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Some Good News About Grantor Trusts: Rev. Rul. 2004-64

Mitchell M. Gans
Maurice A. Deane School of Law at Hofstra University

Stephanie E. Heilborn

Jonathan G. Blattmachr

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A favorable new Revenue Ruling clarifies the estate and gift tax treatment of a grantor trust when the grantor is reimbursed for income taxes paid on trust income. The authors analyze this significant Ruling and its ramifications.

MITCHELL M. GANS, STEPHANIE E. HEILBORN, AND JONATHAN G. BLATTMACHR, ATTORNEYS

On 7/6/04, the IRS issued Rev. Rul. 2004-64[1] (the "Ruling"). It addresses (1) gift tax consequences of a grantor's payment of the income tax attributable to the inclusion of the trust's income in the grantor's gross income under the grantor trust rules and (2) estate tax consequences of the trust's reimbursement to the grantor for those income tax payments.

The Ruling concludes that (1) the grantor's payment of the income tax attributable to the inclusion of the trust's income in the grantor's gross income is not a gift to the beneficiaries of the trust, because the grantor (not the trust) is liable for those taxes, (2) the trust's reimbursement of the grantor for the income tax payments made by the grantor is not a gift by the trust beneficiaries to the grantor, (3) if the trust contains no provision permitting the trust to reimburse the grantor for income taxes, or permits the trust to do so only in the trustee's discretion, the trust assets will not be includable in the grantor's estate for federal estate tax purposes unless other factors warrant inclusion, but (4) if the trust is *required* to reimburse the grantor for the income taxes paid by the grantor, the full value of the trust will be included in the grantor's estate for estate tax purposes under Section 2036(a)(1).

This article provides background on the grantor trust rules of subpart E of Part I of Subchapter J, Chapter 1 of the Internal Revenue Code, describes the advantages and disadvantages of creating a grantor trust, analyzes the holdings set forth in the Ruling, and explores the possible applications and implications of the Ruling for practitioners in drafting and administering grantor trusts.

MITCHELL M. GANS is a professor at Hofstra University School of Law in Hempstead, New York. STEPHANIE E. HEILBORN is an associate, and JONATHAN G. BLATTMACHR is a partner, in the New York City office of the law firm of Milbank, Tweed, Hadley & McCloy LLP.

Background on grantor trusts

A trust described in any of Sections 673 through 677 or Section 679 is treated as a so-called grantor trust for federal income tax purposes, which means that the income, deductions and credits of the trust must be included under Section 671 in determining the grantor's federal taxable income liability.[2] A trust may be a grantor trust either by its terms or by the way in which it is administered.

For example, a trust will be a grantor trust if it includes one or more specified terms, such as a provision giving the grantor a reversionary interest in the income or corpus of the trust that exceeds 5% of the value of that income or corpus,[3] a provision giving the grantor (or another, in some cases) the power to control the beneficial enjoyment of income or corpus[4] or to revoke the trust,[5] or a provision permitting the income of the trust to be distributed to, held or accumulated for future distribution to, or applied to the payment of premiums on insurance policies on the life of the grantor.[6] Alternatively, granting an indi-

vidual certain administrative powers over the trust, such as a power (held in a non-fiduciary capacity) to reacquire the trust's assets by substituting other assets of equal value,[7] or a power to add to the class of beneficiaries (other than later-born or later-adopted persons),[8] makes the trust a grantor trust. A trust may be a grantor trust in whole or in part.[9]

The income tax treatment and estate/gift tax treatment of trusts are somewhat asymmetrical—that is, the fact that a trust is a grantor trust for income tax purposes does not necessarily mean that all or a portion of the trust will be includable in the grantor's gross estate for estate tax purposes. For example, a trust may be treated as a grantor trust under Section 677(a) because the grantor or the grantor's spouse is entitled to receive discretionary distributions of income from the trust, but that factor alone will not cause the trust to be included in the grantor's gross estate under Section 2036 or otherwise. Alternatively, Section 674 subjects a trust to grantor trust treatment if anyone—not just the grantor—who is not an adverse party holds the powers described in that section (subject to certain exceptions), but Sections 2036(a) and 2038 apply to cause the trust to be included in the grantor's estate only if the grantor holds the "proscribed" powers. This disparity means that an individual can create a trust that is treated as a grantor trust for income tax purposes but will not be includable in the grantor's estate. Depending on the grantor's intent, that result may be viewed as good or bad.

Advantages and disadvantages of grantor trusts

There may be three major advantages to creating grantor trusts. First, having the grantor pay the income tax on the trust's income permits the trust assets to grow tax-free. Structuring asset ownership to take advantage of tax-free compounding is one of the most important facets of estate and financial planning.

