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TOPIC: Warning Will Robinson: Tax Reimbursement Clauses May Cause Problems.

MARKET TREND: With new tax laws and limits on itemized deductions impacting individual tax liabilities, creators of grantor trusts may be looking more often to tax reimbursement clauses.

SYNOPSIS: As creators ("grantors") of irrevocable grantor trusts must pay the trusts' annual income taxes without receiving any trust benefits, advisors typically suggest incorporating a tax reimbursement power that gives the trust flexibility to reimburse the grantor for the tax payment. Despite their prevalence, however, tax reimbursement powers must be crafted and used with care, not simply exercised as a matter of course. Specifically, a tax reimbursement power (1) should be at the complete discretion of an independent trustee, (2) should not trigger access to trust assets by the grantor's creditors under applicable state law, (3) should not be exercised as part of a pre-existing arrangement or understanding between the trustee and the grantor, and (4) should comply with the trustee's fiduciary obligations to the trust and its beneficiaries.

TAKE AWAYS: For trusts with tax reimbursement powers (1) the circumstances should indicate that the grantor can pay the trust's taxes without relying on or expecting reimbursement, (2) the trustee should document its rationale for reimbursing the grantor, including how the reimbursement is in the interest of the trust and beneficiaries, and (3) the trust should still give the grantor the ability to terminate grantor trust status, if, due to changed circumstances, the grantor needs or wants to eliminate his ongoing obligation to pay the trust's taxes.

With irrevocable grantor trusts, the grantor's obligation to pay the trust's income taxes may become increasingly burdensome over time. Advisors typically suggest incorporating a tax reimbursement power, providing the trust with flexibility to reimburse the grantor for payment of the trust's income tax liability. Despite their prevalence, however, tax reimbursement powers must be crafted and handled with care.

GRANTOR TRUSTS: QUICK TAKE

There is a unique dichotomy in the federal tax treatment of grantor trusts – gifts to the trust are treated as complete for federal gift, estate, and generation-skipping transfer tax purposes, but the grantor is still treated as the owner of the trust assets for income tax purposes. As a result, the grantor must include and pay tax on all the trust's taxable income and gains on his individual income tax returns as if earned or received personally.

- ***Practically Speaking:*** These features make grantor trusts a mainstay of legacy and life insurance planning, as they allow the following:
    - Payment of the trust's income tax liability is not treated as an additional gift to the trust, enhancing the growth in the value of the trust assets.
    - Transactions between a grantor and the grantor trust, such as loans or sales, are disregarded for income tax purposes and do not trigger income or gain recognition.
    - Transfers of life insurance policies insuring the grantor between the grantor and a grantor trust (or two grantor trusts with the same insured as the grantor) will not trigger transfer for value issues that could otherwise result in income taxation of the policy death benefits.
    - The grantor can use a non-fiduciary substitution power to reacquire the assets held in the trust by substituting assets of equivalent value.

ADDRESSING THE GRANTOR'S TAX BURDEN: YOU PAY … NO YOU PAY

As a trade-off for grantor trust flexibility, the grantor must continue to pay the trust's income taxes without receiving any corresponding benefit from the trust's income and gains. Paying taxes on "phantom" income, however, may become difficult for the grantor, especially if tax law changes increase the grantor's overall tax burden and/or the trust has a substantial increase in income or gains (e.g., due to a sale of assets). One solution is for the trust to give the trustee the discretion to reimburse the grantor for payment of the trust's income taxes (a "tax reimbursement power").

- ***Practically Speaking:*** A tax reimbursement power may be desired if the grantor has some concerns about the stability of his future cash flow and/or expects significant appreciation and eventual sale of the trust assets.

A tax reimbursement power can assist the grantor with the trust's tax burden without causing estate inclusion of the trust assets. Advisor, grantors, and trustees, however, must proceed with care in using such powers, keeping the following in mind:[1]

Absolute Discretion of the Trustee*.* The exercise of a tax reimbursement power should be in the complete discretion of a trustee not "related or subordinate" to the grantor.[2] If the trust mandates tax reimbursement for the grantor, or if the grantor retains a right under applicable state law to require such a reimbursement, then the trust assets could be used to discharge a legal obligation of the grantor, triggering estate inclusion of the trust assets.[3]

Not Accessible by Grantor's Creditors. Including a tax reimbursement power in the trust agreement must not cause the trust assets to become subject to claims of the grantor's creditors. Applicable state law will determine the creditors' rights in such a case. Some states have enacted statutes specifying that tax reimbursement powers will not make the grantor a beneficiary of the trust and/or subject the trust assets to the grantor's creditor claims (e.g., Delaware, New York, Texas, and Virginia).[4] For states that do not directly address the issue, state statues and case law as a whole must be analyzed to determine the potential rights of the grantor's creditors.

