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NONGRANTOR TRUSTS

Income Taxation and Planning Opportunities

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Nongrantor Trusts

- Trust treated as a separate taxpayer for income tax purposes.
- Irrevocable
- Pays tax on undistributed income.
  - Compressed tax brackets – For 2026, taxed at 37% once taxable income exceeds $16,000
- Receives a deduction for distributed net income (DNI).
- Beneficiaries report the DNI distributed to them on their individual income tax returns.

Nongrantor Trusts

Two general types:

Simple Trust

- Must distribute its income (fiduciary accounting income) at least annually to the trust's income beneficiaries.
- Cannot distribute to charities
- Did not make any corpus distributions during the year.

Complex Trust

- Distributions of income and principal are made to the beneficiaries at the discretion of the trustee(s).
- May make distributions to charities.
- May accumulate fiduciary accounting income.

Nongrantor Trusts

Income is taxed to either the trust or the beneficiary

- If income is accumulated, then the income is taxed to the trust
- If income is distributed, then the trust gets an income tax deduction and beneficiaries report the income
- Income is reported net of allocated expenses and will retain its character as dividends, interest, rental income, etc.
- Trusts are generally required to use a calendar year

OBBBA 2/37th Reduction Rule

- 2/37th rule – for tax years starting 1/1/26 or later, limitation applies to itemized deductions (including charitable deductions, fiduciary fees, professional fees, etc).

Limit reduces otherwise allowable itemized deductions by 2/37ths of the lesser of:

- The itemized deductions or
- The amount by which taxable income exceeds the threshold for the 37% bracket ($16,000 for 2026)
- Prior to OB3, trusts and estates were exempt from itemized deduction limitations. OB3 repealed that exemption.
- Because of the low threshold for the 37% bracket, most non-grantor trusts and estates will be impacted.
- Note: A trust or estate that distributes all income to charity may now have a tax liability due to the reduction of the charitable deduction.
- Will the DNI deduction be reduced by this threshold? Does that mean that a portion of the DNI will be double taxed – both to the beneficiary and to the estate/trust?
- Will other uniquely fiduciary deductions (ex: fiduciary commissions) be impacted by this reduction?

***This is as of June, 2026.

Fiduciary accounting income (FAI), Distributable net income (DNI) and the Income distribution deduction (IDD)

FAI

- Defined by trust document or state law. *Generally*, total receipts of income during the accounting period less expenses allocated to that income.

DNI (IRC 643(a))

- Tax concept
- This is the amount of income that is passed out to the beneficiary
- Calculated on Form 1041, page 2, Schedule B, line 7

IDD (§651 & §661)

- Tax concept
- Calculated on Form 1041, page 2, Schedule B, line 15
- Carries out income to the Schedule K-1 and removes income from Form 1041, page 1, line 18

Uniform Fiduciary Principal and Income Act (UFIPA) vs Uniform Principal and Income Act (UPIA)

- Provide guidance regarding allocating receipts and disbursements to income and principal to arrive at Fiduciary Accounting Income
- UFIPA is a revision of the former UPIA, Uniform Principal and Income Act
- Most states have enacted one of the prior versions of the UPIA, Uniform Principal and Income Act
- Eight states have enacted UFIPA – CA, WA, UT, CO, KS, AR, FL, VA
- UFIPA contains flexible and innovative unitrust conversion provisions (where a fixed percentage of the total trust value is paid out annually, regardless of income generated) and a default rule on governing law (the law of the situs of the trust will apply, unless the terms of the trust specify a different jurisdiction).

Fiduciary Accounting Income (FAI)

- Items included in fiduciary accounting income (broad overview based on N.J.S.A. 3B:19B-1 et seq)
- Interest
  - Taxable
  - Tax-exempt
- Dividends
- Rents*
- Distributions of cash in the normal course of operations from pass-through entities (Schedule K-1 income items are for tax reporting purposes, not FAI computation)

*A trustee who conducts a trade or business can opt to account for that activity separately and determine the allocation of receipts between income and principal.

