k)(3).

- **Tax reimbursement clauses.** A discretionary clause exercisable by an independent trustee, included at inception, gives flexibility if the grantor's liquidity weakens. Several states have enacted statutes providing that a discretionary reimbursement power does not expose the trust to the grantor's creditors, which bears directly on the third situation in Rev. Rul. 2004-64.
- **Toggle provisions.** A power held by a nonadverse party to add or release a grantor trust power (for example, a power to add charitable beneficiaries under Section 674 or a Section 675(4) power that the holder may release) lets the family end the tax burn. Before releasing, confirm that the trust does not hold property with liabilities exceeding basis, or an outstanding note from the grantor, to avoid the *Madorin* result.
- **Spousal trusts after divorce.** Because Section 682 no longer applies to post-2018 instruments, SLAT drafting should address what happens to grantor status and reimbursement if the marriage ends.

B. Using Nongrantor Status Deliberately

- **Distribution planning.** With the 65-day election, the trustee can measure DNI and each beneficiary's bracket and NIIT position before distributing. Distributing to a beneficiary in the 22 or 24% bracket rather than accumulating at 37% plus 3.8% NIIT is often the largest recurring saving available. Until the Section 68 question is resolved, part of that saving may be offset.
- **Capital gains in DNI.** Drafting that gives the trustee authority to allocate gains to income, and a consistent practice of doing so, can shift gain to beneficiaries in lower capital gains brackets.
- **State income tax.** The Supreme Court held that a state may not tax undistributed trust income based solely on the in-state residence of a beneficiary who has no right to demand income and is uncertain to receive it.⁵⁰ Trustee residence, place of administration, and source income then determine exposure.
- **Incomplete gift nongrantor (ING) trusts.** These trusts aim to avoid both grantor status and a completed gift, commonly by vesting distribution decisions in a committee of adverse parties. The Service has issued a series of letter rulings on the structure over the years. New York and California now treat ING trusts created by their residents as grantor trusts for state purposes, so the strategy is state specific.⁵¹ Practitioners should confirm the current ruling posture before planning around a ruling request.
- **Separate taxpayers.** Nongrantor trusts can each claim a Section 1202 exclusion and, through 2029, a SALT limitation. Each benefit must survive Section 643(f), Treas. Reg. § 1.643(f)-1 where applicable, and substance-over-form scrutiny, and each costs an annual Form 1041, compressed brackets on undistributed income, and possible Section 68 exposure.
- **Charitable deductions.** A nongrantor trust may deduct amounts of gross income paid for charitable purposes under the governing instrument without the percentage limits that apply to individuals. Whether new Section 68 reaches the Section 642(c) deduction is one of the open questions noted above.

⁵⁰*N.C. Dep't of Revenue v. Kimberley Rice Kaestner*, 1992 Family Trust, 588 U.S. 262 (2019).

⁵¹Cal. S.B. 131 (2023), adding Cal. Rev. & Tax. Code § 17082 (effective for taxable years beginning on or after Jan. 1, 2023).

C. A Decision Framework

The choice between regimes can be reduced to five questions.

1. Is the client's taxable estate large enough that shifting the income tax burden to the grantor produces a meaningful transfer tax saving, and can the client comfortably afford that burden for many years?
2. Will the trust hold assets that the grantor may want to buy back, swap for basis, or sell to the trust, all of which depend on grantor status?
3. Does the trust hold or expect to hold assets that benefit from a separate taxpayer (QSBS, state-taxed income in a high-tax state, property taxes) and can that separate taxpayer be defended under Section 643(f)?
4. Where will the trustee, the beneficiaries, and the trust's income be located, and does any state tax the trust on its own terms?
5. Does the instrument preserve flexibility: a power to toggle status, a reimbursement clause, authority to allocate gains to income, and a trust protector or decanting power, since later modification now carries gift risk and no prospect of a ruling?

VII. Conclusion

The grantor trust rules began as anti-abuse provisions and have become planning tools. In 2026 the calculus has shifted again. The permanent \$15 million exclusion reduces transfer tax pressure for many families, Rev. Rul. 2023-2 makes basis a central concern, and new Section 68 threatens the conduit treatment that has defined nongrantor trust taxation for decades. The durable lesson is to build flexibility into the original instrument, to model both the income tax and the transfer tax consequences of each regime, and to revisit the choice as the law, the family, and the assets change.