Federal income taxation of trusts — an overview

A common question for a grantor or a beneficiary of a trust is: "How will income in my trust be taxed?" Unfortunately, the answer to that question can be complex, because it is dependent on many factors, including the type of trust, the rights of the beneficiaries under the trust, and the activity in the trust during the tax year. Below are some general rules for the federal income taxation of trusts that may help answer this important question.

1. **Grantor trust:** For income tax purposes, a trust is either a grantor trust or a nongrantor trust. If the trust is a grantor trust, it is treated as the same taxpayer as the grantor. All income realized in a grantor trust is passed through to the grantor and reported on the grantor's income tax return. The grantor is responsible for paying the tax, even if the trust's assets are outside the grantor's estate for estate tax purposes.

   A trust will be classified as a grantor trust if the grantor or the grantor's spouse has one or more specific powers or rights over the trust. Those powers and rights include, among others, the following:
   - Right to revoke the trust
   - Right to receive income from the trust
   - Power to substitute trust assets for equivalent value
   - Power to borrow trust property without adequate security

   Even if the grantor or the grantor's spouse do not retain any of those rights and powers over a trust, a trust may be a grantor trust with respect to a beneficiary if the beneficiary has the right to withdraw the trust assets. In that situation, the beneficiary is treated as the grantor for purposes of the grantor trust rules and is responsible for the income tax arising from the trust.

2. **Nongrantor trust:** If a trust is not classified as a grantor trust, then it is a nongrantor trust and will be treated as a separate taxpaying entity. Generally, taxable income of a nongrantor trust is computed as it is for an individual, but the trust is allowed a personal exemption, a distribution deduction and a deduction for certain administrative expenses.

   Because a nongrantor trust receives a distribution deduction, income is taxed either to the trust or to the beneficiary. Any income that is accumulated in the trust is taxed to the trust, but any income distributed (or required to be distributed) to a beneficiary is taxed to that beneficiary, subject to the following rules:
   - The amount taxed to the beneficiaries is limited to the trust's distributable net income (DNI)
   - Generally, capital gains are taxed to the trust, even if a principal distribution is made to a beneficiary

   While DNI is a complex concept under tax law and has many nuances depending on the trust, it is generally computed as follows:

   Taxable income (without reduction for the personal exemption or distribution deduction)
   \- Capital gains
   \+ Capital losses allocable to principal
   \- Extraordinary dividends and taxable stock dividends not paid or credited to a beneficiary
   \+ Tax-exempt interest
   \- Expenses allocated to tax-exempt interest
   DNI

Once DNI is determined, it is allocated proportionately among the beneficiaries based on the amount of distributions to those beneficiaries, but not in excess of any distribution that beneficiary actually received. In addition, items of income allocated to a beneficiary will have the same character in the hands of the beneficiary as in the trust.

For example, if a trust has DNI equal to $20,000 ($10,000 of dividend income and $10,000 of interest income), and $20,000 is distributed equally to two beneficiaries, then each beneficiary will report $5,000 of dividend income and $5,000 of interest income. (See sidebar for additional examples.)

3. **Tax rates:** Any income taxable to a trust is subject to special federal income tax brackets for trusts. Unfortunately, a trust hits the highest tax bracket much earlier than an individual does.

Ordinary income tax rates (2026)

Taxable income	Applicable rate
$0 – $3,300	10%
$3,301 – $11,700	24%
$11,701 – $16,000	35%
Over $16,000	37%

Long-term capital gains tax rates (2026)

Net capital gain and qualified dividends	Applicable rate
$0 – $3,300	0%
$3,301 – $16,250	15%
Over $16,250	20%

In addition to the general federal income tax rules described above, there are other nuanced rules that may apply to a particular trust depending on the terms of the trust and the income realized by the trust. There may also be state income tax that applies to the trust. It is important to consult with your tax advisor to determine the specific income tax implications for you and your trust.

Examples of federal income taxation of trusts

Example 1: Under the terms of a nongrantor trust for the benefit of Peter and Riley, the trustee has the discretion to make distributions of income and principal to any one or more of the beneficiaries for their health, support and education. During 2026, the trustee made discretionary distributions of $50,000 to Peter and $25,000 to Riley, and the trust realized the following income:

- Interest: $10,000
- Dividends: $30,000
- Long-term capital gains: $50,000

The trust paid a trustee's fee of $10,000, which is deductible for federal income tax purposes.

The trust's 2026 taxable income (without reduction for the personal exemption or distribution deduction) is computed as follows:
Items of income ($10,000 + $30,000 + $50,000)
- Expenses ($10,000 trustee fee)
Taxable income = $80,000

The trust's DNI is computed as follows:
Taxable income ($80,000)
- Long-term capital gains ($50,000)
DNI = $30,000

As a result, the amount that can be taxed to Peter and Riley is limited to $30,000. The income tax results for Peter, Riley and the trust are as follows:

- **Peter** will report $20,000 on his income tax return, $5,000 of which will be interest income and $15,000 of which will be dividend income.
- **Riley** will report $10,000 on her income tax return, $2,500 of which will be interest income and $7,500 of which will be dividend income.
- The **trust** will pay tax on the $50,000 of long-term capital gains

Example 2: The facts are the same as in Example 1, but Peter and Riley each received $10,000 from the trust in 2026. While DNI may be $30,000, the trust only distributed $20,000 for the year, so the income tax results for Peter, Riley and the trust are as follows:

- **Peter** will report $10,000 on his income tax return, $2,500 of which will be interest income and $7,500 of which will be dividend income.
- **Riley** will report $10,000 on her income tax return, $2,500 of which will be interest income and $7,500 of which will be dividend income.
- The **trust** will pay tax on the balance of the taxable interest and dividend income, since only $20,000 was distributed to Peter and Riley. The trust will also pay tax on the $50,000 of long-term capital gains.