Fiduciary Accounting Income (FAI)

- Items included in fiduciary accounting principal (broad overview based on N.J.S.A. 3B:19B-1 et seq)
- Contributions to the trust
- Realized long-term capital gain
- Realized short-term capital gain
- Return of capital
- Special or Extraordinary Dividends
- Income not required to go to an income beneficiary
- Distributions of cash from an entity that were for redemption of the trust's interest in the entity, for total or partial liquidation of the entity or cash received from a RIC or a REIT if the money distributed is a capital gain dividend for federal income tax purposes.
- Distributions of property from an entity.

Fiduciary Accounting Income (FAI)

Disbursements from INCOME (broad overview based on N.J.S.A. 3B:19B-1 et seq):

- Half of any fees for investment advisory or custodial services
- Half of expenses for accounting, judicial proceedings or other matters that involve both the income and remainder interests
- Trustee commissions allowed by law on income receipts
- All other ordinary expenses incurred in connection with the administration, management or preservation of trust property and the distribution of income (includes property taxes)
- Recurring premiums on insurance covering the loss of a corpus asset or the loss of income from or use of the asset

Fiduciary Accounting Income (FAI)

Disbursements from PRINCIPAL (broad overview based on N.J.S.A. 3B:19B-1 et seq):

- Trustee commissions allowed by law on principal receipts or distributions or on termination of the trust
- Half of any fees for investment advisory or custodial services
- Half of all expenses for accounting, judicial proceedings, or other matters that involve both the income and remainder interests.
- Principal payments made on trust debts.
- Expenses of a proceeding that concerns primarily corpus.
- Insurance premiums not allocated to income on policies owned by the trust.
- Estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust.
- Disbursements related to environmental matters.

Distributable Net Income (DNI)

- Distributable Net Income is the final component in the calculation of a trust's taxable income
- DNI determines the maximum amount of the trust's income distribution deduction
- DNI acts as a ceiling for both the allowable distribution deduction for the trust as well as the amount of income a beneficiary must report on his/her tax return
- Determines the character (e.g. interest, dividends, etc.) of the taxable income in beneficiaries' hands

Distributable Net Income (DNI)

Taxable income (Before income distribution deduction)

+ Exemption

+ Net tax-exempt income

+ Capital losses allocated to principal*

< Capital gains allocated to principal* >

< Extraordinary/stock dividends** >

= Distributable Net Income (DNI)

*Except in the year of termination

**This adjustment is for simple trusts in which these are allocated to principal.

DNI – Capital Gains/Losses

Normally, capital gains and losses are allocated to principal, not included in DNI and trapped at the trust level. Capital gains are included in DNI if (Reg. 1.643(a)-3(b)):

- Specifically allocated to income per the trust document or local law;
- Exercised according to the fiduciary's reasonable and impartial discretionary power and
  - Allowed by the trust document and local law or
  - Allocated according to the fiduciary's reasonable and impartial discretion as one of the following which is authorized by the trust document and not prohibited by local law:
    1. FAI
    2. Principal but treated consistently by the fiduciary as part of a distribution to a beneficiary
    3. Principal but actually distributed to the beneficiary or used to determine the distributable amount
  - Made in partial or complete termination of the trust (Reg. 1.643(a)-3(e))
  - Paid, permanently set aside, or used for charitable purposes (Reg. 1.643(a)-3(c))

PLANNING OPPORTUNITIES

65-Day Election (IRC 663(b))

- Available to estates and complex trusts.
- Ability to treat any distribution made within the first 65 days of the subsequent tax year as having been made in the prior year (by March 6, 2027, for the 2026 year).
  - If the amount(s) distributed within the first 65 days of the subsequent year exceed the amount needed for the election, only the portion for which the election is desired needs to be included in the election.
- Shift income out of compressed trust/estate income tax brackets to beneficiaries (try to avoid the highest tax rates and Medicare surtax).
- Maximum amount for which the election can be made is the greater of fiduciary accounting income (FAI) or distributable net income (DNI).