Second, the Service has ruled that transactions between a grantor and a grantor trust have no effect (that is, are treated as not occurring) for federal income tax purposes.[10] The grantor, therefore, may sell assets to, or buy assets from, a grantor trust without income tax recognition. This characteristic of a grantor trust could permit, for example, the grantor and the trustee to engage in "market timing" of investments, having the trust purchase certain assets from the grantor when the grantor and the trustee conclude they will increase in value more rapidly than the assets held by the trust and have the grantor purchase them from the trust when the grantor and the trustee believe other assets available for investment by the trust will appreciate more quickly, all without income tax effect. Of course, the conclusion by the grantor and the trustee about the relative increase in value of one asset over another may be wrong, but if he or she is more "right" than "wrong," the grantor may be able to shift wealth that otherwise would accumulate in his or her hands over to the trust without income tax (and, if the value of what is taken from the trust and the value of what is contributed are the same, without gift tax).

Third, because the existence of the trust is ignored for income tax purposes, the grantor is treated as owning the trust assets. That may be beneficial where ownership by an individual produces a preferred result. For example, although certain types of trusts (such as a qualified subchapter S trust ("QSST") and an electing small business trust ("ESBT")) may be shareholders of an S corporation, there may be restrictions on the terms of the trust, or the level of tax the trust must pay may be higher than an individual would pay. Because a grantor trust is ignored for income tax purposes, the grantor is treated as the owner of the trust for S corporation purposes.[11] There are other similar provisions in the Code that favor making the trust a grantor trust.

From a pure estate planning perspective, therefore, individuals generally may wish to contribute property to a grantor trust rather than transfer that property outright or to a trust that is not a grantor trust. In addition, if the trust is created in a jurisdiction that permits self-settled spendthrift

1 2004-27 IRB 7.

2 Section 671. Under Section 678, the income, deductions, and credits of a trust may be attributed to the trust beneficiary who is treated as the trust's owner, even though the beneficiary is not the grantor.

3 Section 673(a).

4 Section 674(a).

5 Section 676(a).

6 Section 677(a). An interest or power held by the grantor's spouse is attributed to the grantor for purposes of the grantor trust rules. Section 672(e).

7 Section 675(4)(C). Although the term "reacquire" could be construed as applying only if the power is held by the grantor, the context in which the rule appears suggests otherwise. The Service has issued several private letter rulings holding that the section applies regardless of whether the power of substitution is held by the grantor or someone else. See, e.g., Ltr. Rul. 9642039. Private letter rulings may not be used or cited as precedent (see Section 6110(k)(3)), but may be useful in showing how the Service views certain issues.

8 Section 674(c). This power need not be held by the grantor or the grantor's spouse (or even a person who is a related or subordinate party with respect to the grantor) to make it a grantor trust. Indeed, the power should not be held by the grantor, because that may cause the property to be included in the grantor's estate under Sections 2036(a)(2) and 2038 (relating to a power to control the beneficial enjoyment of property transferred prior to death).

9 Reg. 1.671-3(a).

10 Rev. Rul. 85-13, 1985-1 CB 184.

11 Section 1361(c)(2)(A)(i).

trusts to be exempt from claims of the grantor's creditors, contributing property to the trust may significantly reduce the property's exposure to the claims of creditors.[12] In summary, there may be no "downside" and there may be several advantages to placing property in a grantor trust: there should be no gain recognition on the contribution of property to the trust, the grantor can continue to take advantage of certain tax benefits available only to "individual" owners, and, to the extent that the grantor is able to pay the income tax on the trust, the property in the trust can grow "tax-free" until grantor trust status terminates.

Yet for a long time, many individuals tried to avoid creating trusts that were grantor trusts but were not includable in the grantor's estate (in fact, such grantor trusts were called "defective" trusts). One situation in which a grantor may wish to avoid creating a grantor trust is where the grantor lives in a jurisdiction with a high state and/or local income tax. If the trust is a grantor trust, the state or locality—just like the federal government—probably will impose the income tax on the trust's income by combining it with the grantor's other income, but if the trust is not a grantor trust, that income may escape state and local income taxation.[13]

A second case where the trust should not be a grantor trust is where a tax benefit would be denied. For instance, a grantor trust cannot be a qualified charitable remainder trust under Section 664.[14] A third situation in which an individual would try to avoid creating a grantor trust is where the taxpayer does not wish to be burdened with the tax on the trust's income. Although it may be better from an overall estate planning viewpoint for the grantor to pay the income tax on the trust's income, the grantor will incur "additional" personal income tax liability each year that the trust earns income. Consequently, the grantor may wish to be reimbursed by the trust for the income taxes attributable to the inclusion of the trust's income in the grantor's gross income, and many taxpayers do seek reimbursement for those income taxes. The "big question" for such taxpayers was how to create a grantor trust but leave the grantor no worse off—with respect to income tax liability—than he or she was before the trust was created.

