

Estate & Trust Income Tax: Your Complete Guide to Form 1041



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How Estate and Trust Taxation Evolved in the Federal System

Estates and trusts have been treated as taxable entities under the federal income tax landscape since the inception of income tax in 1913. Initially, Congress made the decision to subject trusts and estates to income tax to prevent wealthy individuals from sidestepping taxes by sheltering assets. Overtime, the Internal Revenue Codes (IRC) of 1954 and 1986 refined this framework by introducing grantor trust rules, the distributable net income system, and highly compressed rate brackets designed to discourage long-term income accumulation within trusts.

Today, a coordinated policy architecture exists: the estate tax governs wealth transfers at death, while the trust and estate income tax governs the taxation of income generated by transferred wealth. Although each system applies to a narrow number of taxpayers, both estate and trust taxes remain critical tools for revenue generation, curbing tax deferral and avoidance, and balancing intergenerational wealth concentration.



Decoding Estate and Trust Jargon

Estate and trust taxation is an area of tax law that is riddled with complex terminology and unclear definitions. For effective compliance and planning, it's important to understand the most essential terms when it comes to estate and trust taxation.

Key Terms in Estate and Trust Taxation Explained

Estate: An estate is a legal entity formed upon an individual's death, encompassing all their assets and liabilities until all debts are paid, and all remaining property is distributed. This process is referred to as the estate being in "administration" or "settlement." Estates are taxed in two ways:

- Estate tax (Form 706) on wealth transfers to beneficiaries
- Income tax (Form 1041) on any income generated by the assets held in the estate

Trust: A trust is a fiduciary arrangement where a trustee holds legal ownership of a property and manages it for the benefit of one or more beneficiaries, guided by a trust agreement, will, or relevant laws. For federal income tax purposes, trusts are generally treated as separate taxpayers unless classified as grantor trusts. When a trust is classified as a separate taxpayer, it must file its income tax return using Form 1041.

Types of Trusts:

- **Simple Trust:** A simple trust must distribute all its fiduciary accounting income each year and cannot distribute corpus (principal) or make charitable contributions. If a trust fails to meet these requirements in a taxable year, it's not treated as a simple trust for that year.
- **Complex Trust:** A complex trust is any trust that is not a simple trust for the taxable year. It can accumulate income, distribute principal, or make charitable contributions, which leads to more complex income tax considerations.

Grantor: The grantor is the individual who establishes or funds a trust, transferring assets to a trustee for management. For income tax purposes, if the grantor retains certain powers or interests, the trust may be classified as a grantor trust, meaning the grantor is responsible for paying taxes on the trust's income rather than the trust or its beneficiaries.

Non-Grantor Trust: A non-grantor trust operates independently of the grantor or other individuals under the grantor trust rules. As a result, the trust itself is generally taxed on any undistributed income. Beneficiaries only pay taxes on amounts distributed to them or amounts they are required to receive, following the rules for distributable net income.

Trustee: A trustee is the individual or entity holding legal ownership of the trust's assets. They are responsible for managing, investing, and distributing those assets in accordance with the trust document and under fiduciary law. The trustee also files the trust's fiduciary income tax returns and has primary responsibility for tax compliance.



Executor: An executor (also referred to as executrix) serves as the personal representative named in a decedent's will and appointed by the probate court to administer the estate. This individual's responsibilities include gathering assets, paying debts, and distributing property to beneficiaries. The executor also manages all required tax filings, such as the decedent's final income tax return, any necessary estate income tax returns, and the federal estate tax return, if applicable.

Beneficiary: A beneficiary is any person or entity who, by the terms of a will, trust, or local law, is entitled to receive income or principal from an estate or trust. For income tax purposes, beneficiaries are taxed on the share of distributable net income that is deemed allocated or distributed to them.

Distributable Net Income (DNI): Distributable net income is a key tax concept that measures the maximum amount of an estate's or trust's income that can be passed through to beneficiaries and deducted by the fiduciary in a single year. By allocating taxable income between the fiduciary and the beneficiaries, DNI ensures that each dollar is only taxed once, protecting against double taxation within the estate or trust structure.

Navigating the Framework: How New Laws are Shaping Taxation

Recent Legislative Updates

The current landscape governing estates and trusts was shaped by a mixture of updates from the Tax Cuts and Jobs Act of 2017 (TCJA) and the One Big Beautiful Bill (OBBBB). These updates brought key revisions to how income, deductions, and distributions are taxed and reported.

Both estates and trusts use Form 1041 (U.S. Income Tax Return for Estates and Trusts) to report their income, deductions, gains, losses, distributions, credits, taxes, payments, exemptions, basis, and allocations.

