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Strategies for Mitigating the 'Burn' of Grantor Trust Status

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I. INTRODUCTION

Grantor trusts are akin to a hammer in the estate planner's toolbox. They are standardly used when creating an irrevocable trust for wealth transfer purposes. Estate planners are quick to extol the virtues of grantor trusts. They allow for flexible provisions in the trust agreement, such as the power to add beneficiaries, swap assets of an equivalent value, and make loans to the settlor. Revenue Ruling 85-13 disregards transactions between grantors and their grantor trust for income tax purposes, which sets the stage for tried-and-true planning techniques like installment sales to grantor trusts.

Creating a grantor trust also means the creator of the trust (the trustor) will be responsible for payment of the income tax liability associated with the trust during the trustor's lifetime. When the trustor (rather than the trust) pays the trust's income taxes, the beneficiaries and the trustor benefit. The beneficiaries are relieved of the tax burden and the growth of the trust property is enhanced. The payment of the trust's income taxes reduces the trustor's estate, and, because the tax payment by the trustor is not considered a gift, it does not require any additional allocation of the trustor's unified lifetime gift and estate exemption or generation-skipping transfer (GST) tax exemption.

While grantor trusts may sound like paradise, estate planners and advisors know (perhaps all too well) every technique has a trade-off. Over a long period of time, the transfer tax-free shifting of value from grantor trust status has a far greater impact than valuation discounts and the shifting of future income and appreciation in value *combined*.[1] The income tax paid on the grantor trust's income (the ''burn'') can easily become too much for clients to bear financially or psychologically over their lifetime.

How can we better advise clients about the ''burn'' of grantor trust status at the outset? And how can we help clients with existing grantor trusts who no longer want to pay the tax bill? First, we discuss how to illustrate the financial and emotional ''burn'' of grantor trusts to clients. Next, we will cover strategies on how to mitigate the ''burn'' of grantor trusts. This will help clients tame the flame of grantor trusts by exploring the use of different strategies, such as using grantor trust reimbursement statutes, toggling off grantor trust

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[1] Jerome M. Hesch and Paul Lee, *The Financial Danger of Maximizing Taxable Gifts* (2012) (emphasis added).

status or having grantor trust status automatically expire on a certain date, the strategic use of loans and more. Then, grantor trust reimbursement statutes are examined with a particular focus on state law developments. We consider how to migrate or decant a trust to a jurisdiction with a reimbursement statute and offer options to ''fix'' a trust to get the desired result. We also address the income tax consequences of toggling off grantor trust status and how to protect estate planners and trustees from liability from turning off grantor trust status. Finally, we recognize choices must be made and how to evaluate them so clients can make informed choices.

II. THE 'BURN' OF GRANTOR TRUSTS

Practitioners are tasked with educating clients about the financial and emotional ''burn'' of a grantor trust. By paying the income tax on the trust's income, the grantor is reducing his estate for both transfer tax and creditor exposure purposes. However, a grantor trust that becomes too financially successful may result in economic hardship for the grantor who has to shoulder the tax burden. In addition to the financial burn, paying hefty income taxes over a long period of time that directly benefits the trust's ungrateful or unproductive beneficiaries may take an emotional toll on the grantor.

A. The Financial Burn

By illustrating the financial burn, practitioners can empower clients by allowing them to decide how much value should be transferred to their grantor trusts during their lifetimes. All good things must come to an end — including grantor trust status.

The following example illustrates the burn caused by the grantor's payment of federal and state income taxes on the trust's taxable income.[2]

Example: John and Jane are a 63-year-old retired married couple who own $35 million of investment assets that appreciate 5% annually and earn 2% ordinary income. They understand their heightened gift tax exemptions ($12.92 million each) may dip as low at $6 million per person after 2025. To maximize use of their exemptions, John transfers $16 million to a limited liability company (LLC). John creates three separate irrevocable grantor trusts (one for each of his three children) and gives one-third of the LLC to each trust (the ''Family Trusts''). After applying a 30% valuation discount, the value of a one-third interest in the LLC interest is $3,733,333.33 (for a total gift tax value of $11.2 million). Assume John and Jane split gifts[3] and allocate their GST tax exemptions to the transfers to the Family Trusts. John and Jane retain $19 million of their own income-producing assets that pay 5% annually. At age 63, assume John and Jane's joint life expectancy is 30 years because they have access to top-notch health care.[4] John and Jane's annual living expenses are $500,000 and increase by 3% each year due to inflation. They are in the top marginal federal income tax bracket (37%) and are residents of East Hampton, New York (8.25% state income tax).

As shown in the financial projection below, the financial benefit to the three Family Trusts over a 30-year period is impressive. Each is worth $40,598,694 as a result of its tax-free growth and appreciation, for a total cumulative value of $121,796,082. What a windfall for the Family Trusts! As Warren Buffet has been known to say: ''My wealth has come from a combination of living in America, some lucky genes, and compound interest.'' Over a sustained period of time, this income tax-free compounding of the funds in the Family Trusts resulted in a substantial amount no longer exposed to any further gift or estate taxes.[5]

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[2] A version of this helpful example first appeared in the following publication: *Jerry Hesch & the Financial Danger of Maximizing Taxable Gifts in 2012*, LISI Estate Planning Newsletter #2035 (Dec. 5, 2012). Copyright 2012 Leimberg Information Services, Inc.

[3] §2513(a)(1). All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise specified.

[4] Practitioners may consult Table 2000CM (actuarial life table) to estimate a client's life expectancy.

[5] Jerome M. Hesch and David A. Handler, *Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth*, 68 N.Y.U. Tax Inst. on Fed Tax'n (2009) (hereafter ''Hesch and Handler'').

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Growth of Each Separate Family Trust (3 Total)

Year	Start of Year	Growth	Income	Realized Gains	Unrealized Gains	Tax Paid by Trust	End of Year
1	$5,333,333	$266,667	$106,667	$53,333	$213,333	$0	$5,706,667
2	$5,706,667	$285,333	$114,133	$99,733	$398,933	$0	$6,106,133
3	$6,106,133	$305,307	$122,123	$140,848	$563,392	$0	$6,533,563
4	$6,533,563	$326,678	$130,671	$178,014	$712,056	$0	$6,990,912
5	$6,990,912	$349,546	$139,818	$212,320	$849,281	$0	$7,480,276
6	$7,480,276	$374,014	$149,606	$244,659	$978,636	$0	$8,003,895
7	$8,003,895	$400,195	$160,078	$275,766	$1,103,065	$0	$8,564,168
8	$8,564,168	$428,208	$171,283	$306,255	$1,225,018	$0	$9,163,660
9	$9,163,660	$458,183	$183,273	$336,640	$1,346,561	$0	$9,805,116
10	$9,805,116	$490,256	$196,102	$367,363	$1,469,454	$0	$10,491,474
11	$10,491,474	$524,574	$209,829	$398,805	$1,595,222	$0	$11,225,877
12	$11,225,877	$561,294	$224,518	$431,303	$1,725,213	$0	$12,011,688
13	$12,011,688	$600,584	$240,234	$465,159	$1,860,638	$0	$12,852,507
14	$12,852,507	$642,625	$257,050	$500,653	$2,002,610	$0	$13,752,182
15	$13,752,182	$687,609	$275,044	$538,044	$2,152,176	$0	$14,714,835
16	$14,714,835	$735,742	$294,297	$577,583	$2,310,334	$0	$15,744,873
17	$15,744,873	$787,244	$314,897	$619,515	$2,478,062	$0	$16,847,014
18	$16,847,014	$842,351	$336,940	$664,083	$2,656,330	$0	$18,026,305
19	$18,026,305	$901,315	$360,526	$711,529	$2,846,116	$0	$19,288,147
20	$19,288,147	$964,407	$385,763	$762,105	$3,048,419	$0	$20,638,317
21	$20,638,317	$1,031,916	$412,766	$816,067	$3,264,268	$0	$22,082,999
22	$22,082,999	$1,104,150	$441,660	$873,684	$3,494,734	$0	$23,628,809
23	$23,628,809	$1,181,440	$472,576	$935,235	$3,740,940	$0	$25,282,826
24	$25,282,826	$1,264,141	$505,657	$1,001,016	$4,004,065	$0	$27,052,624
25	$27,052,624	$1,352,631	$541,052	$1,071,339	$4,285,357	$0	$28,946,307
26	$28,946,307	$1,447,315	$578,926	$1,146,534	$4,586,138	$0	$30,972,549
27	$30,972,549	$1,548,627	$619,451	$1,226,953	$4,907,812	$0	$33,140,627
28	$33,140,627	$1,657,031	$662,813	$1,312,969	$5,251,875	$0	$35,460,471
29	$35,460,471	$1,773,024	$709,209	$1,404,980	$5,619,919	$0	$37,942,704
30	$37,942,704	$1,897,135	$758,854	$1,503,411	$6,013,643	$0	$40,598,694

