



## OUTSIDE COUNSEL

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### *New York Statute Eases Estate Planning With Grantor Trusts*

**N**ew York passed important legislation on May 31, 2005, that will facilitate estate planning with intentionally defective grantor trusts.

In response to Revenue Ruling 2004-64,<sup>1</sup> the New York Legislature amended Estates Powers and Trust Law (EPTL) §7-3.1. That amendment clarifies that a trustee's discretionary authority to pay or reimburse the grantor for taxes attributable to a grantor trust does not expose the trust to the claims of the grantor's creditors.

This clarification, as described below, has significant estate tax implications.

#### **Intentionally Defective Grantor Trusts**

The intentionally defective grantor trust,<sup>2</sup> or IDGT, is the centerpiece of many estate plans. With an IDGT, the grantor is treated as the owner of the underlying trust property for income tax purposes; yet, the grantor's transfers to the very same trust are complete for gift tax purposes, and the trust property is excluded from the grantor's gross estate.<sup>3</sup>

Taxable income attributable to an income tax grantor trust generally is taxed to the grantor.<sup>4</sup> Assuming the grantor's income tax payments are not considered gifts, such payments reduce the grantor's estate and benefit the trust beneficiaries, without gift tax consequences.

Until recently, the Internal Revenue Service (IRS) struggled with the transfer tax consequences of income tax payments with respect to IDGTs. The IRS had sent conflicting messages as to whether such income tax payments by the grantor would be considered further gifts subject to gift tax. The estate tax consequences, in addition, were unclear if the trustee could pay the income tax or reimburse the grantor for the tax payments.

#### **Revenue Ruling 2004-64**

On July 6, 2004, the IRS released Revenue

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*The intentionally defective grantor trust is a potent estate planning tool. The grantor's ongoing income tax payments may be viewed as further gifts outside the transfer tax system.*

Ruling 2004-64. The ruling confirms that the grantor's payment of income taxes attributable to an IDGT is not a transfer for gift tax purposes. It further concludes that the trustee's discretionary authority (whether under the trust instrument or applicable law) to reimburse the grantor for income tax payments alone will not cause estate tax inclusion.

The IRS, however, warned that the discretionary authority to reimburse the grantor for the income tax payments, coupled with other facts, may cause estate tax problems.<sup>5</sup> Specifically, the IRS explained that estate tax inclusion would occur if, among other circumstances, applicable local law subjected the trust's assets to the claims of the grantor's creditors.<sup>6</sup>

• **Creditor's Rights and Estate Tax Consequences.** If a trust is revocable under state law,<sup>7</sup> the trust assets are includible in the grantor's gross estate under Internal Revenue Code (IRC) §2038. A trust is deemed revocable if the grantor's creditors may reach the trust assets. The rationale is that, assuming the trust assets are subject to the claims of the grantor's creditors, the grantor could at any time obtain the economic benefit of the trust

by individually borrowing or incurring other obligations; such action could force the creditors to look to the grantor's interest in the trust as a source of payment.<sup>8</sup>

Revenue Ruling 2004-64 raises the question as to whether a discretionary tax reimbursement provision, under applicable state law, causes the trust to be subject to the grantor's creditors. If so, such reimbursement provision would cause the trust property to be included in the grantor's gross estate.

• **Creditor Rights Under State Law.** Under the laws of many states, creditors can reach the maximum amount that the trustee could pay to the grantor or apply for the grantor's benefit.<sup>9</sup> For example, EPTL §7-3.1(a) provides that "a disposition in trust for the use of the creator is void against the existing or subsequent creditors of the creator."<sup>10</sup>

Does EPTL §7-3.1(a) expose trust assets to the claims of the grantor's creditors if the trustee of an IDGT has discretionary authority to pay or reimburse the grantor for taxes attributable to the IDGT? Note that, if the trust instrument is silent, the trustee of an IDGT governed by New York law has such discretionary authority, at least as to trust corpus. This is so because, under EPTL §7-1.11(a), unless the governing instrument provides otherwise, a trustee of a trust may "pay from principal to the creator of such trust an amount equal to any income taxes on any portion of the trust principal" charged to the creator.