The filing thresholds for estates and trusts are intentionally low because most estates and non-grantor trusts engaged in meaningful financial activity will have a federal filing obligation. However, it's essential to analyze estates and trusts separately, as the rules and nuances for completing Form 1041 differ between the two entities.

The Basics of Estate Income Tax Returns

Estates must report and allocate income earned during the administration period (after the decedent's passing) by filing a fiduciary income tax return on Form 1041 between the estate as a separate taxpayer and the beneficiaries. The executor is responsible for filing an estate tax return if the estate's gross income for the tax year reaches at least \$600, or if any beneficiary is a nonresident alien. The filing deadline is the 15th day of the fourth month following the end of the estate's tax year.



Estates may choose to adopt a fiscal year ending on the last day of any month, provided the year does not exceed 12 months. Establishing the tax year must occur on or before the initial Form 1041 due date (without extensions), and once a particular year is chosen, it cannot be changed without special permission from the IRS. Selecting the most efficient tax year is an important and strategic aspect of estate planning.

The process for calculating estate income tax closely resembles the individual income tax system:

- Report gross income,
- Exclude tax-exempt income,
- Subtract allowable deductions, and
- Apply a more aggressive progressive rate structure.

Estates reach the top marginal tax bracket at relatively modest levels of taxable income, though long-term capital gains and qualified dividends receive preferential tax rates as they are for individuals. One key deduction available to estates is for income distributed to beneficiaries during the year, commonly known as DNI.

A decedent may have earned income or gain during life without yet recognizing it for income tax purposes. This is known as income in respect of the decedent (IRD), and under Section §691, it is taxable to whoever receives it, whether the estate or a beneficiary. Common examples of IRD include:

Unpaid salary	Deferred compensation
Accrued interest	Installment sale proceeds not yet received
IRA and 401K balances	Accounts receivable of a cash-basis taxpayer

To illustrate: if a beneficiary inherits a traditional IRA and takes a withdrawal, the beneficiary reports the amount as ordinary income on Form 1040. If the estate has already paid tax on that same amount, the beneficiary may claim a Section §691(c) deduction to avoid double taxation. It's important to note that the character of the income carries through to the recipient, and the IRD does not receive a basis step-up at death.



Why Trust Classification Matters

Trust taxation is not a one-size-fits-all system. The IRC draws several overlapping distinctions among different categories of trusts, and these classifications hold the key to determining who shoulders the tax burden, how income and deductions are reported, and what strategic planning opportunities are available. Proper classification is foundational for fiduciary income tax compliance, as mischaracterization can lead to costly errors, such as incorrect reporting, duplicated income, or omitted tax liability.

Legal vs. Tax Classifications of Trusts

It's important to distinguish between legal classifications of trusts from income tax classifications. State legal terms such as “revocable” and “irrevocable” describe the grantor’s ability to amend or terminate the trust, concepts that matter most for estate planning, asset protection, and control. Under state law, a revocable trust permits the grantor to modify, amend, or revoke the trust at will, while an irrevocable trust cannot be modified or revoked once established by the grantor.

IRS Income Tax Classifications

The IRS, however, uses its own classifications—grantor, non-grantor, simple, and complex. These tax classifications determine whether the trust is treated as a separate taxpayer, and how its income is allocated between the trust and its beneficiaries. For this reason, the trust’s legal form does not necessarily dictate its income tax treatment.

How Legal Form and Tax Status Interact

A revocable trust is generally classified as a grantor trust for income tax purposes, making the grantor responsible for all tax obligations. Conversely, an irrevocable trust is usually treated as a separate tax entity, bearing its own responsibility for all reporting and tax payments.

However, an irrevocable trust can lose its separate tax status due to tax classification. For example:

If a grantor has given up the power to modify or revoke the trust (thus creating an “irrevocable” trust as a separate tax entity), the grantor could still retain the power to borrow from the trust without adequate security. Even an “irrevocable” trust may be classified by the IRS as a “grantor trust,” resulting in all tax obligations shifting back to the grantor.

For state law purposes, the trust would still be considered an irrevocable trust, but for tax purposes, the character has changed, and the trust would no longer be considered a separate tax entity.



Grantor Trusts: Ownership, Tax Reporting, and Estate Planning Advantages

A grantor trust is a trust where the grantor, or another person is treated as the owner of all or a portion of the trust under IRC §§671 through 679. Under these code sections, when a person is considered the owner, the trust's income, deductions, and credits are reported directly by that person. These provisions attribute ownership when the grantor retains certain powers or beneficial interests, including:

Power to
revoke the
trust

Ability to
control
beneficial
enjoyment

Right to
substitute trust
assets

Borrowing
without
adequate
security

Receiving
income or
principal

Common examples of grantor trusts include:

Revocable living trusts

Irrevocable trusts with retained
administrative or economic
powers

Intentionally defective grantor
trusts used in estate planning
transactions

Tax Treatment and Planning Benefits

For federal income tax purposes, a grantor trust is disregarded as a separate taxpayer to the extent of the grantor portion. All items related to income, deductions, gains, losses, distributions, credits, taxes, payments, exemptions, basis, and allocation are reported directly by the grantor on their individual income tax return, and the trust itself generally does not pay federal income tax on that income. This approach aligns with the principle that income should be taxed to the person who retains control or economic benefit.

