WHITE PAPER

Proposed enactment of § 736.08145, Florida Statutes, to give trustees discretionary authority to reimburse the deemed owner of grantor trusts for income taxes attributable to trust income.

I. CURRENT LAW

Sections 671 through 678 of the Internal Revenue Code (often called the "grantor trust rules") provide that, if certain conditions are met, property held in a trust will be treated as owned by the settlor or another person for federal income tax purposes. (Such a trust is often called a "grantor trust", and the deemed owner is often called the "grantor", and this paper follows that custom.) When the grantor trust rules apply, the grantor is required to report all items of income, loss, deduction and credit realized by the grantor trust on his or her individual income tax return. As a result, the grantor—and not the trust or its beneficiaries—will be liable to pay any resulting income tax.[1]

The Internal Revenue Code requires the grantor to pay income taxes on trust income even if the grantor has no beneficial interest in the trust and thus cannot access its income. This result benefits the trust and its beneficiaries because the trust estate is not diminished by income taxes.[2] When the grantor is willing and able to bear the trust's income tax burden in order to benefit trust beneficiaries, practitioners often employ grantor trusts intentionally. However, when the grantor does not have the means or desire to pay income taxes associated with the grantor trust, the grantor trust rules can be highly undesirable for the grantor.[3]

When the grantor is unwilling or unable to bear all of the trust's income tax burden, the parties to the trust may convert the trust into a nongrantor trust so that the trust or its beneficiaries bear the income tax burden. However, in some cases, such a conversion would be undesirable. For instance, the conversion may cause the grantor to realize "phantom" income that is not attributable to an economic gain.[4] A conversion may also cause the trust to cease

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[1] I.R.C. § 671.

[2] Some empirical studies suggest that grantor trust status adds more value to a trust estate than ordinary market performance or valuation discounts. Jonathan G. Blattmachr, Mitchell M. Gans, and Alvina H. Lo, <u>A Beneficiary as Trust Owner: Decoding Section 678</u>, 35 ACTEC J. 106, 106 (2009).

[3] Indeed, for many years following the enactment of the grantor trust rules, planners often referred to grantor trusts as "defective" trusts. <u>Id.</u> at 106 n. 5.

[4] Gross income results if the trust holds an interest in a partnership and the trust's share of partnership nonrecourse liabilities exceeds its adjusted basis in the partnership interest. Treas. Regs. § 1.1001-2(c), Ex. 5; Rev. Rul. 77-402, 1977-2 C.B. 222. Some commentators believe that gross income can result if the grantor previously sold appreciated assets to the trust in exchange for a promissory note (as is common in sophisticated estate planning) and the obligation remains outstanding when the trust ceases to be a grantor trust. <u>E.g.</u>, F. LADSON BOYLE & JONATHAN G. BLATTMACHR, BLATTMACHR ON INCOME TAXATION OF ESTATES AND TRUSTS § 5:7.1[B] (17th ed., rev. 2018) (discussing arguments for and against recognition of gain by reason of loans from the grantor to the trust outstanding at the time that grantor trusts status ends).

being eligible to own stock in an S corporation[5] or to qualify for a $250,000 federal capital gains exclusion on the sale of a residence that is the grantor's primary residence.[6]

For these reasons, the parties to the trust may want the trust to remain a grantor trust yet at the same time relieve the grantor of the tax burden. In those cases, the parties may want to empower the trustee to reimburse the grantor for some or all of the income taxes attributable to the trust. However, until 2004, the gift and estate tax consequences of granting such power were uncertain—practitioners were concerned that the grantor's eligibility for tax reimbursement would cause trust property to be included in the grantor's gross estate for estate tax purposes.[7] Practitioners were also concerned that actually reimbursing the grantor could constitute a taxable gift by the trust beneficiaries to the grantor.[8] In the absence of definitive guidance from the IRS, few practitioners wrote trust documents permitting the trustee to reimburse the grantor for income taxes. In fact, many wrote trust documents explicitly forbidding such reimbursement.

On July 1, 2004, the Service resolved these uncertainties by issuing Revenue Ruling 2004-64.[9] In that Ruling, the Service held that, when an independent trustee has discretionary power under the terms of a trust agreement or applicable law to reimburse the grantor for taxes attributable to trust income, (a) the exercise of such power does not result in a taxable gift by the trust beneficiaries to the grantor and (b) the existence of such power will not by itself cause the value of the trust assets to be included in the grantor's gross estate for federal estate tax purposes.[10] The Service indicated that its holding might be different if, for example, (i) an understanding or arrangement existed between the grantor and the trustee regarding the exercise of such discretion, (ii) the grantor had the power to remove the trustee and name himself as trustee or (iii) applicable local law subjected the trust assets to claims by the grantor's creditors by reason of the reimbursement power.

