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Grantor Trust Reimbursement Statutes

A magic wand to allay the woes of grumpy trustors

Creating a trust that qualifies for grantor trust status 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 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 isn’t considered a gift, it doesn’t require any additional allocation of the trustor’s unified lifetime gift and estate exemption or generation-skipping transfer (GST) tax exemption. T&E attorneys love this feature and so do trustors—that is, until the trustor is no longer jazzed about paying the tax bill. What’s a T&E attorney to do when their client has a serious case of buyer’s remorse? Several jurisdictions now offer a solution. In 2020, Connecticut and Florida joined the ranks of Colorado, Delaware, New Hampshire and New York to enact legislation that expressly authorizes reimbursement of taxes paid by the trustor from the trust. In addition, numerous jurisdictions have enacted statutes stating the inclusion of the reimbursement power in an irrevocable trust won’t make the trust’s assets subject to the claims of the trustor’s creditors.

Let’s compare the reimbursement statutes of these six jurisdictions, with particular focus on the

recently enacted Connecticut and Florida statutes. Additionally, should you have a client with a case of the grantor trust tax payment blues, we’ll discuss 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’ll also provide drafting tips and sample reimbursement language to include in an irrevocable trust agreement. Finally, we’ll share a few words of caution a trustee should heed before reimbursing the trustor.

Brief Background

Revenue Ruling 2004-64 is the muse that inspired grantor trust reimbursement legislation. In this ruling, the Internal Revenue Service held that when the trustor of a trust, who’s treated as the owner of the trust under subpart E¹, pays the income tax attributable to the inclusion of the trust’s income in the trustor’s taxable income, the trustor isn’t treated as making a gift of the amount of the tax to the trust beneficiaries. The ruling further provided that 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’s attributable to the trust’s income, then the full value of the trust’s assets is includible in the grantor’s gross estate under Internal Revenue Code Section 2036(a)(1). The ruling added that 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) won’t cause the value of the trust’s assets to be includible in the trustor’s gross estate.

Rev. Rul. 2004-64 created an opportunity for trustors to transfer more wealth (and thereby reduce their taxable estate) without impacting their available gift

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tax or GST tax exemptions. That is, a trustor's payment of the trust's income taxes equates to making tax-free contributions to the trust.

The ruling introduced a framework for state legislatures to apply when drafting a reimbursement power that wouldn't trigger adverse tax consequences for trustors. "Grantor Trust Reimbursement," p. 27, provides the language from the six states that have enacted grantor trust reimbursement statutes, including whether authority to reimburse has to be included under the trust agreement and whether there's specific creditor protection language that expressly bars creditors of the trustor from reaching the trust property by virtue of inclusion of the reimbursement clause.

Currently, several states don't expressly authorize the trustee to repay the trustor for the trustor's income tax liability but have statutes that prevent the trustor's creditors from reaching trust property based on a trustee's reimbursement power under the trust agreement.² This language is critical because it will prevent inclusion in the trustor's estate for estate tax purposes. If a state enacts a statute stating the reimbursement power won't 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), you may safely include a reimbursement power in that jurisdiction even without a statute expressly allowing the reimbursement power.

New State Laws

Let's now turn to the recent reimbursement statutes enacted in Connecticut and Florida in 2020 and a 2021 proposed amendment to the Delaware reimbursement statute.

Connecticut. This state's reimbursement statute became effective Jan. 1, 2020.³ The focus of the Connecticut statute is creditor protection, one of the factors set forth in Rev. Rul. 2004-64. Notably, the statute doesn't permit reimbursement unless the trust agreement or "any other provision of law" authorizes such reimbursement. This statute, therefore, doesn't serve as an independent basis on which reimbursement can be sought. In addition, the statute is silent with respect to other Rev. Rul. 2004-64 factors such as whether there's an implied or express agreement to reimburse the trustor or if the trustor holds the power to remove and replace the trustee with himself or someone who's related or subordinate under IRC

Section 672(c), a violation of which could cause estate tax inclusion.

Florida. This state's reimbursement statute became effective July 1, 2020.⁴ The Florida statute is similar to Delaware's statute in many respects and provides that a trustee of a grantor trust may reimburse or pay the trustor's income tax liability related to the trust, provided that the trust agreement doesn't prohibit such actions. Reimbursement may only be made if the trustee isn't a beneficiary of the trust or an individual who's related or subordinate to the trustor under Section 672(c).⁵

The Florida statute specifies that a life insurance policy, its cash value or proceeds from a loan made against the policy may not be used for the reimbursement of income taxes if the trustor is the insured.