- Grantor trust status is a valuable planning technique because the grantor's payment of income tax is not treated as an additional gift, allowing trust assets to grow for beneficiaries on a tax-free basis.
- Grantor trust treatment may apply to the entire trust or only to a portion. In a partially grantor trust, the grantor portion is reported by the grantor, while the non-grantor portion follows the normal fiduciary income tax rules, which may require filing Form 1041.



Some grantors choose to pay income taxes on triggering events, such as dividends, interest, rental income, business income, or realized capital gains, during their lifetime, allowing the trust to grow efficiently for future beneficiaries. An intentionally defective grantor trust (IDGT) provides the vehicle to achieve this goal. To establish one, a grantor creates a trust that is valid under state law, transfers assets into it, and appoints a trustee. However, for tax purposes, the trust does not pay income tax on its assets. Instead, under §675(4)(C), the grantor retains a legally recognized power of ownership and is therefore obligated to report and pay the trust's income, deductions, and gains on their personal return.

The retained control is typically stated in the trust document as the grantor's right to reacquire the trust corpus by substituting other property of an equivalent value. While this language does not reference income tax payments directly, its phrasing authorizes significant enough control that the IRS will deem the grantor to be the owner of the trust's assets, resulting in the grantor bearing tax liability, which is precisely the intended goal.

Non-Grantor Trusts: Responsibilities and Strategies to Maximize Tax Efficiency

A non-grantor trust is treated as a separate taxable entity for federal income tax purposes. The trust is responsible for:

Filing Form 1041

Reporting all items of income, deductions, gains, losses, distributions, credits, taxes, payments, exemptions, basis, and allocation

Paying any tax on taxable income that is not distributed to beneficiaries

The trust is allowed a deduction for distributions of DNI, and beneficiaries report distributed amounts in their own taxable income based on the Schedule K-1 they receive from the trust.

Tax Planning Considerations

- Non-grantor trusts are subjected to highly compressed tax brackets and reach the highest marginal federal income tax rate at relatively low levels of taxable income.
- Timing and character of distributions, allocation between income and principal, and coordination with beneficiary tax profiles are key to minimizing overall tax liability.

- Trustees may distribute income to beneficiaries who are taxed at lower individual rates, leveraging the flexibility in the trust document.
- Capital gains, when permitted, can be distributed to beneficiaries to benefit from their lower tax rates.



Simple Trusts: Annual Criteria and Tax Benefits for Beneficiaries

For a trust to be classified as a simple trust for a particular tax year, it must meet all three requirements:

1

The trust instrument requires that all income be distributed currently

2

No amounts are distributed from principal during the year

3

No charitable contributions are made during the year

If these conditions are met, the trust is treated as a conduit, and nearly all trust income is taxed to the beneficiaries rather than to the trust. Because all income is distributed, the trust typically has minimal or no taxable income and claims a deduction for the distributed amount, which beneficiaries report on their individual returns. Simple trust status is determined annually and depends both on the governing instrument and the trust's actual activities. A trust may switch between a simple or complex trust status from year-to-year if it accumulates income, distributes principal, or makes charitable contributions.



Complex Trusts: Income Accumulation, Distribution Strategies, and Tax Implications

Any trust that does not meet the definition of a simple trust is classified as a complex trust. Complex trusts may accumulate income, distribute principal, or make charitable contributions, and they can retain income and pay tax at the trust level on undistributed taxable income. Distributions to beneficiaries must follow DNI principles and are taxed to the beneficiaries.

Common Examples and Planning Challenges

Discretionary and accumulation trusts

Testamentary trusts created under a decedent's will

Charitable remainder and charitable lead trusts subject to specialized statutory rules

Because complex trusts often involve retained income, discretionary distributions, and charitable components, they present the most significant fiduciary income tax planning challenges. The compressed rate structure applicable for retained income makes thoughtful distribution planning and careful characterization of receipts and disbursements particularly important.

Filing Form 1041: When is it Required for Trusts?

Non-Grantor Trusts: Key Filing Criteria

Non-grantor trusts are the only trusts required to file Form 1041 with the IRS. If a trust is classified as a grantor trust for federal income tax purposes, it's disregarded as a separate entity, and all income is reported directly by the grantor on their individual return.



FILING FORM 1041: WHEN IS IT REQUIRED FOR TRUSTS?