Cumulative of Growth of Family Trusts (3 Total)

Year	Start of Year	Growth	Income	Realized Gains	Unrealized Gains	Tax Paid by Trust	End of Year
1	$16,000,000	$800,000	$320,000	$160,000	$640,000	$0	$17,120,000
2	$17,120,000	$856,000	$342,400	$299,200	$1,196,800	$0	$18,318,400
3	$18,318,400	$915,920	$366,368	$422,544	$1,690,176	$0	$19,600,688
4	$19,600,688	$980,034	$392,014	$534,042	$2,136,168	$0	$20,972,736
5	$20,972,736	$1,048,637	$419,455	$636,961	$2,547,844	$0	$22,440,828
6	$22,440,828	$1,122,041	$448,817	$733,977	$2,935,908	$0	$24,011,686
7	$24,011,686	$1,200,584	$480,234	$827,299	$3,309,194	$0	$25,692,504
8	$25,692,504	$1,284,625	$513,850	$918,764	$3,675,055	$0	$27,490,979
9	$27,490,979	$1,374,549	$549,820	$1,009,921	$4,039,684	$0	$29,415,347
10	$29,415,347	$1,470,767	$588,307	$1,102,090	$4,408,361	$0	$31,474,422
11	$31,474,422	$1,573,721	$629,488	$1,196,416	$4,785,665	$0	$33,677,631
12	$33,677,631	$1,683,882	$673,553	$1,293,909	$5,175,638	$0	$36,035,065
13	$36,035,065	$1,801,753	$720,701	$1,395,478	$5,581,913	$0	$38,557,520
14	$38,557,520	$1,927,876	$771,150	$1,501,958	$6,007,831	$0	$41,256,546
15	$41,256,546	$2,062,827	$825,131	$1,614,132	$6,456,527	$0	$44,144,505
16	$44,144,505	$2,207,225	$882,890	$1,732,750	$6,931,001	$0	$47,234,620
17	$47,234,620	$2,361,731	$944,692	$1,858,546	$7,434,186	$0	$50,541,043
18	$50,541,043	$2,527,052	$1,010,821	$1,992,248	$7,968,991	$0	$54,078,916
19	$54,078,916	$2,703,946	$1,081,578	$2,134,587	$8,538,349	$0	$57,864,441
20	$57,864,441	$2,893,222	$1,157,289	$2,286,314	$9,145,257	$0	$61,914,951
21	$61,914,951	$3,095,748	$1,238,299	$2,448,201	$9,792,804	$0	$66,248,998
22	$66,248,998	$3,312,450	$1,324,980	$2,621,051	$10,484,203	$0	$70,886,428
23	$70,886,428	$3,544,321	$1,417,729	$2,805,705	$11,222,819	$0	$75,848,478
24	$75,848,478	$3,792,424	$1,516,970	$3,003,049	$12,012,195	$0	$81,157,871
25	$81,157,871	$4,057,894	$1,623,157	$3,214,018	$12,856,071	$0	$86,838,922
26	$86,838,922	$4,341,946	$1,736,778	$3,439,603	$13,758,413	$0	$92,917,647
27	$92,917,647	$4,645,882	$1,858,353	$3,680,859	$14,723,437	$0	$99,421,882
28	$99,421,882	$4,971,094	$1,988,438	$3,938,906	$15,755,624	$0	$106,381,414
29	$106,381,414	$5,319,071	$2,127,628	$4,214,939	$16,859,756	$0	$113,828,113
30	$113,828,113	$5,691,406	$2,276,562	$4,510,232	$18,040,929	$0	$121,796,081

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While the Family Trusts are in excellent shape, John and Jane are not faring as well. This would be the perfect estate plan if John and Jane die at age 90. But what if they die at age 91? As illustrated below, John and Jane would run out of money at age 91 and would have to rely on the generosity of their children for support. This seems unfair considering John has spent 28 years paying about $25 million of income taxes on behalf of the Family Trusts.

John and Jane

Year	Start of Year	Growth	Income	Realized Gains	Unrealized Gains	Annual Income	Tax Paid for Self	Tax Paid for Trust	Annual expenses	End of Year
1	$19,000,000	$950,000	$380,000	$190,000	$760,000	$0	$225,625	$190,000	$500,000	$19,414,375
2	$19,414,375	$970,719	$388,288	$194,144	$776,575	$0	$230,546	$239,460	$515,000	$19,788,376
3	$19,788,376	$989,419	$395,768	$197,884	$791,535	$0	$234,987	$285,150	$530,450	$20,122,975
4	$20,122,975	$1,006,149	$402,459	$201,230	$804,919	$0	$238,960	$328,253	$546,364	$20,418,006
5	$20,418,006	$1,020,900	$408,360	$204,180	$816,720	$0	$242,464	$369,745	$562,754	$20,672,303
6	$20,672,303	$1,033,615	$413,446	$206,723	$826,892	$0	$245,484	$410,438	$579,637	$20,883,806
7	$20,883,806	$1,044,190	$417,676	$208,838	$835,352	$0	$247,995	$451,018	$597,026	$21,049,633
8	$21,049,633	$1,052,482	$420,993	$210,496	$841,985	$0	$249,964	$492,068	$614,937	$21,166,139
9	$21,166,139	$1,058,307	$423,323	$211,661	$846,646	$0	$251,348	$534,096	$633,385	$21,228,939
10	$21,228,939	$1,061,447	$424,579	$212,289	$849,158	$0	$252,094	$577,549	$652,387	$21,232,935
11	$21,232,935	$1,061,647	$424,659	$212,329	$849,317	$0	$252,141	$622,831	$671,958	$21,172,310
12	$21,172,310	$1,058,616	$423,446	$211,723	$846,892	$0	$251,421	$670,312	$692,117	$21,040,522
13	$21,040,522	$1,052,026	$420,810	$210,405	$841,621	$0	$249,856	$720,340	$712,880	$20,830,282
14	$20,830,282	$1,041,514	$416,606	$208,303	$833,211	$0	$247,360	$773,249	$734,267	$20,533,527
15	$20,533,527	$1,026,676	$410,671	$205,335	$821,341	$0	$243,836	$829,364	$756,295	$20,141,379
16	$20,141,379	$1,007,069	$402,828	$201,414	$805,655	$0	$239,179	$889,010	$778,984	$19,644,103
17	$19,644,103	$982,205	$392,882	$196,441	$785,764	$0	$233,274	$952,513	$802,353	$19,031,051
18	$19,031,051	$951,553	$380,621	$190,311	$761,242	$0	$225,994	$1,020,206	$826,424	$18,290,601
19	$18,290,601	$914,530	$365,812	$182,906	$731,624	$0	$217,201	$1,092,435	$851,217	$17,410,090
20	$17,410,090	$870,505	$348,202	$174,101	$696,404	$0	$206,745	$1,169,557	$876,753	$16,375,742
21	$16,375,742	$818,787	$327,515	$163,757	$655,030	$0	$194,462	$1,251,947	$903,056	$15,172,579
22	$15,172,579	$758,629	$303,452	$151,726	$606,903	$0	$180,174	$1,340,000	$930,147	$13,784,338
23	$13,784,338	$689,217	$275,687	$137,843	$551,374	$0	$163,689	$1,434,134	$958,052	$12,193,367
24	$12,193,367	$609,668	$243,867	$121,934	$487,735	$0	$144,796	$1,534,790	$986,793	$10,380,523
25	$10,380,523	$519,026	$207,610	$103,805	$415,221	$0	$123,269	$1,642,439	$1,016,397	$8,325,055
26	$8,325,055	$416,253	$166,501	$83,251	$333,002	$0	$98,860	$1,757,580	$1,046,889	$6,004,480
27	$6,004,480	$300,224	$120,090	$60,045	$240,179	$0	$71,303	$1,880,747	$1,078,296	$3,394,447
28	$3,394,447	$169,722	$67,889	$33,944	$135,778	$0	$40,309	$2,012,509	$1,110,645	$468,596
29	$468,596	$23,430	$9,372	$4,686	$18,744	$0	$5,565	$2,153,472	$1,143,964	-$2,801,603
30	-$2,801,603	-$140,080	-$56,032	-$28,016	-$112,064	$0	-$33,269	$2,304,285	$1,178,283	-$6,447,014

These projections demonstrate estate planners must evaluate what can be done to stop the burn at the appropriate point in the future.