Prior to the issuance of Rev. Rul. 2004-64, the estate and gift tax treatment of both the grantor's payment of income taxes on the trust's income and the trust's reimbursement of the grantor for those tax payments was unclear. At one point, the Service said that the payment of income tax by the grantor on income imputed to the grantor under the grantor trust rules was treated as a gift to the trust.[15] This position seems so incorrect that, not surprisingly, the Service reissued the ruling a year later without that statement.[16] No further guidance was issued regarding the gift tax treatment of the grantor's payment of income taxes on the trust's income. As for estate tax consequences of those payments, the Service has ruled that if a trust is required to reimburse the grantor annually for income taxes paid by the grantor on income attributable to the trust, the trust assets will not be included in the grantor's estate under Section 2036(a).[17]

However, commentators continued to wonder whether the payment by the grantor of income taxes attributable to the trust's income might constitute a gift to the trust, and whether the payment of income tax by the grantor might subject the trust to estate tax inclusion under Section 2036(a)(1).[18] Under the Ruling, the answer to both those questions is "no," which is good news for grantors.

Analysis of Rev. Rul. 2004-64

Facts. The facts of the Ruling are as follows: In Year 1, a U.S. citizen (the "grantor") creates an irrevocable inter vivos trust for the benefit of his descendants. The governing instrument requires that the trustee be a person not related or subordinate to the grantor within the meaning of Section 672(c). Under the terms of the trust, the grantor retains no beneficial interest in or power over the trust's income or corpus that would cause the transfer to the trust to be an incomplete gift for gift tax purposes or would cause the trust corpus to be included in the grantor's gross estate for estate tax purposes. Nevertheless, the grantor retains sufficient powers over the trust so that the trust is a grantor trust with respect to the grantor. During Year 1, the trust receives taxable income of \$10x, which the grantor includes in his

[12] See Blattmachr, "The Right Answer: Put it All in Trust," NYSBA Elder Law Attorney, p. 12 (Winter 2000).

[13] In New York, for example, a trust created by a New York resident is not subject to New York income taxes if, among other conditions, the trust has no New York trustee. See N.Y. Tax L. § 605(b)(3)(D). But *cf.* Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn., 1999), *cert. den.*; District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. Ct. App., 1997) (holding that a state or the district may tax a trust on its accumulated income based on the residence of one or more of the income beneficiaries in that state, if the grantor was a domiciliary of that state and the trust was governed by the law of that state).

[14] Reg. 1.664-1(a)(4).

[15] Ltr. Rul. 9444033.

[16] Ltr. Rul. 9543049.

[17] Ltr. Rul. 9413045.

[18] *Cf.* Outwin, 76 TC 153 (1981); see also Gans and Blattmachr, "*Strangi*: A Critical Analysis and Planning Suggestions," Tax Notes, p. 1153 (9/1/03).

taxable income and which increases the grantor's income tax liability by $2.5x. The grantor dies in year 3.

Holdings. The Ruling addresses three situations. In Situation 1, neither state law nor the trust instrument contains any provision requiring or permitting the trustee to distribute any amounts to the grantor in satisfaction of the grantor's income tax liability attributable to the trust's income. In Situation 2, the trust instrument *directs* the trustee to distribute income or principal to the grantor sufficient to satisfy the grantor's income tax liability attributable to the trust's income, and the trustee distributes $2.5x to the grantor in reimbursement of his income tax liability. In Situation 3, the trust instrument provides that the trustee may, in the trustee's discretion, distribute income or principal to the grantor sufficient to satisfy the grantor's income tax liability, and the trustee distributes $2.5x to the grantor in reimbursement of his income tax liability.

The Service's gift tax rulings are as follows: In all three situations, the payment by the grantor of the income taxes on the income attributable to the trust is not a gift by the grantor to the beneficiaries, because the grantor, not the trust, is liable for the taxes. In Situations 2 and 3, the distribution of $2.5x to the grantor as reimbursement for the income tax payment is not a gift by the trust beneficiaries to the grantor because, in both cases, the reimbursement was made pursuant to the terms of the trust instrument.

The Service's estate tax rulings are as follows: In Situation 1, the grantor did not retain the right to have trust property spent in discharge of his legal obligation to pay income taxes, so there is no estate tax inclusion. In Situation 2, by contrast, the grantor's right to receive reimbursement is, in effect, the retention of a right to have the trust property expended in discharge of the grantor's legal obligations, so the full value of the trust assets is includable in the grantor's gross estate under Section 2036(a)(1) and Reg. 20.2036-1(b)(2).[19]

In Situation 3, the existence or exercise of the trustee's discretion alone (regardless of whether the discretion is conferred by the trust instrument or by state law) is insufficient to cause inclusion under Section 2036(a)(1). This conclusion is consistent with case law holding that Section 2036(a)(1) is generally not applicable when trust property may be used to satisfy the decedent's legal obligations only in the discretion of the trustee, whether or not the trustee actually exercises that discretion.[20] However, the Service indicates in the Ruling that certain factors combined with such discretion, such as a pre-existing arrangement between the grantor and trustee regarding the exercise of discretion to reimburse the grantor, the grantor's retention of the power to remove the trustee and name the grantor as successor trustee, or the existence of local law subjecting the trust assets to the claims of the grantor's creditors, might warrant inclusion in the grantor's estate under Section 2036(a)(1).