A non-grantor trust must file Form 1041 for a tax year if any of the following applies:

- The trust earns gross income of \$600 or more in the tax year
- Any taxable income is present for the year, even if gross income is less than \$600
- A beneficiary is a nonresident alien

Form 1041 serves as a trust's primary reporting tool for:

- Income from sources like interest, dividends, capital gains, rental income, and business income activities
- Deductions including fiduciary fees, accounting fees, state and local taxes, and charitable contributions
- Calculating DNI
- Reporting distributions to beneficiaries via Schedule K-1

Unlike estates, trusts are generally required to use a calendar year for tax purposes and may operate for years or even generations. As a result, this ongoing nature makes compliance and planning critical components of trust administration.

Grantor Trusts: Special Filing Rules

If the entire trust is a grantor trust, it is generally disregarded as a separate taxpayer for federal tax purposes. The fiduciary may file Form 1041 solely as an information return, completing only the trust's identifying information and marking the return as a grantor trust. No dollar amounts are reported on the face of the return; instead, the fiduciary must attach a statement that identifies the grantor and details all items of income, deduction, and credits taxable to the grantor. Schedule K-1 is not used, and a copy of the attachment must be provided to the grantor for inclusion on their individual return.

If only a portion of the trust is treated as a grantor trust, Form 1041 must be filed, indicating both the grantor and non-grantor status.

- The non-grantor portion is reported under normal fiduciary income tax rules, and any income distributed from that portion is reported to beneficiaries on Schedule K-1.
- The grantor portion is excluded from the trust's taxable income and reported on a separate attachment to Form 1041 identifying the grantor and detailing the items taxable to the grantor. The fiduciary must provide a copy of the attachment to the grantor, who reports the items directly on their return.

Because partial grantor trusts involve multiple reporting streams, careful allocation and consistent reporting is essential to avoid duplicate entries, omitted income, and IRS inquiries.

Practical Considerations for Filing Form 1041

Evaluating whether a trust must file Form 1041 should happen early and be revisited regularly. Even small amounts of bank interest can trigger a filing requirement. Incorrectly classifying a trust can lead to significant reporting errors, while many states impose their own fiduciary filing rules, often with different thresholds and residency requirements.

Trusts and estates may also be required to make quarterly estimated tax payments. Early identification of the filing obligation allows advisors and fiduciaries to avoid penalties, manage cash flow, and integrate income tax planning into the overall administration strategy.





Distributable Net Income: How it Shapes Beneficiaries' Bottom Line

DNI represents the amount of taxable income that the IRS allows an estate or trust to allocate to beneficiaries, ensuring income is taxed only once, either to the fiduciary entity or to the beneficiary, but not both.

- DNI is calculated on Form 1041 and enables the fiduciary to claim a “distribution deduction” against the taxes imposed on the estate or trust.
- The yearly distribution deduction equals the amount distributed to the beneficiaries minus any distributions that are non-taxable.

Typically, the DNI amount and the distribution deduction are the same number, but they can differ if part of the distribution is non-taxable income, such as tax-free interest from U.S. government bonds.

Understanding Principal and Income Distribution

In relation to DNI, an important term is “principal,” which refers to the original cash or property that established the estate or trust. This principal generates income in the form of rents, interest, or royalties each year. The fiduciary determines the distribution amounts to the beneficiaries based on state law and the language of the governing instrument.

- Income is generally distributed to the “income” beneficiaries
- The principal is reserved for the “remainder” beneficiaries, who receive their distribution when the estate or trust concludes

Calculating the DNI Deduction and IRS Rules for Capital Gains

After setting the distribution amounts, the fiduciary must then calculate DNI. The IRS restricts DNI to the DNI amount or the amount distributed, whichever is less. Each income type is then reported in boxes 1–8 on the beneficiaries Schedule K-1 forms.

Both the IRS and states generally allow most income to be distributed to, and taxed to, income beneficiaries, although there are some exceptions. For instance, recognized capital gains typically cannot be distributed to a beneficiary unless the trust formation instrument specifically provides for it. The IRS will only tax beneficiaries on capital gains if:

1. The trust instrument explicitly permits the taxation of the beneficiary in lieu of the trust.
2. The fiduciary consistently reflects capital gains distributions on tax reporting.
3. The capital gains are actually distributed to the beneficiary.

If any of these requirements are not met, the estate or trust bears the tax obligation. Similar rules apply to extraordinary dividends and liquidated dividends.

Navigating Federal Estate and Trust Income Tax Brackets

One of the most striking features of fiduciary income taxation is that it's not imposed at a single rate. It operates on a compressed bracket system. Trusts and estates reach the highest marginal federal income tax rate at a very low level of taxable income compared to individuals. This design is intentional. The exact dollar thresholds are adjusted annually for inflation.