After running the numbers, practitioners may be surprised to discover grantor trust status can shift more wealth free of transfer taxes than valuation discounts over the grantor's lifetime.[6] In the example above, each Family Trust received a 1/3 interest in the LLC which had a fair market value of $5,333,333.33 but was discounted by 30% ($5,333,333.33 × 30% = $1,600,000) so that its value for gift tax purposes was $3,733,333.33. As stated above, John paid about $8.33 million of income taxes for each Family Trust over a 30-year period (for a total of $25 million across all three Family Trusts). Assuming the same rates of income and appreciation, the $1,600,000 transfer from the discount would grow to only $12,179,608 after 30 years. As illustrated below, this means that John's payment of income taxes on behalf of the Family Trusts ($25 million total) transferred *double* the amount of the valuation discount ($12.18 million) over a 30-year period.

[6] *Id.*

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Growth of $1,600,000 Valuation Discount Over 30 Years

Year	Start of Year	Growth	Income	Realized Gains	Unrealized Gains	Tax Paid by Trust	End of Year
1	$1,600,000	$80,000	$32,000	$16,000	$64,000	$0	$1,712,000
2	$1,712,000	$85,600	$34,240	$29,920	$119,680	$0	$1,831,840
3	$1,831,840	$91,592	$36,637	$42,254	$169,018	$0	$1,960,069
4	$1,960,069	$98,003	$39,201	$53,404	$213,617	$0	$2,097,274
5	$2,097,274	$104,864	$41,945	$63,696	$254,784	$0	$2,244,083
6	$2,244,083	$112,204	$44,882	$73,398	$293,591	$0	$2,401,169
7	$2,401,169	$120,058	$48,023	$82,730	$330,919	$0	$2,569,250
8	$2,569,250	$128,463	$51,385	$91,876	$367,506	$0	$2,749,098
9	$2,749,098	$137,455	$54,982	$100,992	$403,968	$0	$2,941,535
10	$2,941,535	$147,077	$58,831	$110,209	$440,836	$0	$3,147,442
11	$3,147,442	$157,372	$62,949	$119,642	$478,567	$0	$3,367,763
12	$3,367,763	$168,388	$67,355	$129,391	$517,564	$0	$3,603,507
13	$3,603,507	$180,175	$72,070	$139,548	$558,191	$0	$3,855,752
14	$3,855,752	$192,788	$77,115	$150,196	$600,783	$0	$4,125,655
15	$4,125,655	$206,283	$82,513	$161,413	$645,653	$0	$4,414,450
16	$4,414,450	$220,723	$88,289	$173,275	$693,100	$0	$4,723,462
17	$4,723,462	$236,173	$94,469	$185,855	$743,419	$0	$5,054,104
18	$5,054,104	$252,705	$101,082	$199,225	$796,899	$0	$5,407,892
19	$5,407,892	$270,395	$108,158	$213,459	$853,835	$0	$5,786,444
20	$5,786,444	$289,322	$115,729	$228,631	$914,526	$0	$6,191,495
21	$6,191,495	$309,575	$123,830	$244,820	$979,280	$0	$6,624,900
22	$6,624,900	$331,245	$132,498	$262,105	$1,048,420	$0	$7,088,643
23	$7,088,643	$354,432	$141,773	$280,570	$1,122,282	$0	$7,584,848
24	$7,584,848	$379,242	$151,697	$300,305	$1,201,219	$0	$8,115,787
25	$8,115,787	$405,789	$162,316	$321,402	$1,285,607	$0	$8,683,892
26	$8,683,892	$434,195	$173,678	$343,960	$1,375,841	$0	$9,291,765
27	$9,291,765	$464,588	$185,835	$368,086	$1,472,344	$0	$9,942,188
28	$9,942,188	$497,109	$198,844	$393,891	$1,575,562	$0	$10,638,141
29	$10,638,141	$531,907	$212,763	$421,494	$1,685,976	$0	$11,382,811
30	$11,382,811	$569,141	$227,656	$451,023	$1,804,093	$0	$12,179,608

Nonetheless, valuation discounts received a lot of air time (and hand-wringing) over the past year and a half after the House Ways and Means Committee threatened to legislate family limited partnership valuation discounts out of existence.[7] Estate planners might play down valuation discounts and remind clients the size of the discount is likely the most significant factor in deciding whether the IRS will audit the gift tax return.[8] With the Inflation Reduction Act of 2022 [9] providing nearly $80 billion to the IRS over 10 years (in addition to the money the agency normally receives from Congress on an annual basis), the likelihood of an audit is real.[10] More than half (about $45.6 billion) would go toward strengthening enforcement activities — including collecting taxes owed, providing legal support, conducting criminal investigations, and providing digital asset monitoring, according to the bill text.[11]

B. The Emotional Burn

Placing the financials aside, estate planners should also discuss the emotional burn of grantor trust status with their clients. Asking how the client feels about transferring a great deal of wealth to his trust beneficiaries (typically his descendants) on an annual basis over a long period of time may shed light on a client's wealth transfer philosophy and family relationships.

For example, imagine a client sharing he does not want his children to turn into ''Trustafarians'' — a breed of wealthy young people whose trust fund enables them to live a careless or unambitious lifestyle. The client describes his modest upbringing and explains how that experience fueled his hard work ethic. If his children knew they had millions sitting in a trust for them, the client is concerned it would destroy their creativity and motivation. With this in mind, the estate planner might build in collaborative language across the client's estate planning documents to ensure that his children receive enough money to be

[7] On October 28, 2021, the tax writers of the $1.75 trillion Build Back Better bill (also known as H.R. 5376, eventually resulting in the Inflation Reduction Act of 2022) signaled they did not plan to move forward with changes to valuation discounts. *See* William H. Frazier, *The FLP Valuation Discount is Here to Stay. . . For Now*, Penton Wealth Mgmt., Tr. & Est. (Nov. 10, 2021).

[8] Hesch and Handler.

[9] Pub. L. No. 117-169 (Aug. 16, 2022).

[10] Katie Lobosco, *The IRS is set to get billions for audit enforcement. Here's what it means for taxpayers*, CNN Politics (Aug. 11, 2022). The IRS received nearly $12.6 billion for fiscal year 2022.

[11] *Id.*

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comfortable but not complacent. This might also involve shutting off grantor trust status after a certain period of time.

Also consider a client who feels he has given enough to his children after a certain period of time and feels it is inappropriate to pay income taxes for adult children who have professional careers and families of their own. Or conceive of a client who gets older, survives a life-changing event (such as beating cancer) and shifts his wealth transfer goals to more philanthropic endeavors.

These examples illustrate good estate planning often involves good math — but the best spreadsheet cannot solve for the human element of estate planning. Clients have diverse outlooks on wealth and family relationships. People change and priorities shift over time. Estate planners are tasked with understanding their clients' values and drafting trust agreements that provide maximum flexibility for life's twists, turns, and changes of heart.

III. MITIGATING THE 'BURN'

In addition to grantor trust reimbursement statutes (which are discussed in V., below), practitioners may consider several ideas to eliminate or mitigate the grantor's income tax liability.

A. 'Toggle Off' Grantor Trust Treatment

The trust's structure (i.e., who is serving as trustee) and the trust's terms (i.e., if certain powers can be released that trigger grantor trust treatment) may be reviewed to determine whether a grantor trust may be converted into a non-grantor trust. To ''toggle off'' grantor trust status, practitioners should pay close attention to the following provisions of the trust agreement.[12]

1. *Grantor's spouse cannot serve as a trustee.* If a grantor's spouse is serving as trustee or co-trustee, then such spouse must resign as trustee to avoid triggering grantor trust status. The grantor is treated as holding any power held by the grantor's spouse.[13] If the grantor's spouse serves as trustee, then the grantor will be treated as if he holds the powers the spouse holds as trustee. A trust is a grantor trust if the grantor (or non-adverse party) may exercise a power of disposition over the trust property, without approval or consent of an adverse party.[14] Thus, grantor trust treatment is triggered if the grantor's spouse is serving as trustee.