New York quickly responded to Revenue Ruling 2004-64 by amending EPTL §7-3.1. Specifically, the amendment adds the following paragraph (d):

A disposition in trust shall not be considered to be for the use of the creator under paragraph (a) of this section by reason of the trustee's authority to pay trust principal to the creator pursuant to section 7-1.11 of this article. Nor shall a disposition in trust be considered to be for the use of the creator under paragraph (a) of this section where the trustee is authorized under the trust instrument or any other provision of law to pay or reimburse the creator for any tax on trust income or trust principal that is payable by the creator under the law imposing such tax or to pay any such tax directly to the taxing authorities. No

creditor of a trust creator shall be entitled to reach any trust property based on the discretionary powers described in this paragraph.<sup>11</sup>

The first two sentences of new EPTL §7-3.1(d) confirm that, if a trustee has a discretionary power to reimburse the grantor for income tax payments or to pay taxing authorities directly (under EPTL §7-1.11(a) or the governing instrument), the trust "shall not be considered to be for the use" of the grantor. This confirmation is significant because, under EPTL §7-3.1(a), a disposition in trust "for the use" of the grantor is void against the grantor's creditors. To remove any doubt, the final sentence of new paragraph (d) specifically confirms that no creditor may reach any trust property as a result of a discretionary reimbursement power.

The legislative history is clear that EPTL §7-3.1(d) was prompted directly by Revenue Ruling 2004-64.<sup>12</sup> However, the new paragraph (d) does not change New York law; rather, it confirms existing law. No New York case has held (or considered) that EPTL §7-1.11(a) or similar discretionary authority would cause a trust to fall within the scope of EPTL §7-3.1(a). Furthermore, the legislative history of EPTL §7-1.11(a) does not suggest that the provisions of that statute would cause trust assets to be subject to the claims of the grantor's creditors.<sup>13</sup>

## Safe Harbor

Under the facts described in Revenue Ruling 2004-64, the trustee with discretionary reimbursement authority is not related or subordinate to the grantor within the purview of IRC §672(c).<sup>14</sup> Query whether the estate tax consequences would differ if the trustee were a related or subordinate person with respect to the grantor.

This issue turns on an analysis of IRC §2036(a)(1). Under that provision, property that is transferred, by trust or otherwise, generally will be included in the transferor's gross estate if the transferor has retained (for life or for a period that does not end before death) the income from, or the enjoyment of, such property. If the trust property is to be used to discharge a legal obligation of the grantor, the transferor will be deemed to have retained one of the proscribed powers or rights under IRC §2036.<sup>15</sup> Significantly, the income tax liability with respect to an IDGT resides with the grantor. Hence, there had been a concern that tax reimbursement or tax payment might be considered a discharge of the grantor's legal obligation, resulting in estate tax inclusion. However, Revenue Ruling 2004-64 confirms that, so long as such authority is within the discretion of the trustee (and not mandated by the grantor or applicable law), the power to reimburse or pay the tax will not run afoul of IRC §2036(a)(1).<sup>16</sup>

Estate tax inclusion under IRC §2036(a)(1) generally requires a retained, legally enforceable right.<sup>17</sup> However, the IRS and courts will infer the existence of such an enforceable right

if, based on the circumstances, there is an implied or express agreement between the grantor and trustee regarding the trust property.<sup>18</sup> The ruling's safe harbor—where the trustee is not related or subordinate—leaves open whether the IRS will infer an implied agreement based on the trustee's relationship to the grantor.<sup>19</sup>

On the one hand, courts have been reluctant to find an implied agreement solely based on the trustee's relationship to the grantor.<sup>20</sup> On

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the other hand, caution dictates that any discretionary reimbursement authority reside with a trustee who is not related or subordinate to the grantor in order to come squarely within the revenue ruling's safe harbor.

## Conclusion

The IDGT is a potent estate planning tool. The grantor's ongoing income tax payments may be viewed as further gifts outside the transfer tax system.

Some grantors, however, may be concerned that the income tax liability may become burdensome. There are several alternatives to alleviate this concern. One option, assuming the grantor is married, is to include the grantor's spouse as a permissible beneficiary of the trust. The spousal beneficial interest could provide an escape hatch in case the grantor's household needs funds (to pay income taxes or otherwise). This route, however, is available only if the grantor's spouse is alive (and married to the grantor). Another option is to enable the grantor to turn off grantor trust status, say by releasing a power. However, before toggling off grantor trust status, one must consider the income tax consequences. Furthermore, this approach may lack some flexibility.<sup>21</sup>

Revenue Ruling 2004-64 and EPTL §7-3.1(d) provide a third alternative: granting a trustee (who is not related or subordinate to the grantor) discretionary authority to pay the tax or reimburse the grantor.

