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Feature Story

IRS Ruling Clarifies Income, Gift & Estate Tax Issues For Grantor Trusts

By Jeffrey A. Baskies

A favorable IRS Revenue Ruling came out on July 6 regarding the income and estate tax consequences of grantor trusts. (Some call them "intentionally defective grantor trusts" or "intentionally defective irrevocable trusts" but herein let's just call them "grantor trusts.")

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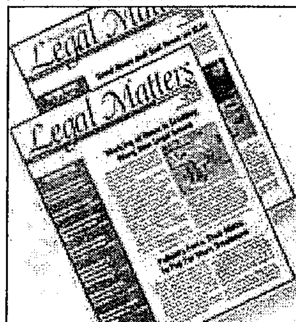

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In the ruling, the issues presented included (i) whether the grantor's paying income tax for income earned in the grantor trust (and held for the beneficiaries) constituted a gift to the beneficiaries and/or made the trust includible in the grantor's estate; and (ii) whether a tax reimbursement provision in the trust might create gift or estate tax consequences.

The Three Situations Presented

In Rev. Rul. 2004-64, a grantor created an irrevocable trust that had an independent trustee and did not include any retained control, which would either have made a gift to the trust incomplete or made the trust subject to estate inclusion for the grantor. The income earned in the trust is reported on the grantor's income tax return and increases his overall income tax liability. Then there were three situations presented.

Situation 1

Neither state law nor the governing instrument of trust contains any provision requiring or permitting the trustee to distribute to the grantor amounts sufficient to satisfy the grantor's income tax liability attributable to the inclusion of trust's income in the grantor's taxable income. Accordingly, the grantor pays the additional income tax liability from his own funds.

Situation 2

The governing instrument of trust provides that if the grantor is treated as the owner of any

portion of trust pursuant to the provisions of subpart E of the Internal Revenue Code for any taxable year, the trustee shall distribute to the grantor for the taxable year, income or principal sufficient to satisfy the grantor's personal income tax liability attributable to the inclusion of all or part of the trust's income in the grantor's taxable income. Accordingly, the trustee distributes an amount to the grantor to reimburse him for the additional income tax liability.

Situation 3

The governing instrument of trust provides that if the grantor is treated as the owner of any portion of trust pursuant to the provisions of subpart E for any taxable year, the trustee may, in the trustee's discretion, distribute to the grantor for the taxable year, income or principal sufficient to satisfy the grantor's personal income tax liability attributable to the inclusion of all or part of trust's income in the grantor's taxable income. Pursuant to the exercise of the trustee's discretionary power, the trustee distributes an amount to the grantor to reimburse him for the additional income tax liability.

The Statutory Support

The IRS ruling then analyzed the most relevant sections of the Internal Revenue Code.

First, the ruling cites to Sect. 671 of the code, which essentially provides that if the grantor of a trust is treated as the owner of any portion of the trust under subpart E, those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust must be included in computing the taxable income of the grantor.

Second, the ruling points to Sect. 2501 and Sect. 2511 of the code, which combined impose a tax on the transfer of property by gift by an individual, whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. Further, the ruling notes in the regulations under Sect. 2511, that gift tax is applied where one gratuitously pays the tax liability of another.

Third, the ruling points out that Sect. 2036 of the code read in conjunction with the regulations thereunder, causes inclusion in the grantor's estate where the grantor has retained the use, possession, right to income, or other enjoyment of transferred property, and the grantor is deemed to have retained such to the extent that the transferred property is to be applied towards the discharge of a legal obligation of the grantor.

The Ruling

Essentially, the IRS ruled that when the grantor of a trust, who is treated as the owner of the trust under subpart E of the code, pays the income tax liability attributable to the inclusion of the trust's income on his return, the grantor is not treated as having made a gift to the trust or its beneficiaries. Or said another way, when one pays one's own tax liability, one has not made a gift. However, the ruling went on to note that the tax reimbursement clauses suggested in Situation 2 and Situation 3 could cause estate tax issues.

The IRS first ruled that, in Situation 1, the grantor's payment of the income tax liability did not constitute a gift by the grantor to the trust or it's beneficiaries for federal gift tax purposes. The reasoning was that the grantor, not the trust or its beneficiaries, was liable for the taxes. Thus paying his own taxes did not constitute a gift.

The ruling contrasted that situation with one where a grantor paid taxes for someone else. In that case, where someone else's tax is being paid by the grantor, that would constitute a taxable gift.

Further, the IRS ruled that in Situation 1 that no portion of trust would be included in the grantor's gross estate for federal estate tax purposes under Sect. 2036. That was because the

grantor had not retained the right to have trust property expended in discharge of his legal obligations.

Next, in Situation 2, the ruling noted that because the trust requires the trustee to reimburse the grantor from the trust's assets for the amount of the income tax he pays (attributable to trust's income), the grantor's payment of the income tax liability does not constitute a gift by him to the trust or its beneficiaries. Further, the IRS ruled, the trust's reimbursement for the income tax payment to the grantor is not a gift from the beneficiaries to the grantor, because the distribution from trust is mandated by the terms of the trust instrument.

However, the ruling noted that in Situation 2 there is adverse estate tax treatment. Essentially, the IRS ruled that since the grantor retained the right to have trust property expended in discharge of his legal obligation (income tax), the full value of the trust's assets at his death would be included in his gross estate under Sect. 2036(a)(1).

And beware: If you practice in a state where, under your state law, the trustee must - unless the governing instrument provides otherwise - reimburse a grantor his personal income tax liability attributable to the inclusion of all or part of the trust's income in his taxable income (and if the governing instrument does not provide otherwise), then the same result will apply. The trust will be included in the grantor's estate.

Finally, in Situation 3, where the trust provides the trustee with the discretion to reimburse the grantor from trust's assets for the amount of income tax he pays that is attributable to trust's income, his payment of the additional income tax liability does not constitute a gift by the grantor because he is liable for the income tax.

Further, the payment from the trust to the grantor as reimbursement for his income tax payment (if distributed pursuant to the exercise of the trustee's discretionary authority) does not create a gift by the trust or its beneficiaries to the grantor.

But, the ruling warned of potential problems with this plan. The IRS stated that "such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between A and the trustee regarding the trustee's exercise of this discretion; a power retained by A to remove the trustee and name A as successor trustee; or applicable local law subjecting the trust assets to the claims of A's creditors) may cause inclusion of Trust's assets in A's gross estate for federal estate tax purposes."

Thus, using a discretionary reimbursement clause might cause estate inclusion under Sect. 2036 in the wrong circumstances.

Conclusion

The Revenue Ruling is a big help to estate planners. For a long time we have believed/argued that a grantor paying his legal debts (income tax imposed on him by the Internal Revenue Code) should not be deemed to be making a gift. Further, we felt that should not cause estate tax inclusion.

This ruling supports both of those conclusions.

The ruling also highlights one actual and one potential problem with reimbursement clauses. Obviously, we know now that we cannot include a mandatory reimbursement clause when we draft grantor trusts. That will definitely cause estate inclusion.

But we are also cautioned about using discretionary clauses. If your client can afford not to worry about reimbursement, it definitely appears safer to avoid including such a clause in your grantor trusts.

Finally, this ruling will likely bolster the use of grantor trusts in sophisticated tax planning. They were already popular and these positive results were not fully known. Now that we have assurances from the IRS on the income, gift and estate tax consequences, we can more freely and aggressively advise our clients.

[EDITOR'S NOTE: The full text of the Revenue Ruling discussed in this article can be found in the Important Documents section of Lawyers Weekly USA's website.]

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