2. *Grantor's spouse cannot be a beneficiary.* Clients often include a spouse as a beneficiary of irrevocable grantor trusts as a safety net to regain access to trust assets if needed. However, grantor trust treatment is triggered if the trust's income (again, read ''taxable income'') may be (or is) distributed without approval or consent of any adverse party to the grantor or the grantor's spouse, or held or accumulated for future distribution to either.[15] Practically this statute typically requires adverse-party consent before a distribution to the spouse in order to preserve non-grantor trust treatment.[16] Practitioners may consider including a helpful administrative provision in their trust agreements that provide if the trustee has absolute discretion to make distributions of income and principal to the beneficiaries, then the trustee may distribute the trust property to another trust held upon substantially the same terms and conditions for the benefit of *fewer* than all of the beneficiaries of the trust (subject to the same perpetuities provision as the original trust). This way, the spouse easily may be removed as a beneficiary if needed.

3. *No one should have the power to add a beneficiary of the trust.* A favorite ''grantor trust power'' is granting the trustee the ability to add beneficiaries during the grantor's life.[17] However, this power will trigger grantor trust treatment.

4. *Other Administrative Powers*. Below is a list of common administrative powers that should be carefully drafted to avoid application of grantor trust status:

> a. The trustee should not have the power to lend property of the trust without adequate security and adequate interest;[18]
>
> b. The trustee should not have the power to use (taxable) income of the trust to pay premiums on

[12] For a thorough overview of structuring non-grantor trusts that provides a detailed analysis of these points, see David A. Handler and Christiana M. Lazo, *Structuring and Planning with Non-Grantor Trusts*, 47th Annual Notre Dame Tax & Estate Planning Institute (Nov. 2021) (hereafter, ''Handler and Lazo'').

[13] §672(e); *see* Handler and Lazo.

[14] §674(a); *see* Handler and Lazo.

[15] Section 677 provides that ''[g]rantor trust treatment will result if the trust *income* may be distributed to the grantor's spouse, or accumulated for future distribution to the grantor's spouse, without the approval or consent of an adverse party, or in the discretion of the grantor or a nonadverse party.'' *See* Handler and Lazo.

[16] ''Alternatively, the statute might permit a partially grantor trust as to accounting income, as long as taxable income may never be accumulated for or distributed to the grantor's spouse. However, complete discussion of this structure and which of the non-grantor trust planning opportunities it might serve is beyond the scope of this article.'' *See* Handler and Lazo.

[17] §674(a).

[18] §675.

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policies of insurance on the life of the grantor, the grantor's spouse, or their joint lives;[19]

c. No person, acting in a non-fiduciary capacity and without approval or consent of a person in a fiduciary capacity, should have the power to:

(1) vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are ''significant'' from the viewpoint of voting control,[20]

(2) control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are ''significant'' from the viewpoint of voting control,[21] or

(3) reacquire all or any part of the property of the trust by substituting other property of equivalent value.[22]

When drafting grantor trusts, practitioners should organize trust agreements so that all administrative powers that trigger grantor trust status (such as the powers identified in Items 4 and 5 above) are grouped together in one Article *along with* a provision making such powers inapplicable upon the occurrence of an event that changes the status of the trust from grantor to non-grantor or requiring the trustee to release such powers upon the direction of a non-fiduciary third party.

B. Loans

It is common to include provisions in the trust agreement permitting the trustee to make loans to the grantor. These provisions can be structured so the trustee must obtain adequate security before the loan is made, but this is not required in the context of a grantor trust. However, the trust agreement should specify the trustee must charge adequate interest on the loan, because if adequate interest is not charged, it could result in estate tax inclusion for the grantor.[23] A loan to the grantor can be a good way to offset a particularly significant income tax period, by providing the grantor with liquidity to pay the income taxes, which can be repaid over a period of time. Pursuant to Revenue Ruling 85-13, transactions between a grantor and grantor trust are disregarded for income tax purposes. Therefore, the principal and interest payments on the note have no income tax effect.[24] In order to avoid an inference that interest was inadequate, the Applicable Federal Rate (''AFR'') for the appropriate period of the note should be used.[25] However, if the note is structured as a self-cancelling installment note, the interest rate should be increased (so long as such increased rate is in compliance with applicable usury laws in effect) in accordance with §163(i) in order to account for the risk premium.[26] To combat any argument that the loan is not a bona fide debt, the parties to the note should take care to abide by the terms of the note, including the timely payment of interest and principal. Otherwise, with respect to a loan made by the trust to the grantor, the IRS could challenge the legitimacy of the loan by arguing the grantor retained use of the trust property. With respect to a loan made by the grantor to the trust, ignoring the terms of the note and repaying the borrowed amount following the death of the grantor-obligor may result in the IRS challenging the legitimacy of the loan by arguing that it was a gift by the grantor.

C. Automatic Expiration of Grantor Trust Status

While taxable income can be expected in each year of a trust, there may be certain capital events that dramatically increase the income tax liability in a given year of the trust. Examples are the sale of a closely held family business or the sale of a significant position of any highly appreciated asset owned by the trust. If the trust is funded with an interest in a closely held business or any concentrated position and it is

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[19] §677(a)(3). ''Because income is 'taxable', this would include capital gains and presumably any income and gains that have been accumulated and added to principal. This would leave initial contributions to the trust as 'available' to pay insurance premiums without triggering grantor trust treatment.'' *See* Handler and Lazo.

[20] ''This could mean that stock subject to an agreement (trust or otherwise) which cedes voting power to a non-fiduciary could trigger grantor trust status.'' *See* Handler and Lazo.

[21] '' 'Significant' is not defined within the statute or regulations. Does this require a majority, or something less or more? Further does an agreement (trust or otherwise) requiring consent by a non-fiduciary always trigger grantor trust treatment (when holdings of the grantor and the trust are 'significant' from the viewpoint of voting control in stocks or securities of corporations) because it represents an effective veto power?'' *See* Handler and Lazo.

[22] §675(4). ''When a person is serving in a non-fiduciary capacity but has the authorities especially described in [(1)] and [(2)] of this [Section, then this role] should be carefully considered, especially in the context of what is deemed 'significant' and when a person has authority over a trust's investments, especially when the power is exercisable indirectly because of direct holdings of a trust.'' *See* Handler and Lazo.

[23] Martin Shenkman, *Loans From an Irrevocable Trust: How To Do Them Right*, Forbes (Dec. 8, 2021).

[24] Hesch and Handler.

[25] Jerome M. Hesch, Alan Gassman, and Christopher Denicolo, *Interesting Interest Questions: Interest Rates for Intra-Family Transactions*, 36 Tax Mgmt. Est., Gifts and Tr. J., No. 2 (Mar. 10, 2011).

[26] *Id.*

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contemplated such asset will be liquidated during the grantor's lifetime, consider including language in the trust agreement automatically terminating grantor trust status immediately prior to the occurrence of such event.

1. Distinguish Between Average Annual Income and Income From a Capital Event

While taxable income can be expected in each year of a trust, there may be certain capital events that dramatically increase the income tax liability in a given year of the trust. Examples are the sale of a closely held family business or the sale of a significant position of any highly appreciated asset owned by the trust. If the trust is funded with an interest in a closely held business or any concentrated position and it is contemplated such asset will be liquidated during the grantor's lifetime, consider including language in the trust agreement automatically terminating grantor trust status immediately prior to the occurrence of such event.

2. Turn Off Grantor Trust Status After Final GRAT Annuity Payment

If the trust agreement creates a grantor retained annuity trust (''GRAT''), the grantor will receive an annual annuity payment during the GRAT term. The annuity payment can be used to offset any income tax liability for which the grantor is responsible during the GRAT term. Once the term expires and the assets of the GRAT pour into a remainder trust, the tax liability may become burdensome to the grantor, who is no longer a beneficiary. Instead, structure the remainder trust as a non-grantor trust.

3. Terminate Grantor Trust Status After Note Is Repaid

If the grantor sold assets to the trust in exchange for a note, the cash flow from the note will be available to offset the grantor's income tax liability associated with grantor trust status. However, once the note is paid in full, the cash flow disappears. Consider including provisions in the trust agreement terminating grantor trust status effective upon repayment of the note.