A long-running concern of Congress is that trusts can be used as vehicles to shelter income at low rates. Therefore, by compressing the tax brackets for trusts, the IRC discourages long-term income accumulation inside trusts. For example, under the 2026 tax year:

- The highest bracket floor is \$640,600 and \$768,700, for single individuals and married filing jointly, respectively.
- The top bracket floor begins at \$15,200 of taxable income, for estates and trusts.

Tax Planning and Additional Considerations

- **Compressed Structure:** Due to the way trusts are structured, holding income within a trust can lead to tax inefficiency. Even a relatively modest amount of accumulated ordinary income can quickly be taxed at the highest marginal rate, while an individual beneficiary might pay less because they fall into a lower tax bracket. This reality makes distribution planning an essential part of any fiduciary income tax strategy.



- **Rate Schedule:** Although estates and trusts share the same rate schedule, estates generally have more flexibility, such as electing a fiscal year or deducting certain administration expenses. This flexibility can help mitigate the impact of compressed brackets.
- **Net Investment Income Tax:** Estates and trusts may be subject to the 3.8% Net Investment Income Tax (NIIT) on investment income—interest, dividends, capital gains, and rental income—if their income exceeds a relatively modest threshold. When combined with the compressed rate brackets, the NIIT can push the effective tax rate on retained trust income well above 40%.



Form 1041: The Hidden Complexity Behind Elections

For trusts and estates, Form 1041 may appear to be deceptively simple. For an entity return, the main form is only three pages, but its Schedules carry significant complexity. The return always includes the following core Schedules:

1. Schedule A – Charitable Deductions
2. Schedule B – Income Distribution Deduction
3. Schedule G – Tax Computation and Payments

Depending on the entity's circumstances, the following additional Schedules may also be required:

1. Schedule D – Capital Gains and Losses
2. Schedule I – Alternative Minimum Tax
3. Schedule J – Accumulation Distribution for Certain Complex Trusts
4. Schedule K-1 – Beneficiary's Share of Income, Deductions, Credits, etc.



Important Calculation Notes

Before diving into the details of each Schedule, it is important to mention that the calculations may require modifications depending on:

The type of entity	Whether the entity is a simple or complex trust	Whether the entity is a grantor or non-grantor trust	Trust instrument requirements on distribution amounts and how those distributions must be utilized	How income, credits, and deductions are apportioned amongst beneficiaries
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Schedule A – Charitable Contributions

Schedule A appears first on page 2 of Form 1041, immediately after page 1. It must be completed only when both of the following conditions apply:

1. The trust or estate filing the return is not a simple trust or a pooled income fund
2. The entity made charitable contributions during the tax year, including contributions to foreign charities

Once the final amount is calculated, the deduction flows to page 1 of Form 1041 as an expense, reducing taxable income.

Schedules with Fewer Elective Relief Options

The following Schedules are generally straightforward and do not provide significant elective relief:

Schedule B – Income Distribution Deduction

Must be completed if the entity was required to distribute any income or was paid, credited, or required to distribute any other amounts to beneficiaries during the tax year. To protect the integrity of other return calculations, Schedule B adjusts for:

Capital gains and losses

Tax-exempt interest

Charitable deductions

Through the calculations, Schedule B computes the estate or trust's income distribution deduction. This deduction in turn flows to page 1 of Form 1041 as an expense, reducing taxable income.

Schedule G – Tax Computation and Payments

Schedule G calculates the total tax on an entity's taxable income, netting out various credits and tax payments. It also includes a series of yes/no questions covering:

Foreign accounts

Elections

Financing
arrangements

Other
compliance topics

Answers to these questions may require additional attached statements. Due diligence is essential for Schedule G, as incorrect responses may trigger compliance issues.



Schedule D – Capital Gains and Losses

Schedule D follows similar rules to its equivalent on a personal return.

PART I
Net short-term gains and losses

PART II
Net long-term gains and losses

However, this is where the similarities to Form 1040 end. In Part III, the trust instrument becomes critical as net short- and long-term gains or losses are allocated between the beneficiaries and the entity.

- Amounts allocated to the entity factor into the entity's tax calculations
- Amounts allocated to the beneficiaries flow through their K-1s to their personal returns

Schedule I – Alternative Minimum Tax (AMT)

The estate and trust equivalent of Form 6252 on an individual return. Schedule I is organized as:

PART I
Calculates the entity's minimum taxable income through a series of adjustments

PART II
Calculates an alternative income distribution deduction to reduce AMT income

PART III
Calculates AMT

PART IV
Calculates AMT for qualified dividends and capital gains and losses

Schedule J – Accumulation Distribution for Certain Complex Trusts

Schedule J is used for domestic complex trusts that fall into two specific categories:

1

Trusts previously treated as a foreign trust at any time, unless an exception is provided in future regulations.