We expect other states to follow New York's lead. It is true that, due to the unique default rule under EPTL §7-1.11, there was a pressing need in New York for legislation. Nevertheless, in other states, unless it is clear that reimbursement provisions (or discretionary power to pay directly to the taxing authorities) does not expose trust assets to the claims of the grantor's creditors, there is a risk that such authority will cause the trust property to be included in the grantor's gross estate. New York's Legislature has removed that risk.

1. 2004-27 IRB 7.

2. The common reference to a trust as "intentionally defective" is a holdover from a time when income tax grantor trust status was considered adverse.

3. This result is possible because the grantor trust rules for income and transfer tax purposes are not aligned.

4. IRC §671.

5. The ruling lists three factors, any one of which could result in the trust assets being included in the grantor's gross estate, if combined with a discretionary reimbursement provision. Such circumstances exist, according to the IRS, if (1) there is a pre-existing arrangement between the grantor and trustee regarding the exercise of discretion to reimburse the grantor, (2) the grantor has retained the power to remove the trustee and name the grantor as successor trustee, or (3) local law subjects the trust assets to the claims of the grantor's creditors.

6. See generally Alan Halperin and Andrea Levine Sanfr, "Revenue Ruling 2004-64 Sparks Applause, but Leaves Questions," *Trust and Estates*, Vol. 143 No. 9 (September 2004); Mitchell M. Gans, Stephanie E. Heilborn and Jonathan G. Blattmachr, "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," *Estate Planning*, Vol. 31 No. 9 (October 2004).

7. As the Supreme Court has explained, "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." *Morgan v. Comm'r*, 309 US 78, 80 (1940).

8. See, e.g., *Outwin v. Comm'r*, 76 TC 153 (1981); *Paolozzi v. Comm'r*, 23 TC 182 (1954); Rev. Rul. 76-103, 1976-1 C.B. 293.

9. Restatement (Third) of Trusts, §60 (2003) Comment f ("if settlor is discretionary beneficiary, creditors can reach maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor").

10. This statute has its roots in a sixteenth century English law known as the Statute of Elizabeth. 13 Eliz. Ch. 5 (1570) (Eng.).

11. The amendment was adopted on May 31, 2005, and applies prospectively and retroactively from the date of enactment. See Memorandum in Support of Assembly Bill A07254 (NY 2005).

12. See New York State Bar Association, Memorandum in Support of S. 3441 and A. 7254 (April 15, 2005), Legislative History 2005, Chapter 76. (Noting that Revenue Ruling 2004-64 has generated concern over whether the discretionary authority under EPTL §7-1.11 or similar discretionary authority granted in the instrument creating the trust would cause a trust in which the creator retains no beneficial interest to come within the scope of EPTL §7-3.1(a).)

13. See generally, the Association of the Bar of the City of New York Report on Legislation A. 7254 and S. 3441 (March 16, 2005), Legislative History 2005, Chapter 76.

14. Under IRC §672(c), the term "related or subordinate" includes the grantor's spouse, if living with the grantor, or any one of the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; and a subordinate employee of a corporation in which the grantor is an executive.

15. Treas. Reg. §20.2036-1(b)(2).

16. The IRS observed: "Section 2036 generally does not apply where trust property may be used to satisfy the decedent's legal obligations only in the discretion of the trustee, whether or not the discretion is exercised by the trustee." Rev. Rul. 2004-64, 2004-27 IRB 7, 8.

17. See *In re Uhl's Estate*, 241 F.2d 867 (7th Cir. 1957) (holding where a grantor retains no right to compel or direct the trustee to pay him the trust assets will not be includable in the grantor's estate); *German's Est. v. US*, 7 Ct. Cl. 641, 85-1 USTC ¶13,610 (1985) (holding that when a trustee has "absolute and uncontrolled" discretion to distribute income or principal to grantor-decedent the trust assets will not be included in the grantor's gross estate).

18. Treas. Reg. §20.2036-1(a); *Estate of Whitt v. Comm'r*, 751 F.2d 1548 (11th Cir. 1985); *Estate of Honigman v. Comm'r*, 66 TC 1080 (1976); *Estate of Linderme*, 52 TC 305 (1969); *Skinner Est. v. U.S.*, 197 F.Supp 726 (E.D. Pa. 1961), aff'd, 316 F.2d 517 (3rd Cir. 1963).

19. See Halperin and Sanfr, supra note 6, at 25.

20. See e.g. *Estate of Mitchell v. Comm'r*, 55 T.C. 576 (1970), acq. 1971-2 C.B. 3; *McCullough v. Granger*, 128 F.Supp 611 (W.D. Pa. 1955).

21. See Halperin and Sanfr, supra note 6, at 25.