Analysis. The rulings that (1) in Situations 1, 2 and 3, the payment by the grantor of the income taxes on the income attributable to the trust is not a gift by the grantor to the beneficiaries, and (2) in Situations 2 and 3, the trust's reimbursement of the grantor for the grantor's income tax payments is not a gift by the trust beneficiaries to the grantor, seem to be straightforward applications of existing law. The estate tax rulings in Situations 1 and 2 also are unremarkable. It is clear in Situation 1 that the grantor has not retained the right to have trust property spent in discharge of his or her legal obligation to pay the income taxes attributable to the trust's income, and it is clear in Situation 2 that the grantor *has* retained that right.

Although Situation 1 seems straightforward, questions nonetheless arise. For example, the facts state that no one who is related or subordinate to the grantor within the meaning of Section 672(c) may be appointed as trustee. Does this suggest the result could be different if a related or subordinate party may be a trustee? It does not seem so. The related or subordinate party issue may relate solely to Section 3, as discussed below.

Situation 2 also may seem a straightforward application of state law, but other questions may be raised. For example, it is relatively clear that Section 2036(a) may apply only in part. For example, if the grantor retains 60% of the fiduciary accounting income of the trust, only 60% of the trust is included in the grantor's gross estate.[21] In Situation 2, the grantor retained only the right to be reimbursed for income tax due on the trust's taxable income; this reimbursement presumably would be less than the trust's total taxable

[19] The Service will not apply the estate tax holding in Situation 2 adversely to a grantor's estate with respect to any trust created before 10/4/04. By strong implication, the result also applies in those circumstances, discussed below, in which estate tax inclusion also would arise in Situation 3. Hence, those who relied on the Service's statement in private letter rulings (see, e.g., Ltr. Rul. 9413045) have been grandfathered.

[20] See Douglass' Estate, 143 F.2d 961, 32 AFTR 1108 (CA-3, 1944), *acq.*; Estate of Mitchell, 55 TC 576 (1970), *acq.*

[21] Reg. 20.2036-1(a)(ii).

income (assuming the tax rate is less than 100%).

Perhaps, the Ruling concludes the whole trust is included in the grantor's gross income because capital gain income (traditionally allocated to corpus rather than to the trust's fiduciary accounting income) also is taxed to the grantor and that tax liability plus the tax liability on the trust's ordinary income may meet or exceed the trust's fiduciary accounting income. Alternatively, the Ruling's conclusion may be premised on the assumption that the percentage of the trust's income that will be paid to the grantor is uncertain (because the income tax rate is uncertain on account of the potential imposition of state or local taxes and because even federal income tax rates may be changed by future legislation), which justifies the conclusion that the entire trust is included in the grantor's gross estate.

The ruling in Situation 3 that the existence of the trustee's discretion to reimburse the grantor does not, in itself, warrant estate tax inclusion seems correct and consistent with existing case law. However, the Service's cryptic statement that "such discretion combined with other facts" may cause estate tax inclusion may raise more questions than it answers. First, this ruling may affect a great number of trusts that do not expressly address reimbursement, because the law of many states authorizes reimbursement regardless of the terms of the trust instrument.[22] Even if there is no express statutory authorization, the state's common law may permit reimbursement.[23] As discussed in greater detail below, applicable state law should be carefully reviewed to determine whether state law permits reimbursing the grantor for income tax payments even in the absence of an express provision in the trust instrument.[24]

Situation 3 also indicates that the mere existence of applicable state law authorizing the grantor's creditors to attach trust assets, by reason of the trustee's discretion to reimburse the grantor for income tax payments, may be sufficient to warrant inclusion of the trust assets in the grantor's estate under Section 2036.[25] This may be reason (perhaps, in addition to others)[26] for grantors, who do not wish to prohibit reimbursement for income taxes, to consider creating grantor trusts in jurisdictions (e.g., Alaska or Delaware) that do not subject the trust assets to the claims of creditors.

Finally, the Ruling assumes that the grantor "retains sufficient *powers* with respect to Trust so that A is treated as the owner of Trust under subpart E." (Emphasis added.) The Ruling does not specify what those powers are, except that they are not sufficient to cause (1) an incomplete gift or (2) estate tax inclusion. This assumption raises the question as to whether there are certain powers that are sufficient to have the trust treated as a grantor trust but *would* cause an incomplete gift or estate tax inclusion. For example, could the grantor's retention of the power to reacquire the trust corpus by substituting property of equivalent value under Section 675(4)(C) be considered a power that would cause an incomplete gift or estate tax inclusion? A discussion of this point is outside the scope of this article, but it is a question for further consideration.[27]

Additional issues raised by the Ruling: Effect of existence of a state law power to revoke the trust

The language of Section 2036(a)(1) of the Code, which refers to transfers under which the grantor has "retained" the possession or enjoyment of income or the right to designate the persons who will possess or enjoy the trust property or income, seems to require that the grantor have affirmatively retained a power in order for the property to be includable in the grantor's estate. However, the Ruling states that the trust assets will be includable in the grantor's gross estate even if the trustee's discretion to reimburse the grantor for income tax payments "is granted under applicable state law rather than under the governing instrument." This statement raises the issue of whether the conferral of a power or discretion upon the trustee solely by state law is sufficient to warrant inclusion of the trust assets under Section 2036(a)(1), even if the grantor has not affirmatively retained the power or discretion in the governing instrument.