- ***Practically Speaking:*** Application of a state's creditor laws is an important factor in selecting the trust's jurisdiction if a tax reimbursement power is desired. Grantors and advisors may consider creating the trust in a state with a favorable creditor statute, assuming the jurisdiction will have a sufficient nexus to the trust and not adversely impact other important trust features (e.g., trustee liability, accounting requirements, trust perpetuities period, etc.).[5] Otherwise, the conservative approach may be to forego inclusion of the reimbursement clause but ensure the trust gives the grantor the option to terminate grantor trust status (discussed below).

No Pre-Existing Arrangement or Understanding. Of particular concern, any pre-existing arrangement or express or implied agreement between the grantor and the trustee regarding tax reimbursement also can trigger inclusion of the trust assets in the grantor's estate. All aspects of how and when the trustee reimbursed the grantor's tax payments may be reviewed, giving the IRS wide latitude. For example, if the trustee regularly reimburses the grantor as a routine matter without deliberation, it could raise estate inclusion issues for the grantor. Fiduciary considerations also apply for trustees in exercising the discretionary reimbursement power, as discussed below, which may cause concern.

- ***Practically Speaking:*** To help avoid indications of a pre-existing arrangement or understanding with the trustee, at creation of a grantor trust, the facts and circumstances should show that the grantor could support payment of the trust's on-going tax liability without reliance on reimbursement.

<u>Compliance with Trustee's Fiduciary Duties</u>. Since the trustee owes a fiduciary duty to administer the trust solely in the interest of the beneficiaries, a key question is why the trustee would use the trust assets to help with the grantor's tax liability. To avoid potential fiduciary liability and also implications that the trustee was controlled by or had agreed to benefit the grantor, the trustee should be able to show how exercising the tax reimbursement power supports the interests of the trust and its beneficiaries.

- ***Practically Speaking:*** The trustee should clearly document its deliberations and reasons for exercising the tax reimbursement power. For example, is the grantor otherwise considering a termination of grantor trust status?

<u>Termination of Grantor Trust Status as Alternative</u>. A grantor should not expect or rely on a tax reimbursement power to pay the trust's income tax liability, and the inclusion of such a power may not be advisable in some trusts under applicable state law. As an alternative, the trust agreement also should provide the grantor with the ability to terminate grantor trust status if he no longer can or wants to pay the trust's income taxes. Termination of grantor trust status should not require discretionary actions of the trustee, however, as it may infringe on the trustee's fiduciary duties to the trust beneficiaries.

- ***Practically Speaking:*** The trust could provide that any powers held by the trustee (or others) that trigger grantor trust status are subject to termination based upon the grantor's release of his grantor trust powers (e.g., if the grantor's only grantor trust power is a non-fiduciary substitution power over the trust, which he releases, all other grantor trust provisions in the trust automatically terminate).

Note that the potential income tax consequences to the grantor of turning off grantor trust status should be reviewed before the grantor releases any powers. If, at termination, the trust owns encumbered assets in which its debt exceeds its adjusted basis in its assets, the grantor will recognize gain on the difference.[6]

TAKE AWAYS

For trusts with tax reimbursement powers (1) the circumstances should indicate that the grantor can pay the trust's taxes without relying on or expecting reimbursement, (2) the trustee should document its rationale for reimbursing the grantor, including how the reimbursement is in the interest of the trust and beneficiaries, and (3) the trust should still give the grantor the ability to terminate grantor trust status, if, due to changed circumstances, the grantor needs or wants to eliminate his ongoing obligation to pay the trust's taxes.

NOTES

[1] See generally Rev. Rul. 2004-64 for IRS guidance regarding the inclusion of tax reimbursement provisions in grantor trust agreements.

[2] The factual situations involving a grantor trust tax reimbursement clause, as presented in Rev. Rul. 2004-64 (see note 2 above), specify a trust agreement that requires the trustee to be a person who is not related or subordinate to the grantor of the trust. The ruling does not address a factual situation where the trustee is related or subordinate to the grantor. The IRS may argue that giving tax reimbursement discretion to a related and subordinate trustee could indicate an implied agreement to reimburse the grantor, potentially triggering estate tax inclusion under Code §2036.

[3] Code §2036.

[4] See, 12 Del. Laws §3536; N.Y. EPTL §10-6.6(s)(10); Tex. Prop. Code. Ann. §112.035(d); Va. Code §64.2-747.A.1.

[5] Also, to account for the possibility that the trust's governing law could be changed to another jurisdiction, the trust agreement should provide that the tax reimbursement clause is only effective to the extent it does not subject any portion of the trust's assets to claims of the grantor's creditors under applicable state law.

[6] *Madorin v. Commissioner*, 84 T.C. 667 (1985); Treas. Reg. § 1.1001-2(c), Example (5); Rev. Rul. 77-402.