2

Trusts created before March 1, 1984, unless the trust would not be aggregated with other trusts under IRC §643(f). This section requires multiple non-grantor trusts to be treated as one trust if the primary purpose was tax avoidance, particularly when the grantors and/or beneficiaries are substantially the same.

Schedule K-1 – Beneficiary Reporting

The trust formation document will determine which beneficiaries will receive distributions, and what those distributions will be composed of: income, deductions, credits, etc. Schedule K-1 provides each beneficiary with a detailed breakdown of the amounts that will flow through to the beneficiary's personal tax return.

Form 1041 Elections

Schedule A Election: Prior-Year Contribution Treatment

A fiduciary may elect to treat a charitable contribution as paid in the prior tax year. For example, if a calendar-year entity makes a qualified charitable contribution on February 7, 2026, from income earned in 2025 or earlier, the entity may elect to apply that contribution to its 2025 return.

Requirements:



The election must be made on a timely filed Form 1041 for the tax year to which the contribution is being attributed (e.g., a 2026 payment must be reflected in the election attached to the 2025 Form 1041).



A statement must be filed with Form 1041 for the year in which the contribution is treated as paid.

The required statement must include all of the following details:

1. Fiduciary's name and address
2. Estate or trust's name
3. A statement confirming the election under IRC §642(c)(1) for contributions treated as paid during such tax year
4. Name and address of each charity receiving a contribution
5. The amount and date of each contribution, or the total amount of contributions paid to each charity during the following tax year to be treated as paid in the prior year

65-Day Election: IRC §663(b)

This election allows trustees of non-grantor trusts to take advantage of the difference between the more compressed trust income tax rates versus the individual tax rates. This election impacts the number of distributions reported on Schedule K-1 even though the election is not made directly on Schedule K-1.

This election allows trustees of non-grantor trusts to treat distributions made within the first 65 days of a new calendar year as if made in the prior year. It is a valuable election to reduce trust-level tax by shifting income to beneficiaries who may be in lower individual tax brackets.

Why it matters: Trust income tax brackets make additional distributions after the end of the previous calendar year in order to take advantage of the differences in the tax brackets of trusts versus individuals. Importantly, this election is not applicable to grantor trusts or simple trusts. Grantor trust income passes through to the grantor's personal return while a simple trust must pay all DNI to the beneficiary.

As discussed further above, Trust income tax brackets are more compressed than individual brackets. In 2025:

- A trust with income in excess of \$15,650 is subject to tax at the highest marginal rate of 37%
- A single taxpayer in excess of \$626,350 to subject to tax at the same rate
- The 3.8% NIIT applies to trusts with income that exceeds \$15,650 versus \$200,000 for individuals



By increasing distributions to beneficiaries, the trust can shift income into their lower individual tax brackets. However, this election is not perfect and state income tax implications must be considered. If a trust is situated in a state with lower income tax rates than the beneficiary, then it would be inefficient to reduce the federal tax burden if the state tax increase outweighs the federal tax decrease.

Important limitations:

- Not available for grantor trusts (income passes directly to the grantor's return)
- Not available for simple trusts (which must distribute all DNI to beneficiaries)

How to make the election:

1

Distribute the additional trust income to the beneficiary within the first 65 days of the new year.

2

Check "Yes" to Question 6 on Schedule G of Form 1041, confirming the IRC §663(b) election is being made.

Related DNI elections: Certain elections can be made to change the bookkeeping of DNI. The primary DNI-related elections are the 65-day elections under:

- **IRC §663(b) 65-day election:** Distributions made within 65 days of year-end may be treated as occurring in the prior year.
- **IRC §643(c)(3) In-kind distribution election:** Allows the fiduciary to recognize gain on a property distribution, which can potentially cause that gain to enter DNI, and consequently, pass it out to beneficiaries.

Election to Include Net Capital Gains in Investment Income

In certain situations, electing to treat capital gains and qualified dividends as ordinary income on Form 1041 can be favorable, even though ordinary income tax rates are higher. However, if the trust has sufficient investment interest expense, this election can unlock a larger planning opportunity for a current-year deduction.

The trade-off requires careful analysis, including:

- Projections of future income,
- Whether it would be more beneficial to let some of the investment interest expense to be disallowed and carryover to future years, and
- Future marginal rates.

How to make the election: Enter the applicable amount qualified dividends and capital gains on Line 4g of Form 4952, "Investment Interest Expense Deduction."

Section 645 Election: Qualified Revocable Trust (QRT) as Part of an Estate

This election allows a QRT to be treated and taxed as part of the decedent's estate for income tax purposes during the election period. Key details of this election include:

Filing Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate"

Generally filed with the first Form 1041 for the combined entity

Must be made by the due date, including extensions, for the first combined entity return

The election period is for a two-year period after the decedent's death, or six months after the final determination of estate tax liability, whichever is later.