For example, many states permit the revocation of a trust with the consent of all beneficiaries, even if the grantor has provided in the governing instrument that the trust is irrevocable.[28] It is arguable that

22 See, e.g., N.Y. EPTL § 7-1.11.

23 See, e.g., Matter of Goldman, N.Y. L.J., p. 13, col. 4 (4/17/64) (Sup. Ct.); see also French Trust, 23 Pa. Fid. Rep. 296 (Orphans' Ct. Philadelphia Co., 1963), Doughty Trust, 6 Pa. Fid. Rep. 2d 260, 263 (Ct. C.P. Montgomery Co., 1985).

24 Applicable state law, in this context, probably is the law declared to govern the validity, construction and effect of the trust, although it may be the law of the grantor's domicile. See generally Restatement (Second) of Conflict of Laws § § 268, 270 (1971). This, in turn, raises the question of whether this rule refers to the grantor's domicile at the time of creation of the trust or at the time of the grantor's death.

25 See Restatement (Third) of Trusts § 60 (2003).

26 See generally Blattmachr, Thwaites, and Zaritsky, "New Alaska Act Provides Many Estate Planning Opportunities," 24 ETPL 347 (Oct. 1997).

27 See generally Estate of Jordahl, 65 TC 92 (1975), *acq.*

28 See, e.g., N.Y. EPTL § 7-1.9(a); Uniform Trust Code ("UTC") § 411 (2003). At least nine states have adopted the UTC, and at least a dozen more are expected to introduce it in 2004. Many, if not most, states that have not adopted the UTC nevertheless have a similar revocation provision.

such a revocation power does not cause inclusion of the trust corpus in the grantor's gross estate under Section 2036(a)(2) or Section 2038 by reason of the Supreme Court decision in *Helvering v. Helmholz*,[29] which held that the grantor's power to revoke a trust with the consent of all beneficiaries was not a power within the meaning of Section 2038 if it did not expand the rights of the grantor under state law. However, the Ruling raises the question as to whether in the Service's view the *Helmholz* principle has any relevance in the context of Section 2036. Although *Helmholz* is codified in the Regulations under Section 2038,[30] there is no counterpart in the Regulations under Section 2036, and the Service has previously intimated that *Helmholz* does not apply for purposes of Section 2036.[31] If *Helmholz* applies only for Section 2038 purposes, this raises the question of whether there is any other basis for concluding that such a revocation power, conferred by state law, falls outside the scope of Section 2036.[32]

The apparent popular impression that *Helmholz* applies for Section 2036 purposes is understandable when one considers the underlying rationale. The *Helmholz* decision can be explained on one of three possible grounds: (1) a power conferred by state law does not involve the kind of retained power or right that should result in estate tax inclusion; (2) the requirement that all beneficiaries consent makes the grantor's control too speculative to be considered a power; or (3) based on the combined effect of the first two grounds, estate tax inclusion is inappropriate. Whichever of these explanations is adopted, the logic would appear to preclude any discrimination between Sections 2036 and 2038. Indeed, because Section 2036 applies only where the decedent *retained* the right and Section 2038 does not contain such a requirement—Section 2038 being broader, in other words, than Section 2036 in this regard—any trust falling outside the scope of Section 2038 by reason of *Helmholz* should also be beyond the scope of Section 2036.

The Fifth Circuit in *Estate of Wyly*[33] considered whether affirmative retention is required in order for Section 2036 to apply. In *Wyly*, the decedent had made an outright gift of property to his spouse, making it her separate property. Under Texas community property law, he had a community interest in the post-gift income generated by the property. The Service claimed, as it had it in Rev. Rul. 75-504,[34] that the gift property was includable in the decedent's gross estate under Section 2036(a)(1) because he had retained the right to income from it.

Relying on its decision in *Estate of Hinds*,[35] the Tax Court in *Wyly*[36] held that the decedent had retained the right to the income and that Section 2036 applies whether the decedent affirmatively retains the right or it is conferred on the decedent solely by state law. The Fifth Circuit reversed and rejected both aspects of the Tax Court's analysis in *Wyly*. First, the appellate court concluded that the decedent did not retain anything under the instrument of transfer because the decedent's entitlement with regard to the transferred property was supplied entirely by state law.[37] Second, after examining the nature of the decedent's entitlement under state law, the court concluded that it was so circumscribed that it could be viewed only as an expectancy, not as the kind of right that Section 2036 targets.[38]

In Rev. Rul. 81-221,[39] the Service revoked Rev. Rul. 75-504 but embraced only the second aspect of the *Wyly* holding. Without addressing the retention question, the Service ruled that the decedent had nothing more than an expectancy, not a right, in the post-gift income generated by the property. Hence, while the *Wyly* court read Section 2036 as requiring affirmative retention, the Service may be unwilling to adopt this conclusion, as evidenced by Rev. Rul. 81-221, which applies Section 2036 if the right was created under state law and was not expunged in the instrument.[40]

29 296 U.S. 93, 16 AFTR 979 (S.Ct., 1935).