IRC 643(e)(3) – Property Distributions

- General Rule for Property Distributions - No gain or loss is recognized and the trust's basis in the asset carries over to the beneficiary.
- IRC 643(e)(3) election is available for complex trusts (and estates) and allows for the recognition of gain (but not loss, due to related party rules) on the discretionary distribution of property to beneficiaries of the trust.
- The holding period for the beneficiary(s) begins on the date of the distribution.
- The result of this election is that the asset is treated as "sold" by the trust on the date of distribution.
  - If gain is recognized, the beneficiary's basis is the fair market value (FMV) on the date of distribution.
  - If the loss is realized (not allowed to be recognized by the trust), then the beneficiary needs to keep track of two bases:
    - The trust's basis in the asset will be used to compute a gain on the asset's disposition by the beneficiary.
    - The FMV of the asset will be used to compute a loss on the disposition of the property by the beneficiary.
- If the beneficiary sells the asset at a price that is between the FMV and the trust's basis of the asset on the date of distribution, no gain or loss will be recognized by the beneficiary.
- If the election is made, it applies to all in-kind distributions made during the trust's taxable year.

IRC 643(e)(3) – Property Distributions

Circumstances under which the election should be considered:

- The trust has capital losses or unused deductions to offset the distribution gains.
- The beneficiary plans to sell the asset and there is a built-in unrealized gain at the time of distribution.

There are multiple beneficiaries, and the election will assist in equalizing the tax consequences of property distribution among the beneficiaries.

- There is a desire to shift income to the beneficiaries, and using FMV will cause the property distributions to carry out more DNI.

Caution should be taken to avoid creating a disadvantageous tax situation. It is important to consider both the trust’s and the beneficiaries’ tax situations (such as the trust’s capital gains rates and net investment income tax threshold vs. the beneficiaries’ and the availability of capital losses at the beneficiary level).

Using an LLC to Control FAI Distributions in a Simple Trust

Important to look to what constitutes trust accounting income under the governing instrument and applicable state principal and income law.

- If a trust owns an interest in an LLC that retains cash rather than distributing it to the trust, the trust may not have corresponding FAI, depending on:
  - the classification of the LLC for tax purposes,
  - the trust's accounting rules under the governing instrument, and
  - applicable state principal and income statutes.
- LLC taxed as a partnership - for FAI purposes, the trust generally treats actual partnership distributions as income or principal under the relevant state's version of the Uniform Principal and Income Act (UPIA). Typically:
  - money distributed from the partnership is generally allocated to income,
  - except to the extent the distribution is characterized as a return of capital.
- As a result, the managers of the LLC may be able to influence the amount of FAI generated for the trust from the LLC by controlling the amount of partnership distributions.

Using an LLC to Control FAI Distributions in a Simple Trust

Important limitations to consider when using an LLC solely to suppress FAI distributions:

Fiduciary duty issues. If the trustee controls the LLC and intentionally retains earnings to disadvantage the income beneficiary, the beneficiary could argue that the trustee breached duties of impartiality or loyalty.

Simple trust qualification. If the trust instrument requires all accounting income to be distributed, but the trustee has broad discretion over whether the entity distributes cash, the IRS could question whether the trust truly qualifies as a simple trust.

State law variations. Some states have adopted provisions allowing trustees to adjust between income and principal or to treat entity interests differently. The applicable state's principal and income act is therefore critical.

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Use of Nongrantor trusts in planning for 199A deduction

- Create multiple nongrantor trusts and allocate business interests across trusts.
- Each trust receives a separate QBI deduction threshold.
  - Additional benefit, each trust has its own SALT deduction.
- 199A threshold for nongrantor trusts
  - Phaseout range for deduction in 2026 is $201,750 to $276,750
  - In determining whether a trust has taxable income that exceeds the threshold amount, the taxable income of the trust is determined after taking into account the distribution deduction.
- In addition to the 20% of QBI deduction, some trusts can also get a deduction for 20% of qualified REIT dividends and qualified PTP income.
- Valuable for high-income business owners near or over 199A limits.

Use of Nongrantor trusts in planning for 199A deduction

- Trust is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries and is treated as an individual to the extent it retains the QBI and other items.

- The allocation of the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, relevant UBIA of qualified property, qualified REIT dividends and qualified PTP income is based on the proportion of the trust's DNI distributed to the beneficiary(s) vs retained by the trust.
  - For this purpose, the DNI is determined without regard to IRC Sec. 199A.