Similar to Delaware's statute, the Florida statute specifies that a life insurance policy, the cash value of the policy or proceeds from a loan made against the policy may not be used for the reimbursement of income taxes if the trustor is the insured.⁶ Recognizing that a fiduciary other than the trustee may be responsible for directing distributions from the trust, the Florida statute provides (again, like Delaware's statute) that if the trust agreement requires the trustee to act on the direction of an advisor, trust protector or other person, or if the reimbursement power is exercisable only by an advisor, trust protector or other person, then the powers granted to the trustee under the statute must also or instead be granted to that person, subject to the same criteria applicable to the trustee.⁷ Additionally, the statute provides that a person won't be considered a beneficiary of the trust solely due to the application of the reimbursement or payment provision under the statute, including for purposes of determining the elective estate under Florida law.⁸

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Grantor Trust Reimbursement

Excerpts from state statutes

State	Citation	Excerpt From Statute	Authorization Under Trust Agreement Required?	Creditor Protection for Trustor?
Colorado	C.R.S. § 15-5-818	Unless otherwise provided in the governing instrument, an independent trustee of a trust may, from time to time, in the trustee's discretion, distribute to the settlor an amount equal to any income taxes on any portion of the trust's taxable income for which the settlor is liable.	No	Yes
Connecticut	C.G.S. § 45a-499fff	The settlor of an irrevocable trust shall not be deemed to have a beneficial interest in such trust merely because the trustee is authorized under the trust instrument or any other provision of law to (1) pay or reimburse the settlor for any tax on trust income or trust principal that is payable by the settlor under the law imposing such tax; or (2) pay any such tax directly to the taxing authorities.	Yes	Yes
Delaware	12 Del. C. § 3344	Unless the terms of the governing instrument expressly provide otherwise, if the trustor of a trust is treated under 26 U.S.C. § 671 et seq. as the owner of all or part of the trust, the trustee (other than a trustee who is the trustor or a person who is a "related or subordinate party" with respect to the trustor within the meaning of 26 U.S.C. § 672(c)) may, in the trustee's sole discretion, or at the direction or with the consent of an adviser (who is not the trustor or a person who is a "related or subordinate party" with respect to the trustor within the meaning of 26 U.S.C. § 672(c)), reimburse the trustor for any amount of the trustor's personal federal or state income tax liability that is attributable to the inclusion of the trust's income, capital gains, deductions, and credits in the calculation of the trustor's taxable income.	No	Yes
Florida	Fla. Stat. § 736.08145	Except as otherwise provided under the terms of a trust, if all or any portion of the trust is treated as being owned by a person under section 671 of the Internal Revenue Code or any similar federal, state, or other tax law, the trustee may, in the trustee's sole discretion, reimburse the person being treated as the owner for any amount of the person's personal federal, state, or other income tax liability which is attributable to the inclusion of the trust's income, capital gains, deductions, or credits in the calculation of the person's taxable income.	No	Yes, but under F.S.A. § 736.0505
New Hampshire	N.H. Rev. Stat. § 564-B:8-816	Except as otherwise provided under the terms of the trust, a trustee shall have the discretionary power to reimburse the settlor for the portion of the settlor's income tax liability attributable to the trust under section 6716 of the Internal Revenue Code or any similar tax law.	No	Yes, but under N.H. Rev. Stat. § 564-B:5-505A
New York	EPTL § 7-1.11	The trustee of an express trust, unless otherwise provided in the disposing instrument, may, from time to time, pay from principal to the creator of such trust an amount equal to any income taxes on any portion of the trust principal with which he is charged.	No	Yes, but under EPTL § 7-3.1

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Accordingly, the reimbursement or payment of the trustor's income tax liability alone won't classify the trustor as a beneficiary of the trust.⁹

One area in which the Florida statute distinguishes itself from other states' reimbursement statutes is a provision that permits a trustee to irrevocably elect out of its application by providing written notice to the trustor and any other person who has the ability to remove and replace the trustee within 60 days of such election taking effect.¹⁰ As an additional safeguard, reimbursement isn't available when application of the statute would reduce or disqualify a contribution to the trust from certain federal tax benefits and deductions, including the annual exclusion, transfers to minors, the marital and charitable deductions and direct skip treatment.¹¹

If a trust can be amended under state law, a trust may be modified to include reimbursement language.