30 See Reg. 20.2038-1(a)(2).

31 See G.C.M. 33512 (5/18/67), issued in conjunction with Rev. Rul. 72-552, 1972-2 CB 525.

32 Given the number of states that have enacted the UTC and given the many irrevocable trusts that have obviously been executed in these states, there is an important need for a Revenue Ruling to clarify this issue. A ruling that concludes that section 411 of the UTC (or any similar provision) does not cause Section 2036(a)(2) to apply would be consistent with the Service's prior application of Section 2036 and would be appropriate as a matter of policy.

33 610 F.2d 1282, 45 AFTR2d 80-1737 (CA-5, 1980).

34 1975-2 CB 363. In this Revenue Ruling, the donor spouse transferred $15,000 to his wife more than three years before his death. The wife kept the cash and accrued interest in a separate bank account. The Service ruled that half the value of cash transferred and half the accrued interest were includable in the husband's estate under Section 2036(a)(1) because Texas law characterized the income from separate property as community property; therefore, the Service reasoned, the husband had retained the right to income from half the property.

35 11 TC 314 (1948), *aff'd on other grounds*, 180 F.2d 930, 39 AFTR 159 (CA-5, 1950).

36 Estate of Wyly, 69 TC 227 (1977).

37 Wyly, 610 F.2d at 1290.

38 *Id.* at 1291.

39 1981-2 C.B. 178.

40 The Service's reluctance to adopt this interpretation may be understandable given the Tax Court's unequivocal rejection of the estate's retention argument in *Wyly* and given that the outcome in *Wyly* was driven perhaps by the policy concern about the discrimination that would otherwise result between common law states and community property states. See Rifkind, 5 Cl. Ct. 362, 54 AFTR2d 84-6453 (Cl. Ct., 984) (intimating this view of *Wyly*).

The notion that an entitlement might be too speculative to constitute a right for Section 2036 purposes—in other words, that the entitlement is a mere expectancy—did not originate with *Wyly* or with Rev. Rul. 81-221. In *Byrum*,[41] the Supreme Court concluded that the decedent's retained ability to effect a corporate liquidation was too speculative to constitute a right for Section 2036(a)(1) purposes. Similarly, in *Estate of Tully*,[42] the court ruled that the ability of a shareholder-employee to persuade a co-shareholder to join in modifying a death-benefit agreement for the benefit of his spouse did not constitute a sufficiently substantive right to fall within Section 2036(a)(2) or 2038.[43] In *Tully*, the court determined that the "in conjunction with" language in Sections 2036(a)(2) and 2038 cannot be read literally.[44] The court reasoned that the ability of a 50% shareholder to persuade the other shareholder to modify their agreement is speculative in nature and that it therefore would be inappropriate to apply the "in conjunction with" language in this context.

A grantor's ability to revoke a trust with the consent of all beneficiaries seems similarly too speculative to fall within the scope of Section 2036(a)(2). Given the beneficiaries' usual interest in maintaining the trust, the grantor's ability to persuade them to consent to a revocation seems even more speculative than was the decedent's ability to persuade the co-shareholder in *Tully*. Moreover, the revocation of a trust can be seen as analogous to the liquidation of a corporation situation addressed in *Byrum*. While, on a literal reading, the "in conjunction with" language might be applied in this context, *Byrum* and *Tully* suggest that a more limited reading is appropriate.[45]

In light of Rev. Rul. 2004-64 and the cases described above, the Service should issue a Revenue Ruling clarifying that a power conferred by state law that permits the revocation of a trust with the consent of the beneficiaries (or any similar provision) does not cause the inclusion of that trust in the grantor's estate under Section 2036, because the possibility that the grantor of a trust will be able to revoke under this provision is dependent on the consent of all beneficiaries and, therefore, too speculative to fall within the scope of Section 2036. While Section 2036 is applicable even if the grantor requires the consent of a party having an adverse interest,[46] a state-law requirement that all beneficiaries consent renders whatever entitlement the grantor may hold a speculative one indeed. Thus, such a conclusion appears to be consistent with the conclusion in Rev. Rul. 81-221 that a mere expectancy does not equate with the term "right" in Section 2036(a). A ruling could resolve the issue, in other words, without resolving the larger question concerning the applicability of *Helmholz* for Section 2036 purposes.[47]

Until the Service clarifies this issue, practitioners may wish to consider adding the following clause to any grantor trust: "Notwithstanding any applicable

41 408 U.S. 125, 30 AFTR2d 72-5811 (S.Ct., 1972).

42 528 F.2d 1401, 37 AFTR2d 76-1529 (Ct. Cl., 1976).

43 See also Rev. Rul. 80-255, 1980-2 CB 272 (citing *Tully* for its conclusion that the ability to have additional children is not the retention of a power to change the beneficial interests of the trust for the benefit of all the grantor's children for purposes of Sections 2036(a)(2) and 2038(a)(1)).

44 Section 2036(a)(2) refers to "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." Section 2038(a)(1) refers to "the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person . . . ."