D. Spouse as Beneficiary

If the trust agreement includes the grantor's spouse as a permissible beneficiary of the trust, the trustee can make a distribution to the spouse in accordance with the standard set forth in the trust agreement. A distribution to the grantor's spouse could be used to provide liquidity to pay the income taxes for which the grantor is responsible or to provide flexibility so other funds can be used to pay the income taxes.[27] The inclusion of the grantor's spouse as a permissible beneficiary will trigger grantor trust status.[28] If the trust is intended primarily as a vehicle to transfer wealth to the grantor's descendants, and the grantor does not wish to include her spouse as an initial beneficiary of the trust, a Trust Protector or trustee could be given the power to add the grantor's spouse as a beneficiary in the future, at which point the spouse would become a beneficiary and a distribution to the spouse could be used to ease the grantor's income tax burden.

E. Grantor Retains Sufficient Assets to Pay Income Tax

Estate planners dream of the perfect world where the grantor's taxable estate is approximately equal to the amount of the grantor's estate tax exemption at the time of his death. However, a more realistic reverie is ensuring the grantor retains sufficient assets to fund his lifestyle and pay the income taxes of his grantor trusts. By preparing a financial analysis taking into account how much the client needs for annual living expenses over the course of his lifetime, estate planners can help a client avoid a wealth transfer that leaves the client underwater in the future.

Example: John and Jane are a 63-year-old retired married couple. John transfers $10 million of investment assets that appreciate 5% annually and earn 2% ordinary income to an irrevocable grantor trust for the benefit of his and Jane's descendants. John and Jane retain $15 million of their own income-producing assets that pay 5% annually. At age 63, assume John and Jane's joint life expectancy is 30 years because they have access to top-notch health care.[29] John and Jane's annual living expenses are $500,000 and increase by 3% each year due to inflation. They are in the top marginal federal income tax bracket (37%) and are residents of East Hampton, New York (8.25% state income tax).

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[27] Jerome M. Hesch and Paul Lee, *The Financial Danger of Maximizing Taxable Gifts*, Est. Plan. Newsletter #2035 (Dec. 5, 2012).

[28] Reg. §1.677(a)(1).

[29] Practitioners may consult Table 2000CM (actuarial life table) to estimate a client's life expectancy.

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John and Jane (after making $10 million gift and retaining $15 million)

Year	Start of Year	Growth	Income	Realized Gains	Unrealized Gains	Annual Income	Tax Paid for Self	Tax Paid for Trust	Annual expenses	End of Year
1	$15,000,000	$750,000	$300,000	$150,000	$600,000	$0	$178,125	$118,750	$500,000	$15,253,125
2	$15,253,125	$762,656	$305,063	$152,531	$610,125	$0	$181,131	$149,663	$515,000	$15,475,050
3	$15,475,050	$773,753	$309,501	$154,751	$619,002	$0	$183,766	$178,219	$530,450	$15,665,869
4	$15,665,869	$783,293	$313,317	$156,659	$626,635	$0	$186,032	$205,158	$546,364	$15,824,926
5	$15,824,926	$791,246	$316,499	$158,249	$632,997	$0	$187,921	$231,090	$562,754	$15,950,905
6	$15,950,905	$797,545	$319,018	$159,509	$638,036	$0	$189,417	$256,524	$579,637	$16,041,890
7	$16,041,890	$802,095	$320,838	$160,419	$641,676	$0	$190,497	$281,886	$597,026	$16,095,413
8	$16,095,413	$804,771	$321,908	$160,954	$643,817	$0	$191,133	$307,542	$614,937	$16,108,479
9	$16,108,479	$805,424	$322,170	$161,085	$644,339	$0	$191,288	$333,810	$633,385	$16,077,590
10	$16,077,590	$803,879	$321,552	$160,776	$643,104	$0	$190,921	$360,968	$652,387	$15,998,745
11	$15,998,745	$799,937	$319,975	$159,987	$639,950	$0	$189,985	$389,269	$671,958	$15,867,444
12	$15,867,444	$793,372	$317,349	$158,674	$634,698	$0	$188,426	$418,945	$692,117	$15,678,677
13	$15,678,677	$783,934	$313,574	$156,787	$627,147	$0	$186,184	$450,212	$712,880	$15,426,908
14	$15,426,908	$771,345	$308,538	$154,269	$617,076	$0	$183,195	$483,280	$734,267	$15,106,049
15	$15,106,049	$755,302	$302,121	$151,060	$604,242	$0	$179,384	$518,352	$756,295	$14,709,441
16	$14,709,441	$735,472	$294,189	$147,094	$588,378	$0	$174,675	$555,631	$778,984	$14,229,813
17	$14,229,813	$711,491	$284,596	$142,298	$569,193	$0	$168,979	$595,320	$802,353	$13,659,247
18	$13,659,247	$682,962	$273,185	$136,592	$546,370	$0	$162,204	$637,629	$826,424	$12,989,138
19	$12,989,138	$649,457	$259,783	$129,891	$519,566	$0	$154,246	$682,772	$851,217	$12,210,143
20	$12,210,143	$610,507	$244,203	$122,101	$488,406	$0	$144,995	$730,973	$876,753	$11,312,131
21	$11,312,131	$565,607	$226,243	$113,121	$452,485	$0	$134,332	$782,467	$903,056	$10,284,126
22	$10,284,126	$514,206	$205,683	$102,841	$411,365	$0	$122,124	$837,500	$930,147	$9,114,244
23	$9,114,244	$455,712	$182,285	$91,142	$364,570	$0	$108,232	$896,334	$958,052	$7,789,624
24	$7,789,624	$389,481	$155,792	$77,896	$311,585	$0	$92,502	$959,244	$986,793	$6,296,359
25	$6,296,359	$314,818	$125,927	$62,964	$251,854	$0	$74,769	$1,026,524	$1,016,397	$4,619,413
26	$4,619,413	$230,971	$92,388	$46,194	$184,777	$0	$54,856	$1,098,488	$1,046,889	$2,742,540
27	$2,742,540	$137,127	$54,851	$27,425	$109,702	$0	$32,568	$1,175,467	$1,078,296	$648,188
28	$648,188	$32,409	$12,964	$6,482	$25,928	$0	$7,697	$1,257,818	$1,110,645	-$1,682,599
29	-$1,682,599	-$84,130	-$33,652	-$16,826	-$67,304	$0	-$19,981	$1,345,920	$1,143,964	-$4,270,284
30	-$4,270,284	-$213,514	-$85,406	-$42,703	-$170,811	$0	-$50,710	$1,440,178	$1,178,283	-$7,136,955

As shown above, John and Jane run out of money by the time they celebrate their 91st birthdays (see Year 28). By Year 27, John would have paid $14,662,019 of income taxes on behalf of the grantor trust — but at the expense of losing the ability to support Jane and himself.

Alternatively, assume the same facts as above except John transferred $9 million (instead of $10 million) to the grantor trust in Year 1 and retained $16 million. As shown below, the results are drastically different.

John and Jane (after making $9 million gift and retaining $16 million)