State Income Tax on Trusts and Residency Rules

At the time a trust is formed, the principal itself is not subject to tax. Instead, it's the income generated from that principal that is taxed yearly, rather than stored wealth or ownership transfers.

A state's authority to tax trust income is rooted in two main concepts:

RESIDENCY

A statutory classification that states create and is limited by due process.

NEXUS

A constitutional concept invoking due process and commerce clauses.

If a state cannot establish that a trust is a resident, it will look to nexus rules to justify imposing a tax on trust income.



Trust Residency

Residency rules for trusts differ significantly from those for individuals. While an individual is considered a resident if they live in a state, use its services, or have a continuous presence, a trust is not a person and does not have a physical presence. Unlike corporations, trusts are not legal persons under the law.

A trust is a “legal relationship” involving a grantor, trustee, and beneficiaries, who may reside in various locations. Because a trust itself does not reside anywhere, states address this challenge by establishing statutory rules: if certain factors are met, a state will treat the trust as a resident for legal purposes.

However, these state rules are not unilateral. They must comply with constitutional requirements to justify taxing all trust income. Practitioners typically maintain a state-by-state trust residency chart to track each state’s requirements.

Residency Analysis: Key Thresholds

States use several thresholds to determine trust residency:

1. **Trustee’s location and control:** Who controls investment decisions, distribution determinations, and day-to-day administration? The trustee’s residence is a strong, though not automatically decisive, factor.
2. **Beneficiary status and rights:** States assess whether beneficiaries have enforceable access to trust income, not merely discretionary access. Notably, the U.S. Supreme Court ruled unanimously in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust* that a state cannot tax trust income solely because a beneficiary resides there.
3. **Ongoing connection to the state:** Relationships can dissolve over time, which is why relying solely on the grantor’s location when the trust is created is a weak basis for residency.
4. **Legal infrastructure:** Whether the state’s courts and fiduciary laws actively govern and protect the trust. If another state’s law applies, this weakens the taxing state’s authority.

Due process concerns drive the requirement that benefits and protections can be tied to the ongoing relationship between the state and the taxpayer. If residency is established, the state may tax all income, even income earned outside of the state. Nexus, by contrast, is limited to income connected to that state.

Trust Nexus

The concern of whether a trust has established nexus with the taxing state is similar to some residency concepts but is more laser-focused on the specific income being taxed. Where residency allows a state to tax all income, regardless of source, nexus allows a state to tax only income connected to the specified state. When a trust fails the state’s residency requirements, the state may still impose its tax on trust income that has a sufficient nexus, or connection, to that state.

States may tax all income of resident trusts, but only source income of non-resident trusts. The nexus analysis follows these steps:

- | | |
|--|---|
| <div style="background-color: #f9a825; padding: 5px; display: inline-block; margin-bottom: 10px;">1</div> Identify the income at issue | <div style="background-color: #e67e22; padding: 5px; display: inline-block; margin-bottom: 10px;">3</div> Determine whether the connection is purposeful and ongoing |
| <div style="background-color: #e67e22; padding: 5px; display: inline-block; margin-bottom: 10px;">2</div> Identify which connection the state asserts as justification for the tax (i.e. in-state property, customers, operations, etc.) | <div style="background-color: #e67e22; padding: 5px; display: inline-block; margin-bottom: 10px;">4</div> Assess whether the state provides benefits or protections related to the income |
| | <div style="background-color: #e67e22; padding: 5px; display: inline-block; margin-bottom: 10px;">5</div> Limit taxation to in-state sourced income |



Common Pitfalls of Form 1041

Most errors that can occur when filing Form 1041 stem from insufficient due diligence. The most frequent issues include:

Incorrect drafting of the trust or will instrument

Incorrect interpretation of a trust or will instrument

Not attaching required election statements

Not attaching statements per responses to Schedule G's Other Information section

Incomplete or incorrect schedules (e.g. missing Schedule D for capital gains, or not reporting pass-through income properly)

Incorrect allocation of deductions, especially those related to tax-exempt income

Missed or incorrectly timed elections (e.g. not making the 65-day rule election or not filing Form 1041-T on time)

Failure to disclose foreign accounts and assets on Form 8938

Failure to withhold sufficient U.S. income tax on distributions to non-U.S. citizen beneficiaries



Final Thoughts: Strategic Guidance for Tax Practitioners

Form 1041 isn't just a compliance checkbox; it's a critical filing requirement that is grounded in a longstanding history of treating estates and trusts as separate taxable entities. But practitioners must recognize the practical reality: the filing thresholds are low and can easily be triggered with minimal income. It's essential to analyze estates and trusts separately, as differences in their administration, timing flexibility, and tax planning opportunities can significantly differ. Proper trust classification—whether grantor or non-grantor, simple or complex—is foundational for both compliance and strategic tax planning. With fiduciary tax brackets tightly compressed, accumulating income can quickly become costly and often undesirable, making it vital to coordinate fiduciary accounting, income tax reporting, and beneficiary tax profiles.

