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## Where Are All The Grantor Trust Reimbursement Statutes?

*Why aren't they more ubiquitous?*

Kim Kamin | Jan 17, 2018

While originally intended essentially to punish settlors who tried to evade income taxes by transferring assets to trusts, grantor trust planning has become an essential tool in estate planning.

With grantor trust status, a trust can accelerate growth without the tax drag. Also, the trust can utilize the grantor's Social Security number as its taxpayer ID number and avoid tax preparation hassles and fees. It can engage in desirable transactions with the grantor, like renting residential real estate, buying assets in an installment sale at low interest rates, and swapping out low basis assets for higher basis assets.

## **The Problem with Turning Off Grantor Trust Status**

A well-drafted grantor trust will always include the ability to turn off grantor trust status in case the grantor tires of paying the trust's taxes. For example, in a year when there is an unusually large capital gain or in which the grantor may be particularly cash-strapped, the grantor might be inclined to turn off the status rather than incur the tax liability.

Turning off grantor trust status, however, is harmful to the trust and is always contrary to the best interests of the beneficiaries. It may also have unintended consequences if the grantor is engaged in otherwise non-recognized transactions with the trust, such as a lease with a qualified personal residence trust or an installment sale to an intentionally defective grantor trust. In such situations, it's preferable for the trust to contain a discretionary trustee power to simply reimburse the grantor for the taxes in lieu of turning off the status.

## **Using Grantor Reimbursement Provisions Instead**

Across the country, many practitioners are addressing this issue by inserting language in their trusts giving trustees the authority to reimburse grantors for taxes (or to pay the trust's share of the tax liability directly) as a disincentive for turning off grantor trust status altogether and to build in more flexibility.

The Internal Revenue Service permits reimbursement for taxes and won't include the amount of the trust in the settlor's taxable gross estate as long as the payment isn't: (1) forbidden by state law, (2) subject to a pattern of abuse that suggests an

agreement to reimburse, or (3) mandatory. In Revenue Ruling 2004-64, the IRS addressed this issue and determined that there would be no inclusion in the gross estate for federal estate tax purposes if the trustee has discretionary authority, under the instrument or applicable local law, to reimburse the grantor for the income tax liability. There must not be any facts indicating control by the grantor, such as pre-existing arrangements, powers to remove trustee and name the grantor as trustee, or local law subjecting the trust assets to the claims of the grantor's creditors. On the other hand, if the applicable local law or the trust's governing instrument requires a mandatory payment for the income tax liability, this will trigger inclusion in the grantor's taxable gross estate under Internal Revenue Code Section 2036(a)(1) for any trust created after Oct. 4, 2004.

Under the holding of the above Revenue Ruling, no state statute expressly authorizing reimbursement for grantor taxes should be necessary, as long as such reimbursement is permitted by the instrument and there is no local law subjecting the trust assets to the grantor's creditors claims. Nonetheless, to provide comfort and clarity, many states have enacted statutes that address grantor trust reimbursement, including, but not limited to, New York , New Hampshire , Delaware , Virginia and Idaho .

Note that New York allows for discretionary payments by the trustee even if the instrument doesn't expressly give that, but limits that default reimbursement power to capital gains from the principal of the trust. NY EPTL 10-6.6(s)(10) also provides that a grantor won't be considered a beneficiary of the trust if this amount is paid. New Hampshire, in NH Rev Stat Section 564-B:8-816(c) , gives a trustee the discretionary power to reimburse the settlor's income tax liability attributable to the trust, and notes that the creditors can't reach the trust assets, but is silent on expressly stating that grantor is not a trust beneficiary. In Delaware, the power to reimburse must be given in the instrument, creditors are unable to reach trust assets if there's a discretionary trustee power to reimburse, but there is no express provision stating the grantor is not a trust beneficiary. In Virginia, a trustee's discretionary authority isn't reachable by the settlor's creditors. Lastly, Idaho discusses that a settlor isn't a beneficiary if a grantor trust

has a tax reimbursement provision.

The most comprehensive statutes will provide that: (1) a trustee can reimburse the grantor's taxes even if the instrument is silent, (2) reimbursement doesn't make the grantor a trust beneficiary, and (3) trust assets aren't available to the grantor's creditors. Although none of the states listed above appears to have all three of these, New Hampshire comes the closest with its comprehensive statute.

### **Sample Trust Language**

Below are three examples of sample language for grantor reimbursement in a trust provided by practitioners:

Florida Trust Language from David Pratt of Proskauer Rose LLP:

“Income Tax Reimbursement or Payment. If the Settlor is treated (under Subpart E, Part 1, Subchapter J, Chapter 1 of the Code) as the owner of all or part of any trust under this Agreement, the Trustees (other than a Trustee who is, with respect to the Settlor, a "related or subordinate party" within the meaning of Section 672(c) of the Code) may, in their absolute discretion, reimburse the Settlor for any amount of the Settlor's personal income tax liability that is attributable to the inclusion of such trust's income, capital gains, deductions and credits in the calculation of the Settlor's taxable income. The Trustees may pay the Settlor directly or may pay the reimbursement amount to an appropriate taxing authority on the Settlor's behalf, as they see fit. No policy of insurance on the Settlor's life, if any is held in a trust from which the Settlor is reimbursed, nor its cash value nor the proceeds of any loan secured by an interest in the policy may be used to reimburse the Settlor or to pay an appropriate taxing authority on the Settlor's behalf.”

New Hampshire Trust Company Language from Amy Kanyuk of McDonald & Kanyuk:

**“Waiver of Right of Reimbursement. The Grantor hereby negates any right the Grantor might have under state law to require the Trustee to reimburse him for any federal or state income tax liability the Grantor pays as a result of the existence of the Grantor’s power [to substitute assets]. Notwithstanding the foregoing, during the Grantor’s lifetime, the disinterested Trustee may, in its sole and absolute discretion, make distributions of income or principal to the Internal Revenue Service (or similar state agency) in order to satisfy any federal or state income tax liability incurred by the Grantor pursuant to the laws of the United States or any state in the United States which is attributable to income of any trust created hereunder with respect to which the Grantor is treated as the owner for federal income tax purposes under subchapter J of the Code. The disinterested Trustee is authorized, in its sole and absolute discretion, by an instrument filed with the trust records, irrevocably to release the right to satisfy any such tax liability. Under no circumstances shall the provisions of this Paragraph result in the Grantor being considered a beneficiary of any trust created hereunder.”**

**Delaware Trust Language from Dan Rubin of Moses & Singer LLP:**

**“For each taxable year that the trust constitutes a so-called "grantor trust," the Trustees may reimburse the Grantor out of income or principal (apportioned among the trusts hereunder) for the Grantor's income tax (federal, state, local, or foreign) on the amount of the trust's income (if any) reportable on the Grantor's individual income tax return under Code Sec. 671.”**

**With more states joining the bandwagon and flexibility at a premium, hopefully grantor trust reimbursement statutes and permissive language in trusts will be nearly ubiquitous in the near future.**

**What are your views on and what has been your experience with grantor trust reimbursement clauses?**

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