Year	Start of Year	Growth	Income	Realized Gains	Unrealized Gains	Annual Income	Tax Paid for Self	Tax Paid for Trust	Annual expenses	End of Year
1	$16,000,000	$800,000	$320,000	$160,000	$640,000	$0	$190,000	$106,875	$500,000	$16,323,125
2	$16,323,125	$816,156	$326,463	$163,231	$652,925	$0	$193,837	$134,696	$515,000	$16,622,210
3	$16,622,210	$831,111	$332,444	$166,222	$664,888	$0	$197,389	$160,397	$530,450	$16,897,529
4	$16,897,529	$844,876	$337,951	$168,975	$675,901	$0	$200,658	$184,642	$546,364	$17,148,692
5	$17,148,692	$857,435	$342,974	$171,487	$685,948	$0	$203,641	$207,981	$562,754	$17,374,724
6	$17,374,724	$868,736	$347,494	$173,747	$694,989	$0	$206,325	$230,871	$579,637	$17,574,122
7	$17,574,122	$878,706	$351,482	$175,741	$702,965	$0	$208,693	$253,697	$597,026	$17,744,894
8	$17,744,894	$887,245	$354,898	$177,449	$709,796	$0	$210,721	$276,788	$614,937	$17,884,591
9	$17,884,591	$894,230	$357,692	$178,846	$715,384	$0	$212,380	$300,429	$633,385	$17,990,319
10	$17,990,319	$899,516	$359,806	$179,903	$719,613	$0	$213,635	$324,872	$652,387	$18,058,748
11	$18,058,748	$902,937	$361,175	$180,587	$722,350	$0	$214,448	$350,343	$671,958	$18,086,112
12	$18,086,112	$904,306	$361,722	$180,861	$723,444	$0	$214,773	$377,050	$692,117	$18,068,200
13	$18,068,200	$903,410	$361,364	$180,682	$722,728	$0	$214,560	$405,191	$712,880	$18,000,342
14	$18,000,342	$900,017	$360,007	$180,003	$720,014	$0	$213,754	$434,952	$734,267	$17,877,393
15	$17,877,393	$893,870	$357,548	$178,774	$715,096	$0	$212,294	$466,517	$756,295	$17,693,704
16	$17,693,704	$884,685	$353,874	$176,937	$707,748	$0	$210,113	$500,068	$778,984	$17,443,099
17	$17,443,099	$872,155	$348,862	$174,431	$697,724	$0	$207,137	$535,788	$802,353	$17,118,838
18	$17,118,838	$855,942	$342,377	$171,188	$684,754	$0	$203,286	$573,866	$826,424	$16,713,580
19	$16,713,580	$835,679	$334,272	$167,136	$668,543	$0	$198,474	$614,495	$851,217	$16,219,346
20	$16,219,346	$810,967	$324,387	$162,193	$648,774	$0	$192,605	$657,876	$876,753	$15,627,466
21	$15,627,466	$781,373	$312,549	$156,275	$625,099	$0	$185,576	$704,220	$903,056	$14,928,537
22	$14,928,537	$746,427	$298,571	$149,285	$597,141	$0	$177,276	$753,750	$930,147	$14,112,361
23	$14,112,361	$705,618	$282,247	$141,124	$564,494	$0	$167,584	$806,700	$958,052	$13,167,890
24	$13,167,890	$658,394	$263,358	$131,679	$526,716	$0	$156,369	$863,319	$986,793	$12,083,161
25	$12,083,161	$604,158	$241,663	$120,832	$483,326	$0	$143,488	$923,872	$1,016,397	$10,845,226
26	$10,845,226	$542,261	$216,905	$108,452	$433,809	$0	$128,787	$988,639	$1,046,889	$9,440,076
27	$9,440,076	$472,004	$188,802	$94,401	$377,603	$0	$112,101	$1,057,920	$1,078,296	$7,852,565
28	$7,852,565	$392,628	$157,051	$78,526	$314,103	$0	$93,249	$1,132,036	$1,110,645	$6,066,314
29	$6,066,314	$303,316	$121,326	$60,663	$242,653	$0	$72,037	$1,211,328	$1,143,964	$4,063,627
30	$4,063,627	$203,181	$81,273	$40,636	$162,545	$0	$48,256	$1,296,160	$1,178,283	$1,825,382

By reducing their gift by $1 million to the grantor trust and retaining $16 million for their own use, John and Jane retained enough to cover their living expenses and still paid $16,835,342 of income taxes on

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behalf of the grantor trust over a 30-year period. This example shows how clients can mindfully transfer substantial wealth when understanding the long-term impact of the gift. Presenting clients with a financial projection like the one above is a great way to remind them to put on their own oxygen mask first before helping others.

F. Power of Appointment

Estate planners may consider including a special limited power of appointment in the trust agreement permitting income-producing assets to be transferred to another trust for the benefit of one or more of the beneficiaries of such trust (the ''Appointed Trust''). This special power should be held by an unrelated third party (i.e., a trusted friend or extended family member who is not otherwise mentioned in the trust agreement). The Appointed Trust must be a non-grantor trust so the Appointed Trust is responsible for paying income taxes on all trust assets.

Alternatively, estate planners may check to see if the grantor trust is situated in a jurisdiction permitting decanting under state law (which at least 32 states permit in some form).[30] By using a state decanting statute, income-producing assets may be decanted to a non-grantor trust to achieve the same result as above. If the grantor trust is in a jurisdiction with a restrictive decanting statute, estate planners may consider changing the governing law and/or situs of the trust using one of the methods discussed in VI., below.

Example: Trust 1 is an irrevocable grantor trust that allows distributions of principal to John's descendants for health and education. Trust 2 is an irrevocable non-grantor trust for the benefit of John's descendants that allows for distributions of principal in the trustee's discretion. Trust 1 and Trust 2 are both New York trusts. Trust 1's investment in a tech start-up is successful and it owns stock that is performing incredibly well. John is tired of paying the income taxes on the stock's stellar performance. Trust 1's trustee is amenable to decanting the stock to Trust 2. While the beneficiaries of the two trusts are the same, New York's decanting statute will not permit Trust 1's stock to be appointed to Trust 2 because the distribution standards are different (i.e., Trust 1 has an ascertainable standard and Trust 2 is unlimited discretion). Specifically, New York law provides a trustee without unlimited discretion to invade the principal of the trust may only appoint the assets to a trust with all of the same beneficiaries and with the same limited distribution standard (i.e., distributions for only health and education).[31] However, if Trust 1 moves to a jurisdiction like South Dakota where the trustee is permitted to decant a trust with an ascertainable standard into a discretionary trust,[32] the desired result of decanting the stock from Trust 1 to Trust 2 is achievable.

IV. INCOME TAX CONSEQUENCES OF TURNING OFF GRANTOR TRUST STATUS

When grantor trust status is turned off (whether by toggling or by automatic provisions in the trust agreement), the trust's payment of its own income taxes introduces other complexities. When a trust ceases to be a grantor trust during the grantor's life (as a result of a change to the trust instrument, the trustees, or the powers that may be exercised over trust property), it is no longer disregarded for income tax purposes.[33] At such time, the trust essentially springs into life for income tax purposes.[34] The existing authorities are sparse, but consistent, and take the view that when a trust ceases to be a grantor trust, the grantor is deemed to have transferred, for income tax purposes, to the trust: (1) the assets in the trust and (2) the liabilities of the trust (thus relieving the grantor of such liabilities).[35] Another concern is termination of grantor trust status can have immediate income tax consequences: If, upon termination of grantor trust status, a trust has any outstanding liabilities, such as a note issued by the trust to the grantor, gain will be recognized by the grantor to the extent the amount of all of such liabilities exceeds the grantor's basis in all of the trust assets.[36] In particular, practitioners working with clients who own encumbered real estate in closely held entities should remain cognizant of a trap for the unwary: negative capital accounts.[37] Even if the amount of debt deemed assumed by the trust upon termination of grantor trust status does not exceed the grantor's basis in all of the trust assets, the grantor may neverthe-

[30] Steve Oshins, 8th Annual Trust Decanting State Rankings Chart.

[31] NY EPTL §10.6-6(c).

[32] SDCL §55-2-15.

[33] David A. Handler and Deborah V. Dunn, *The Complete Estate Planning Sourcebook*, Wolters Kluwer (2020 ed.) (hereafter ''Handler and Dunn'').

[34] *Id.*

[35] *Id. See also* Reg. §1.1001-2(c) *Ex.* 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; TAM 200011005 (Mar. 17, 2000); PLR 200011005 (Nov. 23, 1999).

[36] Handler and Dunn.

[37] Stephen M. Breitstone, *Estate Planning for Negative Capital*, Penton Wealth Mgmt., Tr. & Est. (May 2012).

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less recognize gain to the extent the trust owns an interest in a partnership that has liabilities.[38]

V. REIMBURSEMENT CLAUSES

A. Brief Background of Rev. Rul. 2004-64

Revenue Ruling 2004-64 is the muse that inspired grantor trust reimbursement legislation.[39] In this ruling, the IRS held when the trustor of a trust, who is treated as the owner of the trust under subpart E,[40] pays the income tax attributable to the inclusion of the trust's income in the trustor's taxable income, the trustor is not treated as making a gift of the amount of the tax to the trust beneficiaries. The ruling further provided if, pursuant to the trust's governing instrument or applicable local law, the trustor *must* be reimbursed by the trust for the income tax payable by the trustor that is attributable to the trust's income, then the full value of the trust's assets is includible in the grantor's gross estate under §2036(a)(1). The ruling added if the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the trustor for that portion of the trustor's income tax liability, the existence of that discretion, by itself (whether or not exercised), will not cause the value of the trust's assets to be includible in the trustor's gross estate. The ruling introduced a framework for state legislatures to apply when drafting a reimbursement power that would not trigger adverse tax consequences for trustors.