You don't have to navigate the complexities of Form 1041 and fiduciary taxation alone. Aprio is committed to helping you identify potential pitfalls, optimize tax outcomes, and maintain compliance, so you can focus on fulfilling your fiduciary responsibilities with confidence.



Compliance Calendar and Checklists for Trustees and Advisors

Key Deadlines and Extensions

Form	Due Date	Statutory Extension
1041 "U.S. Income Tax Return for Estates and Trusts"	15th day of the 4th month after the close of the trust's tax year (typically April 15th)	5 ½ months by filing Form 7004 (typically September 30th)
"Schedule K-1" (Appended to Form 1041 and reports beneficiary income)	15th day of the 4th month after the close of the trust's tax year (typically April 15th)	5 ½ months by filing Form 7004 (typically September 30th)
1041-ES "Estimated Income Tax for Estates and Trusts"	Quarterly: April 15, June 15, September 15, January 15 No extension; payments only	NONE
56 "Notice Concerning Fiduciary Relationship" (trustee appointment or termination)	Immediately, upon fiduciary appointment or change	NONE
990-PF "Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation"	15th day of the 5th month after the close of the trust's tax year (typically May 15th)	6 months by filing Form 8868 (typically November 15th)
706 United States Estate (and Generation-Skipping Transfer) Tax Return	9 months after date of death	6 months by filing Form 4768
8971 "Information Regarding Beneficiaries Acquiring Property From a Decedent" (estate basis reporting, may affect trusts receiving assets)	30 days after Form 706 is filed or due	NONE



Compliance Checklist for Trustees and Advisors

✓	Confirm trust classification	Verify whether the trust is treated as a revocable or non-revocable, grantor or non-grantor trust for the year, based on federal tax rules.
✓	Confirm trust tax year	Determine whether the trust uses a calendar year or fiscal year, and whether any change has occurred.
✓	Review trust governing document	Reconfirm distribution provisions, trustee powers, charitable interests, and any restrictions affecting taxation. Double-check any state and IRS overrides.
✓	Confirm trustee identity and authority	Verify that the acting trustee(s) are properly appointed and authorized under the trust instrument or by court order. Review scope of authority.
✓	Confirm contacts for fiduciary notices	Confirm the IRS and relevant parties have current fiduciary information (e.g., trustee current contact details).
✓	Identify trust residency status	Evaluate whether the trust is treated as a resident or nonresident trust for each applicable state.
✓	Assess state nexus exposure	Identify states in which the trust may have income-producing property or activity creating nexus.
✓	Review changes in trustees, beneficiaries, or administration	Changes in people or location may affect residency, nexus, or reporting obligations.
✓	Review income sources for the year	Identify interest, dividends, rents, business income, royalties, capital gains, tax-exempt, etc. income.
✓	Confirm allocation between income and principal	Confirm income and principal are properly classified under the trust instrument and applicable fiduciary law and IRS rules.
✓	Review distributions made or required	Determine whether distributions were discretionary or mandatory and to whom they were made.
✓	Confirm beneficiary information	Verify beneficiary identities, addresses, and tax reporting information.
✓	Evaluate estimated tax requirements	Determine whether estimated tax payments are required at the federal or state level.
✓	Confirm charitable reporting obligations	Identify whether the trust qualifies as a split-interest trust or otherwise has charitable filing requirements.
✓	Coordinate federal and state reporting positions	Maintain consistency between federal return positions and state filings.
✓	Review prior-year carryovers	Identify capital loss carryovers, charitable carryovers, or excess deductions. Notate current year carryover, for use in the following year.
✓	Confirm withholding or composite filing obligations	Determine whether state withholding or composite (a permitted state-level convenience where there are multiple non-resident beneficiaries) filings apply for beneficiaries.
✓	Retain supporting documentation	Maintain records of income, expenses, valuations, distributions, and trustee decisions.
✓	Review correspondence from taxing authorities	Confirm that notices, inquiries, or assessments have been addressed timely.
✓	Document trustee decision-making	Keep written records of material tax and distribution decisions as part of fiduciary best practices.



About Aprio

Aprio helps businesses and individuals Account for Anything™ with advisory, tax, audit, legal, wealth, and talent solutions that deliver clarity and confidence in a world full of unknowns. Clients across the U.S. and over 50 countries trust Aprio for the solutions and guidance they need to achieve goals with speed and efficiency. Learn more at [Aprio.com](https://aprio.com)