Use of Nongrantor trusts in planning for 199A deduction

State income tax planning:

- Not all states follow the federal income tax treatment of 199A (NJ and NY do not)
- Completed gift vs incomplete gift transfers
  - Consider creating a nongrantor trust in a state that provides state income tax benefits (for example, DE, AK, TN, NV)
  - Use of a Delaware incomplete-gift non-grantor (DING) trust, Nevada incomplete-gift non-grantor trust (NING) or comparable trust in an income tax friendly state to transfer the business interest.
    - New York and California do not recognize ING trusts as nongrantor trusts.
    - Caution: The IRS has stopped issuing rulings related to ING trusts.
- NOTE: State sourced income will still be subject to tax if sourced to a state with a state income tax.

Use of Nongrantor trusts in planning for 199A deduction

- Must be used carefully to avoid anti-abuse rules.
- **IRS Notice 2018-64:** Anti-abuse rules against "trust stacking" if trusts are not independent.
- **IRC Section 643(f):** Multiple trusts treated as one if formed to avoid tax.
    - **Key Compliance Factors:**
        - Legitimate, non-tax related purpose
        - Different primary beneficiaries for trusts with the same grantor
        - Proposed Regulations state that a principal purpose of avoidance will be presumed if creating multiple trusts results in a significant income tax benefit unless there is a significant non-tax purpose that could not have been achieved without the creation of separate trusts. There must be a sufficient differentiation with respect to the trust beneficiaries and trust terms to avoid aggregation under IRC 643(f).

Use of Nongrantor Trusts in Planning with IRC 1202 stock

- Spread QSBS exclusion across multiple nongrantor trusts “stacking”
- Must acquire QSBS directly or by gift
  - Transfer of QSBS by gift is an exception to the general rule that the original holder must be the seller of QSBS in order to take advantage of the gain exclusion.
  - QSBS basis carries over and holding period tacks to recipient when gifted
  - Upon sale, each trust claims its own §1202 exclusion
- Separate $10M or $15M/$10x basis exclusion per trust
  - $10M if stock issued before July 5, 2025
  - $15M if stock issued after July 4, 2025

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Use of Nongrantor trusts in planning with IRC 1202 stock

Estate planning:

- If the trust is structured so that the transfer is a completed gift, then the grantor files a gift tax return, lifetime exemption is utilized and the assets in the trust(s) are outside of the taxpayer's estate.
  - Best to gift stock early (before value appreciates)
- If the trust is structured so that the transfer is not a completed gift for gift and estate tax purposes, then the transfer would still qualify for the IRC 1202 gain exclusion benefits but the assets of the trust(s) would be included in the taxpayer's estate.
- Watch for IRC 643(f) – anti-abuse rules: multiple trusts with substantially the same grantor and beneficiaries and principal purpose of establishing multiple trusts is avoidance of federal income tax.
- Avoid last-minute transfers close to sale of QSBS (assignment of income doctrine)

Use of Nongrantor trusts in planning with IRC 1202 stock

State income tax planning:

- Not all states follow the federal income tax treatment of QSBS (NJ does beginning 1/1/26)
- New York currently follows the federal income tax treatment of QSBS.
- Completed gift vs incomplete gift transfers
  - Consider creating a nongrantor trust in a state that provides state income tax benefits (for example, DE, AK, TN, NV) to receive the gift or purchase the QSBS from the issuing corporation.
  - Use a Delaware incomplete-gift non-grantor (DING) trust, Nevada incomplete-gift non-grantor trust (NING) or comparable trust in an income tax friendly state to transfer the business interest.
    - New York and California do not recognize ING trusts as nongrantor trusts.
    - Caution: The IRS has stopped issuing rulings related to ING trusts.

Nongrantor Trusts – State and Local Tax (SALT) benefits

- The Tax Cuts and Jobs Act of 2017 limited the deduction for state and local taxes to $10,000 for nongrantor trusts.
- The OBBBA increased the SALT deduction to $40,000 for 2025 with 1% increases to this amount through 2029 ($40,400 for 2026).
- This new $40,000 limit ($40,400 for 2026) is reduced (but not below $10,000) by 30% of the taxpayer’s modified adjusted gross income over $500,000 ($505,000 for 2026).
- This is a temporary increase in the SALT deduction. It will revert to $10,000 in 2030.
- Nongrantor trusts can be used to get additional SALT deductions of up to $40,400 each since each trust is considered a separate taxpayer.
- Transferring income producing assets to a nongrantor trust could result in lowering the grantor’s taxable income below the SALT phase-out.

Questions?

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