Currently, several states do not expressly authorize the trustee to repay the trustor for the trustor's income tax liability but have statutes preventing the trustor's creditors from reaching trust property based on a trustee's reimbursement power under the trust agreement. This language is critical because it will prevent inclusion in the trustor's estate for estate tax purposes. Under the laws of most U.S. and other common law jurisdictions (which are based on England's centuries-old Statute of Elizabeth), a self-settled trust, even one that is irrevocable, is void as to one's own creditors.[41] Because creditors can reach the trust property, the transfer to the trust is deemed to be revocable, and thus at the settlor's death, the trust property would be subject to estate tax under §2038.[42] However, this issue is eliminated if state law (like in states that allow asset protection trusts) exempts the trust from the reach of creditors when the settlor is a beneficiary. Thus, if a state enacts a statute providing that the reimbursement power would not make the assets of an irrevocable trust subject to the claims of the trustor's creditors (or make the trustor a beneficiary of such trust), then the trust agreement may safely include a reimbursement power in that jurisdiction because it specifically carved out an exemption for tax reimbursement clauses.

B. Reimbursement Is a Remedy, But Proceed With Caution

The trustee's power to reimburse the grantor must be discretionary, not mandatory. If the trust agreement *requires* that the trustee reimburse the grantor for the tax liability of the trust, rather than *permits* the trustee to do so, it will cause gross estate inclusion for the grantor under §2036(a)(1). Even if the trust agreement provides the power is discretionary rather than mandatory, if there is a separate agreement or pre-existing arrangement between the trustee and the grantor regarding reimbursement, it will likely also cause gross estate tax inclusion for the grantor.

Trustees must tread carefully because if the reimbursement power is used too often, creditor protection issues may arise. If a trustee exercises its discretion to reimburse the grantor for income taxes too often, creditors of the grantor can argue they should be able to reach the assets of the trust to satisfy their claims because the grantor essentially can access the assets of the trust on demand. Even more daunting, the IRS in Rev. Rul. 2004-64 warns that in a situation where the trust is routinely called upon to reimburse the grantor, it could be inferred there was an implied or express agreement between the trustee and the grantor for reimbursement, which would cause estate tax inclusion under §2036(a)(1).

C. State Law Status and Developments

Six states have enacted legislation authorizing income tax reimbursement to a grantor:[43]

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[38] Handler and Dunn.

[39] A thorough analysis of this Revenue Ruling can be found at Mitchell M. Gans, Stephanie E. Heilborn, and Jonathan G. Blattmachr, *Some Good News About Grantor Trusts: Rev. Rul. 2004-64*, 31 Est. Plan. 467 (2004).

[40] *I.e.*, Subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code.

[41] Handler and Dunn.

[42] *See Outwin v. Commissioner*, 76 T.C. 153 (1981); *Paolozzi v. Commissioner*, 23 T.C. 182 (1954).

[43] *See* Kim Kamin, *Where Are All the Grantor Trust Reimbursement Statutes?* Penton Wealth Mgmt., Tr. & Est. (Jan. 17, 2018). In addition to the six states that have enacted grantor trust reimbursement statutes, legislation has been proposed in Indiana.

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1. New York:[44] New York's statute became effective on May 21, 1969. While this statute allowed for grantor reimbursement, there is not a corollary reference to the protection of the trust assets from the grantor's creditors. The New York legislature addressed this issue in a 2005 amendment to EPTL §7-3.1(d) to provide for creditor protection.

2. New Hampshire:[45] This statute became effective on October 1, 2004, and has been amended five times since its enactment, on September 20, 2005, September 9, 2008, July 1, 2014, July 27, 2015, and September 10, 2015. The July 1, 2014 amendment added a provision permitting grantor reimbursement.

3. Colorado:[46] This statute became effective on January 1, 2019, and permits grantor reimbursement unless the governing instrument provides otherwise, or an independent trustee (as defined in §672(c)) elects otherwise in writing. This statute prevents the creditors of the grantor from reaching the assets of the trust, because of the trustee's power to reimburse the grantor for income tax liability, whether that power is derived from the trust agreement itself, the agreement of beneficiaries, a court order, or any other provision of law.

4. Delaware:[47] Delaware's statute was enacted on June 19, 2019 and amended on June 30, 2021. The Delaware statute is expansive and permits a trustee to reimburse the grantor for personal federal or state income tax liability related to the trust, as well as any county, metropolitan-region, city, local, foreign, and other income tax liability associated with the trust.

5. Connecticut:[48] Connecticut's grantor reimbursement statute became effective on January 1, 2020. Of the six states that have enacted grantor trust reimbursement statutes, Connecticut is the only state requiring explicit authorization for reimbursement to be contained in the trust agreement; the other five statutes permit grantor reimbursement if the trust agreement is silent on the issue.

6. Florida:[49] This statute became effective on July 1, 2020, and provides broad reimbursement authority. In addition, the Florida statute permits the trustee irrevocably to elect out of the application of the reimbursement power if the trustee provides written notice to the grantor (or any other person who has the ability to remove and replace the trustee) within 60 days of such election taking effect.

In addition to the six states discussed above, there are 12 states that do not expressly authorize the trustee to reimburse the trustor for income tax liability but have enacted statutes preventing a trustor's creditors from reaching trust assets based on a trustee's power to reimburse the trustor for tax payments: (1) Arizona;[50] (2) Idaho;[51] (3) Illinois;[52] (4) Iowa;[53] (5) Kentucky;[54] (6) Maryland;[55] (7) Massachusetts;[56] (8) Montana;[57] (9) North Carolina;[58] (10) Pennsylvania;[59] (11) Texas;[60] and (12) Virginia.[61]

VI. MOVING OR MODIFYING TRUSTS TO GET BENEFITS OF A REIMBURSEMENT STATUTE

A. Migrating to a Favorable Jurisdiction

If the trust agreement does not expressly authorize reimbursement and the trust is not sitused in Colorado, Delaware, Florida, New Hampshire or New York, then review the trust agreement to determine if the governing law or situs of the trust may be changed. If the trust agreement allows the situs of the trust to be changed, it may be possible to appoint a trustee (or an administrative trustee) in a favorable jurisdiction to avail the trust of that jurisdiction's trust laws. For example, a California trust may appoint a Delaware trustee to invoke 12 Del. C. §3332(b), which provides on the transfer of a trust to Delaware, ''[e]xcept as otherwise expressly provided by the terms of a governing instrument or by court order, the laws of [Delaware] shall govern the administration of a trust while the trust is administered in [Delaware].'' Assuming the trust agreement includes no prohibitory language, the appointment of a Delaware trustee of such trust would give the California trust access to Delaware's grantor trust reimbursement statute.

B. Nonjudicial Modification Strategies

Before changing the situs of the trust, which would likely require the appointment of a different trustee, consider whether the trust may be nonjudicially modi-

[44] EPTL §7-1.11

[45] N.H. Rev. Stat. §564-B:8-816.

[46] C.R.S. §15-5-818.

[47] 12 Del. C. §3344.

[48] C.G.S. §45a-499fff.

[49] Fla. Stat. §736.08145.

[50] Ariz. Rev. Stat. §14-10505.

[51] Idaho Code Ann. §15-7-502.

[52] 760 ILCS 3/505.

[53] Iowa Code Ann. §633A.2304.

[54] Ky. Rev. Stat. Ann. §386B.5-020.

[55] Md. Code Ann., Est. and Trusts §14.5-1003

[56] M.G.L.A. 203E §505.

[57] M.C.A. §72-38-505.

[58] N.C. Gen. Stat. Ann. §36C-5-505.

[59] 20 Pa. C.S.A. §7745.

[60] Tex. Prop. Code Ann. §112.035.

[61] Va. Code Ann. §64.2-747.

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fied pursuant to applicable state law. It may be possible to decant a trust established in one state into a new trust established in a different state. For example, a trust established in Wisconsin (which has no reimbursement statute but has a decanting statute) may be decanted to a Florida trust allowing the trustor to be reimbursed for income taxes.[62] Alternatively, in some jurisdictions state law permits modification of an irrevocable trust agreement by consent of the beneficiaries. For example, if the trustor is living and all beneficiaries are adults, New York allows a trust agreement to be modified by the written agreement of the trustor and beneficiaries (and trustee consent is not required).[63] Using this statute (or a similar one in another jurisdiction), a trust may be modified to include reimbursement language. Additionally, a nonjudicial settlement agreement is another tool that should be considered. Nonjudicial settlement agreements are permitted under the Uniform Trust Code. Under a nonjudicial settlement agreement, the interested parties may agree to transfer of a trust's principal place of administration or to change the law governing administration of the trust to a state authorizing reimbursement of the trustor's income taxes.