45 But see Estate of Strangi, TCM 2003-145 (indicating that the ability of a shareholder or partner to vote on questions of entity liquidation, together with other shareholders or partners, is a right that triggers Section 2036(a)(2)). For a discussion of the relationship among *Byrum*, *Tully* and *Strangi*, see Gans and Blattmachr, *supra* note 18, at 1160.

46 The Regulations under Section 2036 provide that "it is immaterial whether the power [to designate the person(s) to receive the income of the transferred property] was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest . . . ." Reg. 20.2036-1(b)(3).

47 Such a ruling would be salutary as a matter of policy. Many individuals have created irrevocable trusts in UTC (or UTC-type) states in reliance on an understanding that Section 2036 would not apply to those trusts. The Service itself has presumably operated on the same premise, not having challenged any trusts on this ground to the best of our knowledge. For example, the donee of an outright gift is permitted to reconvey to the donor, yet no one would suggest that the gifted property should be included in the donor's estate under Section 2036 on the theory that he or she could control the enjoyment of the gifted property through collaboration with the donee. If the Service ruled otherwise with respect to trusts, it would in effect be discriminating between outright gifts and gifts in trust, causing many to avoid the use of a trust where it is otherwise indicated. There seems to be no policy justification for such discrimination.

provision of law to the contrary, the grantor shall not be permitted to participate in any decision regarding the revocation of the trust with or without the consent of the beneficiaries. In addition, the grantor shall not be permitted to exercise, either alone or in conjunction with any other person, any power described in Section 2036(a)(2) or 2038 of the Code. It is the grantor's intent that no portion of the trust be includable in the grantor's gross estate for estate tax purposes at the grantor's death, and, notwithstanding any provision herein contained to the contrary, this Agreement shall be construed and the trust hereunder administered in accordance with and to achieve that intent."[48]

Effect of state law prohibitions on exercise of trustee's powers

With respect to Situation 3 of Rev. Rul. 2004-64, relating to a trust that permits reimbursement in the trustee's discretion, practitioners should be aware of possible arguments the Service might make in favor of inclusion in the grantor's estate. If the trustee may reimburse the grantor for the income taxes the grantor owes on trust income attributed to him under the grantor trust rules, and if the grantor may remove the trustee and name himself as trustee, the Ruling concludes that the full value of the trust will be included in the grantor's estate under Section 2036(a)(1) (because it is possible that the entire corpus of the trust could be used to reimburse the grantor for income taxes attributable to the trust's income). Presumably, based on the Ruling's analysis, estate tax inclusion will occur if the grantor acts as trustee from the inception of the trust and remains in that position until his death (or relinquishes the trustee position within three years of death in a manner that causes estate tax inclusion under Section 2035).

The Ruling's conclusion, though, may not apply if state law prohibits the grantor, as trustee, from actually exercising the power, on the grounds that a prohibition against actually exercising the power essentially strips the trustee of discretion to reimburse the grantor. That likely would have been the case under prior New York law, which prohibited a trustee from exercising a discretionary power to pay himself or herself property for any reason.[49]

Now New York, like many other states, allows a trustee-beneficiary to exercise the power to make a discretionary distribution of income or principal to himself or herself as beneficiary if the power is a power to provide for the trustee's health, education, maintenance, or support within the meaning of Sections 2041 and 2514 (or any other ascertainable standard).[50] Payments to the grantor-trustee in reimbursement of the grantor's income tax payments should fall under such an ascertainable standard, because the reimbursement probably falls within the meaning of "support" for the purposes of that standard.[51]

However, if the trustee can reimburse the grantor for income tax payments regardless of the terms of the trust instrument, as may be authorized by state law,[52] the question arises whether the ability of the grantor to receive those payments makes the grantor a beneficiary of the trust. If so, the trust assets might be includable in the grantor's gross estate under Section 2036(a)(1), because the grantor is entitled to reimbursement from the trust for the discharge of the grantor's legal obligation to pay income taxes. The ascertainable-standard exception probably does not apply for purposes of Section 2036(a)(1), so that even if the reimbursement of the grantor for income tax payments were considered "support" for purposes of that standard, Section 2036(a)(1) would still apply. In that case, a state-law prohibition on the beneficiary's exercise of a discretionary power to distribute income or principal to himself[53] probably would not preclude the application of Section 2036(a)(1). Therefore, statutory provisions limiting a trustee-beneficiary's discretionary invasion authority may be of limited, if any, relevance to the scope of a grantor's authority as trustee to reimburse the grantor for income tax payments made by the grantor.

Effect of power to remove and replace trustees

In any case, even if the grantor is not and could not become a trustee, the Ruling might require estate tax inclusion if applied in conjunction with Rev. Rul. 95-

[48] This language is derived from *Wealth Transfer Planning*, a document assembly and expert advice software system, written by Jonathan G. Blattmachr and Michael L. Graham and published by Interactive Legal Systems (www.ilsdocs.com), and is reproduced here with its permission. For more on *Wealth Transfer Planning*, see Kelley, "*Wealth Transfer Planning* Drafts a Wide Array of Comprehensive, Customized Estate Planning Documents," 31 ETPL 53 (Jan. 2004).