After the Service issued Revenue Ruling 2004-64, several states—including Florida, which enacted Florida Statutes § 736.0505(1)(c) effective July 1, 2007—amended their trust laws to provide that the existence of a power in the trust document permitting a trustee to

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[5] See I.R.C. § 1361(c)(2)(A)(i) (a trust is a permissible S corporation shareholder if it is a grantor trust, as to income and corpus, with respect to an eligible S corporation shareholder); see, e.g., Priv. Ltr. Rul. 200001015 (Jan. 7, 2000).

[6] See I.R.C. § 121; cf. Priv. Ltr. Rul. 9118017 (May 3, 1991) (construing prior section 121 provision excluding gain on sale of residence by individual over age fifty-five).

[7] Under Internal Revenue Code Section 2036, the value of a decedent's gross estate will include the value of property that the decedent transferred by gift to a trust during his life if the decedent retained "the possession or enjoyment of, or the right to the income from, the property". See I.R.C. § 2036(a)(1). The regulations clarify that an individual is deemed to have retained the use, possession, right to the income, or other enjoyment of the transferred property to the extent that such property must be applied to discharge such individual's legal obligations. Treas. Regs. § 20.2036-1(b)(2).

[8] Cf. Kathleen M. Weiden and Charles A. Barragato, Get a Handle on Grantor Trust Tax Rules and Strategies, 74 PRAC. TAX STRATEGIES 87, 92 (Feb. 2005). See also I.R.C. § 2511, Treas. Reg. § 25.2511-1(c)(1).

[9] Rev. Rul. 2004-64, 2004-2 C.B. 7.

[10] Id. (Situation 3). On the other hand, if reimbursement of the settlor is mandatory under either the terms of the trust instrument or applicable local law, this will cause the full value of the trust's assets to be included in the settlor's gross estate under Internal Revenue Code Section 2036(a)(1). See id. (Situation 2).

reimburse the grantor for income taxes attributable to trust income does not subject the trust assets to claims by the grantor's creditors.[11] In affirming this public policy, Florida's and other states' legislatures recognized the significant benefits of giving trust parties the flexibility to reimburse the grantor for income taxes attributable to trust income.

II. REASONS FOR CHANGE

Under current Florida law, the flexibility to reimburse the grantor for taxes is unavailable to Florida trusts unless a specific provision appears in the trust document. Such a provision is unlikely to appear in any Florida trust document prior to July 1, 2007, given the state of the law prior to Revenue Ruling 2004-64 and Florida Statutes § 736.0505(1)(c). Furthermore, such a provision would not appear in a trust document after July 1, 2007, unless the draftsperson had the knowledge and foresight to include it. The benefits of tax reimbursement may also be unavailable to trusts created in other jurisdictions which have not enacted laws like Florida Statutes § 736.0505(1)(c). Therefore, many grantor trusts, whether located in Florida or elsewhere, confront the dilemma of (a) forcing the grantor to continue to bear an income tax burden that he or she may no longer be willing or able to bear or (b) converting to nongrantor trust status so that the trust bears its own income tax burden going forward (and accepting whatever negative consequences may follow from that conversion).

A growing number of states have realized that it is unnecessary to place trust parties in this dilemma.[12] To date, five states (Colorado, Delaware, New York, and New Hampshire) have enacted statutes which empower trustees to reimburse the grantor for income taxes attributable to trust income (or to pay these taxes directly on the grantor's behalf).[13]

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[11] FLA. STAT. ANN. § 736.0505(1)(c) (West 2018) ("the assets of an irrevocable trust may not be subject to the claims of an existing or subsequent creditor or assignee of the settlor, in whole or in part, solely because of the existence of a discretionary power granted to the trustee by the terms of the trust, or any other provision of law, to pay directly to the taxing authorities or to reimburse the settlor for any tax on trust income or principal which is payable by the settlor under the law imposing such tax.") (eff. July 1, 2007). See also ALASKA STAT. § 34.40.110(m)(2), ARIZ. REV. STAT. ANN. § 14-10505-A(2)(a), IOWA CODE ANN. § 633A.2303(1), NEV. REV. STAT. § 163.5559(1), N.H. REV. STAT. ANN. § 564-B:5-505A(e)(6)(B), N.Y. EST. POWERS & TRUSTS LAW § 7-3.1(d), OHIO REV. CODE ANN. § 5805.06(B)(3)(c), TENN. CODE ANN. § 35-15-505(c), TEX. PROP. CODE ANN. § 112.035(d)(1).