VII. PROTECTING TRUSTEES AND ADVISORS

A. Protecting Trustees

A trustee should proceed with caution when the grantor wants out of grantor trust status but the beneficiaries want the grantor trust status to continue.

1. Trustee's Duty of Loyalty and Impartiality

Is a trustee is breaching its fiduciary duties to the trust's beneficiaries when (a) reimbursing the grantor for the trust's income taxes or (b) turning off grantor trust status? ''Perhaps the most fundamental duty of a trustee is the trustee's duty of loyalty to the beneficiaries, often stated as the duty to act solely in the interests of the beneficiaries.''[64]

If the trustee has the discretion to reimburse the grantor for income tax liability, exercising that discretion arguably could be a breach of the trustee's fiduciary duty to the beneficiaries because such reimbursement benefits the grantor to the detriment of the beneficiaries. However, granting the trustee the discretion to reimburse the grantor for income tax liability could incentivize the grantor to make additional gifts to the trust without fear of the grantor becoming overburdened by a particularly large income tax liability without ready access to cash to pay this liability.

Similarly, the trustee may struggle to explain how the beneficiaries' best interests are served by having the trust pay its own incomes taxes when the grantor can be made to carry the trust's income tax burden. If the trust agreement is structured as requiring the trustee to release certain powers that trigger grantor trust status, then the trustee may be exposing himself to liability if he cannot articulate a valid reason for releasing the power and turning off grantor trust status. As suggested above, the trustee could take the position that turning off grantor trust status incentivizes the grantor to make additional gifts to the trust because the grantor will not be saddled with the income tax burden. Nonetheless, to protect the trustee, the trust agreement may provide that a non-fiduciary third party must direct the trustee to release the power that turns off grantor trust status.

2. Exculpatory Language in Trust Agreement and Bifurcation of Reimbursement Power

If the trustee is given the discretion to exercise the power to reimburse the grantor, exculpatory language may be included in the trust agreement specifically addressing the exercise of such power. The trust agreement could also be drafted so that the power to reimburse is given to a Trust Protector or independent trustee. For additional protection, the trustee (or individual holding the reimbursement power) could request a release from the beneficiaries prior to exercising the reimbursement power. This strategy ensures the beneficiaries are fully informed and consent to the trustee reimbursing the grantor for the income tax liability generated by the trust.

B. Protecting Advisors

Advisors must communicate the impact of the burn to a potential client. In *Estate of Wellin v. Farace et al.*,[65] a lawyer who drafted a grantor trust was sued for negligence, breach of fiduciary duty, and breach of contract by the grantor's estate. The Fourth Circuit ultimately only decided whether a statute of limitations had run, but the analysis gives helpful guidance as to what information should be provided by lawyers to clients who are creating grantor trusts and how such information should be provided.

The drafting lawyer in *Wellin* worked with the grantor for a period of more than 10 years to create an

[62] However, consider the state income tax consequences of such transfer.

[63] NY EPTL 7-1.9.

[64] Bogert's *The Law of Trusts and Trustees* §543; *Restatement Third, Trusts* §78 (Duty of Loyalty); *Restatement Third, Trusts* §100 (Liability of Trustee for Breach of Trust); *Restatement Second, Trusts* §170 (Duty of Loyalty), §206 (Liability for Breach of Duty of Loyalty).

[65] No. 20-1120 (4th Cir. Nov. 22, 2021).

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estate plan that reduced the amount of estate taxes due on the grantor's death. As one of the strategies to help reduce the grantor's estate taxes, the lawyer recommended the grantor contribute approximately $90 million worth of marketable securities to a partnership in exchange for 98.9% of the interests in the partnership, with his children retaining the remaining 1.1% interest. The grantor then sold his 98.9% interest in the partnership to a grantor trust for a note worth approximately $50 million. In the year prior to the grantor's death, his children sold marketable securities owned by the trust in the amount of $157 million, which caused the recognition of a considerable gain to the grantor trust. Although the grantor's estate did not pay any of the income taxes associated with the sale of the securities because the IRS did not seek to collect within the applicable statute of limitations period, the estate alleged the lawyer had failed to apprise the grantor of all of the risks and consequences associated with the estate planning transactions.

While it is possible the lawyer in *Wellin* gave information to his client related to the potential risks involved with the subject transactions, he did not do so in writing or in the presence of other people who could confirm what information was given to the client. One key takeaway from *Wellin* is an attorney should expressly advise the client that once the transaction is completed, the attorney is under no duty to inform (and will not inform) the client of any law change affecting that transaction. Because the majority of the statutes authorizing grantor reimbursement are relatively new, this is a precaution drafting lawyers should heed. Otherwise, the grantor may have an expectation the lawyer will provide guidance with respect to any updates or changes in the applicable law.

Attorneys and other advisors should also consider potential conflict of interests between clients who are family members (i.e., parents and children). One of the issues giving rise to the litigation in *Wellin* was that the grantor, prior to his death, believed his lawyer was putting his children's interests above his own. One way to minimize this risk is to fully inform the grantor and the beneficiaries of the plan from the outset and answer any questions they may have. This will ensure that everyone is fully informed before the creation of the trust and the implementation of the agreed-upon strategy. If there is any particular concern, a practitioner should consider whether a waiver or separate representation is appropriate.

VIII. OBSERVATIONS AND RECOMMENDATIONS

Wealth transfer planning comes with trade-offs. Transferring an asset out of one's estate for estate tax purposes means forfeiting a basis step-up and access to that asset. Paying income taxes on the trust property over a 20-plus-year period may result in removing substantial wealth from a client's taxable estate– but the client must weigh the financial and emotional burn.

Clients equipped with the relevant knowledge will make better decisions. A client who learns about the benefits of grantor trust status and has reviewed projections of the ''burn'' over a period of time is much less likely to harbor bad feelings toward his estate planner and fiduciaries in the future. The client will be quick to appreciate grantor trust status offers several benefits: (i) tax-free gifting by paying income taxes on the trust's assets, (ii) the ability to transact with their grantor trust without federal income taxes consequences,[66] and (iii) useful powers like the grantor's ability to swap assets of an equivalent value with the trust, having a spouse serve as trustee, or having an independent trustee add beneficiaries to the trust (which includes the possibility of including the spouse as a beneficiary).

With the suggestions outlined in III., above, the client may have the best of both worlds: enjoying the benefits of grantor trust status for a specified term and then converting to non-grantor trust status at a predetermined time. To calculate the correct time to discontinue grantor trust status, a client should review a financial analysis mapping out how much he needs if he lived until his early 90s. Americans are projected to have longer life expectancies in coming decades.[67] By 2060, life expectancy for the total population is projected to increase by about six years, from 79.7 in 2017 to 85.6 in 2060.[68] Stretching a 60-year-old client's financial projection to his 93rd birthday (rather than his life expectancy under the actuarial tables) is important because an individual's life expectancy is an average. Half of all individuals at that age will still be living when they reach their life expectancy age.

A client who reviews the data and examines the impact of wealth transfer planning on his lifestyle as well as his family's will be poised to navigate the trade-offs of grantor trust and non-grantor trust status.

IX. CONCLUSION

For the benefit of both the grantor and the lawyer creating the grantor trust, the client's professionals

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[66] Rev. Rul. 85-13.

[67] Lauren Medina, Shannon Sabo, and Jonathan Vespa, *Living Longer: Historical and Projected Life Expectancy in the United States, 1960 to 2060*, U.S. Census Bureau (Feb. 2020).

[68] *Id*. New research even suggests humans are capable of living up to 150 years. *See* Emily Willingham, *Humans Could Live up to 150 Years, New Research Suggests*, Scientific Am. (May 25, 2021).

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should fully communicate the financial impact of creating such a trust. Ideally, this communication should be written and provided in concert with the grantor's financial advisor, accountant, and attorney.

In order to facilitate this discussion, and because a picture is worth a thousand words, the grantor should be provided with illustrations and projections of the anticipated income tax burden that will be borne by the grantor in the years to come. In this way, the grantor can determine when the income tax liability may become too onerous and can plan for a discrete number of years or the occurrence of an event that will terminate grantor trust status.

The type of assets funding the trust and how and when those assets may change over time should also be discussed with the grantor prior to the creation of the trust. Some assets, such as marketable securities and life insurance policies, do not generate income until the occurrence of an event (e.g., the sale of securities or the death of the insured), and other assets, such as municipal bonds, may generate only modest income tax. A discussion of these variables will help to set expectations about the grantor's obligation to pay the income taxes of the trust in the future.

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