[49] See N.Y. EPTL § 10-10.1 (1992) ("A power conferred upon a person in his capacity as trustee of an express trust to make discretionary distribution of either principal or income to himself . . . cannot be exercised by him."). This provision was amended in 2003, as described below.

[50] See N.Y. EPTL § 10-10.1 (2004).

[51] For example, the Restatement of Trusts provides that, where the instrument authorizes distributions for support of the beneficiary, the trustee is permitted to make a distribution in order to enable the beneficiary to pay for property taxes. Restatement (Third) of Trusts § 50 cmt. d(2). This certainly suggests that reimbursement of the grantor for income tax payments also is within the scope of support.

[52] See, e.g., N.Y. EPTL § 7-1.11.

[53] See, e.g., N.Y. EPTL § 10-10.1.

58,[54] which held that the grantor's reservation of the power to remove a trustee and appoint a successor trustee that is not related or subordinate to the grantor is not a reservation of the trustee's discretionary powers of distribution for purposes of Sections 2036 and 2038. The implication, though, is that the retention of the power to appoint the grantor or a related or subordinate party within the meaning of Section 672(c) *would* be a retention of a power of distribution for purposes of those sections.

In this case, the Ruling states that the trust's governing instrument requires that the trustee be a person not related or subordinate to the grantor within the meaning of Section 672(c) but suggests that, in Situation 3, the grantor's retention of the power to remove the trustee and name the grantor as successor trustee could cause estate tax inclusion under Section 2036. Consequently, if the grantor may remove and replace trustees and may appoint a new trustee who is related or subordinate to the grantor within the meaning of Section 672(c), the Service may contend there is estate tax inclusion if the trustee has discretion to reimburse the grantor for the taxes, as suggested by the recital in the facts of the Ruling that no person who is related or subordinate to the grantor may serve as a trustee.

Conclusions

The Ruling clarifies the estate and gift tax treatment of grantor trusts depending on whether or not the trust instrument or state law directs, authorizes, or makes no provision for reimbursement of the grantor for income taxes paid on income attributable to the trust. The Ruling also confirms that there is an unequivocal advantage to making gifts via a grantor trust as opposed to outright (although it is difficult to justify this discrimination in favor of grantor trusts from a policy perspective).

In general, the grantor's payment of the income taxes attributable to the trust's income is not considered a gift by the grantor to the trust's beneficiaries, and distributions from a grantor trust in reimbursement of the grantor's income tax payments are not considered a gift by the beneficiaries to the grantor.[55] If the instrument makes no provision for reimbursement, or merely authorizes reimbursement in the trustee's discretion, the trust assets will not be includable in the grantor's estate. On the other hand, if the instrument *directs* reimbursement, the full value of the trust assets will be includable under the Ruling in the grantor's estate under Section 2036(a)(1), because the grantor has retained the right to have trust property expended in discharge of the grantor's legal obligation to pay income taxes on the trust's income.

Accordingly, in almost all situations, practitioners should either expressly prohibit reimbursement, or, if desired, expressly authorize reimbursement from the trust for the grantor's income tax payments to eliminate any ambiguity, but, in the latter case, create the trust under the laws of a state that protects self-settled trusts from the claims of the grantor's creditors. In addition, although the Ruling appears to grandfather trusts created before 10/4/04 with respect to the estate tax inclusion issue, practitioners should advise their clients not to make any additions to grandfathered grantor trusts after 10/3/04.

> **Practice Notes**
> In almost all situations, practitioners should either expressly prohibit reimbursement, or, if desired, expressly authorize reimbursement from the trust for the grantor's income tax payments to eliminate any ambiguity, but, in the latter case, create the trust under the laws of a state that protects self-settled trusts from the claims of the grantor's creditors.

Finally, the Ruling invites further clarification by the Service with respect to what rights, powers, or terms might cause inclusion of trust assets under Section 2036(a)(1) when combined with a discretionary power to make distributions from the trust in reimbursement of the grantor for income tax payments attributable to the trust's income. Until further clarification, practitioners should (1) specify in the trust instrument that the grantor is not permitted to participate in any decision regarding the revocation of the trust, with or without the consent of the beneficiaries, or to exercise any power described in Section 2036(a)(2) or 2038, (2) avoid giving the grantor the right to name himself or herself as a trustee (or to remove a trustee and name a successor who is related or subordinate to the grantor within the meaning of Section 672(c)), and (3) encourage grantors who will authorize the trustee to reimburse the grantor to create such grantor trusts in jurisdictions that do not subject the trust assets to the claims of the grantor's creditors. ■

54 1995-2 CB 191. Rev. Rul. 95-58 revoked Rev. Rul. 79-353, 1979-2 CB 325, and Rev. Rul 81-51, 1981-1 CB 458.

55 If neither the governing instrument nor state law requires or permits reimbursement, actual reimbursement might be a gift. *Cf.* Rev. Rul. 84-105, 1984-2 CB 197.