[12] At present, a surprisingly small number of states have enacted statutes like those proposed herein. See Kim Kamin, Where Are All the Grantor Trust Reimbursement Statutes?, https://www.wealthmanagement.com/estate-planning/where-are-all-grantor-trust-reimbursement-statutes (Jan. 17, 2018, last visited Oct. 13, 2019).

[13] E.g., COLO. REV. STAT. § 15-5-818 (West 2018) ("Unless otherwise provided in the governing instrument, an independent trustee of a trust may, from time to time, in the trustee's discretion, distribute to the settlor an amount equal to any income taxes on any portion of the trust's taxable income for which the settlor is liable."); DEL. CODE. Ann. tit. 12 § 3344 ("Unless the terms of the governing instrument expressly provide otherwise . . . the trustee . . . may . . . reimburse the trustor for any amount of the trustor's personal federal or state income tax liability that is attributable to the inclusion of the trust's income, capital gains, deductions, and credits in the calculation of the trustor's taxable income."); N.H. REV. STAT. ANN. § 564-B:8-816(c) (West 2018) ("Except as otherwise provided under the terms of the trust, a trustee shall have the discretionary power to reimburse the settlor for the portion of the settlor's income tax liability attributable to the trust under section 671 of the Internal Revenue Code or any similar tax law."); N.Y. EST. POWERS & TRUSTS LAW § 7-1.11(a) (West 2018) ("Notwithstanding any contrary provision of law, the trustee of an express trust, unless otherwise provided in the disposing instrument, may, from time to time, pay from principal to the creator of such trust an amount equal to any income taxes on any portion of the trust principal with which he is charged."). In addition, some jurisdictions have recognized discretionary tax

These statutes create valuable flexibility for parties to existing grantor trusts as well as for practitioners and grantors of new trusts, who are now able either (a) to "opt out" of the statute for reasons of their own or, if they prefer, (b) to rely on the statute for the tax reimbursement authority needed to optimize the benefits of the trust to all parties. As a result, these jurisdictions are currently more likely to attract trust business from Florida and other jurisdictions.

It is proposed that Florida join these jurisdictions. Florida has already accommodated the trust parties who wish to allow trustees to reimburse the grantor for income taxes. The proposed legislation reflects the same policy on an "opt out" basis instead of requiring parties to "opt in". In updating its trust code, Florida would keep pace with other jurisdictions as a favored home for increasingly mobile trust business. The proposed legislation would entice trustees of existing grantor trusts to relocate such trusts to Florida from other jurisdictions that do not yet offer similar legislation. The proposed legislation would also demonstrate Florida's commitment to maintaining a modern trust code, which is essential not only to attract trusts and private trust companies from other states, but also to prevent the flight of Florida trusts and trust companies to other jurisdictions with more modern laws.

III. SUMMARY OF PROPOSED LEGISLATION

The proposed legislation would permit (but not require) an independent trustee of any grantor trust to reimburse the grantor for all or part of the income taxes paid by the grantor as a result of such trust's income. The proposed legislation would also permit (but not require) an independent trustee to pay all or part of such taxes directly to the appropriate taxing authority on behalf of the grantor (rather than reimburse the grantor after the fact). If enacted, the statute would confer this authority on the trustees of trusts created before or after the effective date unless the terms of the trust instrument expressly provide otherwise or the trustees elect otherwise in writing.

The proposed legislation has been drafted to fit squarely within the principles of Revenue Ruling 2004-64. First, the reimbursement authority granted to trustees would be purely discretionary, not mandatory, which is consistent with the Revenue Ruling's holding that a discretionary reimbursement power will not, by itself, cause estate tax inclusion.[14] Second, the "other facts" identified by the Revenue Ruling as having the potential to cause estate tax inclusion if combined with a discretionary reimbursement power are addressed either by existing Florida law or by the proposed statute itself:

- Florida law already provides that the trustee's power to reimburse the grantor for income taxes paid in respect of trust income will not cause the trust assets to be subject to the claims of the grantor's creditors.[15]

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reimbursement authority as a matter of common law. Mitchell M. Gans, Stephanie E. Heilborn, and Jonathan G. Blattmachr, Some Good News About Grantor Trusts: Rev. Rul. 2004-64, 31 Est. Plan. 467, 472 (2004) (citing New York and Pennsylvania case law).

[14] Rev. Rul. 2004-64, 2004-2 C.B. 7 (holding that a discretionary reimbursement power will not, by itself, cause the value of the trust assets to be included in the grantor's gross estate for federal estate tax purposes).

[15] FLA. STAT. ANN. § 736.0505(1)(c).

- The proposed legislation vests the tax reimbursement authority only in disinterested fiduciaries, which ensures that the tax reimbursement authority will not be held by or imputed to the grantor even if he or she has the power to remove the trustee and name himself or herself as successor trustee.

The proposed legislation also incorporates additional safeguards intended to prevent any adverse federal gift or estate tax consequences under current law or as a result of changes in law. These additional tax safeguards are modeled on the most sophisticated statutes recently enacted in other jurisdictions. For example:[16]

- The proposed legislation provides that insurance policies on the grantor's life cannot be used to satisfy the grantor's tax liability; and

- The reimbursement power cannot be exercised in a manner inconsistent with the marital or charitable deductions or the annual exclusion, or in a manner that would cause the inclusion of such trust's assets in the grantor's gross taxable estate for federal estate tax purposes.

Furthermore, if the parties to any trust do not wish to take advantage of the proposed legislation, or are concerned about the financial or tax impact, the trust document can "opt out" of the law or the independent fiduciaries may simply elect out of the application of the proposed legislation.

IV. TEXT OF LEGISLATION

Section 1. Section 736.08145, Florida Statutes, is created to read:

736.08145 Grantor trust reimbursement.—

(1)(a) Except as otherwise provided under the terms of a trust, if all or any portion of the trust is treated as being owned by a person under s. 671 of the Internal Revenue Code or any similar federal, state, or other tax law, the trustee may, in the trustee's sole discretion, reimburse the person being treated as the owner for any amount of the person's personal federal, state, or other income tax liability which is attributable to the inclusion of the trust's income, capital gains, deductions, or credits in the calculation of the person's taxable income. In the trustee's sole discretion, the trustee may pay such tax reimbursement amount, determined without regard to any other distribution or payment made from trust assets, to the person directly or to the appropriate taxing authority.

(b) A life insurance policy held in the trust, the cash value of any such policy, or the proceeds of any loan secured by an interest in the policy may not be used for such reimbursement or such payment if the person is an insured.

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[16] See COLO. REV. STAT. § 15-5-818 (effective January 1, 2019); DEL. CODE. Ann. tit. 12 § 3344 (effective June 19, 2019).

(2) This section applies to all trusts, whether created on, before, or after July 1, 2020, unless:

(a) The trustee provides written notification that the trustee intends to irrevocably elect out of the application of this section, at least 60 days before the effective date of such election, to the person treated as the owner of all or a portion of the trust under s. 671 of the Internal Revenue Code or any similar federal, state, or other tax law and to all persons who have the ability to remove and replace the trustee.

(b) Applying this section would prevent a contribution to the trust from qualifying for, or would reduce, a federal tax benefit, including a federal tax exclusion or deduction, which was originally claimed or could have been claimed for the contribution, including:

1. An exclusion under s. 2503(b) or s. 2503(c) of the Internal Revenue Code;

2. A marital deduction under s. 2056, s. 2056A, or s. 2523 of the Internal Revenue Code;

3. A charitable deduction under s. 170(a), s. 642(c), s. 2055(a), or s. 2522(a) of the Internal Revenue Code; or

4. Direct skip treatment under s. 2642(c) of the Internal Revenue Code.

(3) A trustee may not exercise, or participate in the exercise of, the powers granted by this section with respect to any trust if any of the following applies:

(a) The trustee is treated as the owner of all or part of such trust under s. 671 of the Internal Revenue Code or any similar federal, state, or other tax law.

(b) The trustee is a qualified beneficiary of such trust.

(c) The trustee is a related or subordinate party, as defined in s. 672(c) of the Internal Revenue Code, with respect to a person treated as the owner of all or part of such trust under s. 671 of the Internal Revenue Code or any similar federal, state, or other tax law or with respect to a qualified beneficiary of such trust.

(4) If the terms of a trust require the trustee to act at the direction or with the consent of a trust advisor, a protector, or any other person, the powers granted by this section to the trustee must instead or also be granted, as applicable under the terms of the trust, to the advisor, protector, or other person subject to the limitations set forth in subsection (3), which must be applied as if the advisor, protector, or other person were a trustee.

(5) A person may not be considered a qualified beneficiary of a trust solely by reason of the application of this section.

Section 2. This act shall take effect July 1, 2020.