Delaware. A proposed 2021 amendment to the Delaware reimbursement statute would expand the types of income tax liabilities reimbursable by the trustee and provide further exceptions to the statute's application when it would negatively affect tax deductions. The existing version of the statute allows the trustee to reimburse the trustor's personal federal or state income tax liability attributable to the trust. The proposed amendment would also permit the trustee to reimburse any county, metropolitan region, city, local, foreign or other income tax liability. The proposed amendment would also revise the exception clause in subparagraph (b) of the provision. Currently, the exception clause states that the reimbursement power granted in 12 Del. C. Section 3344 doesn't apply if it would disqualify or reduce the amount of a charitable deduction available to any person for state or federal income, gift or estate taxes. The proposed amendment adds that the statute also doesn't apply if its application would disqualify or reduce the marital deduction.

Moving or Modifying Trusts

It's possible to move or modify a trust to get the benefits of a reimbursement statute and plan for a better day.

For example, say your client created an irrevocable trust in a jurisdiction that doesn't allow the trustee to reimburse the trustor for income taxes paid. The trust has a considerable income tax bill, but the trustor doesn't want to toggle off grantor trust status. There are a few ways to help your client, which may include migrating the trust to a favorable jurisdiction, decanting the trust to another trust with desirable terms or using a state's trust amendment or non-judicial settlement agreement statute to update the terms of the trust. Also, you may consider building in provisions to irrevocable trusts to give your clients flexibility if state law changes.

Migrating to a favorable jurisdiction. Review the trust agreement to see if the governing law or situs of the trust may be changed. If the governing instrument allows the situs of the trust to be changed, it may be possible to appoint a trustee (or an administrative trustee) in the 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. Section 3332(b), which provides that 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.

Decanting a trust in the wrong place to a trust in the right one. It may be possible to decant a trust that was 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 that allows the trustor to be reimbursed for income taxes. However, consider the state income tax consequences of such transfer.

Amending the trust. Consider whether the trust may be amended under state law. 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 isn't required). Using this amendment statute (or a similar one), a trust may be modified to include reimbursement language.

Non-judicial settlement agreement. Consider whether the trust's governing law and/or situs may be changed to a favorable jurisdiction pursuant to a non-judicial settlement agreement. Non-judicial settlement agreements are permitted under the Uniform Trust Code. Under a non-judicial settlement agreement, the parties interested in the trust agreement 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.

Planning for a better day. Consider including flexible "catch-all" language when drafting irrevocable trusts to allow for the possibility that your state may adopt grantor trust reimbursement legislation in the future. For example, "Sample Language," this page, provides language in an irrevocable trust that may obviate the need to amend or decant such trust if state law changes.

Trustee's Fiduciary Duty

If the trustee holds the power to reimburse the trustor, arguably, the exercise of such a power is a breach of the trustee's fiduciary duty to the beneficiaries, because it benefits the trustor to the detriment of the

Sample Language

What to include in an irrevocable trust

The Trustor hereby waives any right of reimbursement under any applicable law for the Trustor's tax liability (whether federal, state or otherwise), if any, attributable to a trust being treated as a "grantor trust" as to the Trustor under Code Sections 671 through 679. If (i) in any calendar year, a trust created hereunder is treated as a "grantor trust" as to the Trustor under Code Sections 671 through 679 and (ii) Revenue Ruling 2004-64 has not been modified, revoked or withdrawn and may be relied upon as precedent in the jurisdiction in which the trust is administered as it pertains to situation 3 described in Revenue Ruling 2004-64 (or if it has been modified, revoked or withdrawn if other binding precedent then exists that reaches the same holding as currently set forth in Revenue Ruling 2004-64 for situation 3), the trustee may, in the trustee's discretion, pay directly to the taxing authorities or reimburse the Trustor out of the trust property such amount equal to the amount by which the Trustor's Federal, state and local income taxes for the immediately preceding calendar year exceed the amount of such taxes that would have been imposed if the trust's income, gains, losses and deductions had not been included in the determination of the Trustor's income tax liability (the "Incremental Taxes"); provided, however, (i) the cash value of a life insurance policy on the Trustor's life, or proceeds from a loan made against such policy, may not be used or applied for the payment of the Incremental Taxes, and (ii) the trustee shall have no discretion to pay directly to the taxing authorities or reimburse the Trustor out of the trust property any amount pursuant to this Section if such discretion, combined with any applicable state law which would subject the trust property to the claims of the Trustor's creditors, or would cause inclusion

of the trust property in the Trustor's gross estate for federal or state estate tax purposes. If it is finally determined for income tax purposes that the trustee reimbursed the Trustor an amount in excess of the Incremental Taxes, the Trustor shall repay such trust such excess amount within thirty (30) days of the final determination of the Incremental Taxes.

It is intended that the trustee's exercise of discretion to reimburse the Trustor for any such income taxes not be considered a gift from the trust beneficiaries to the Trustor and that the existence of such power shall not be considered a retained right or interest that will cause inclusion of any part of any trust created hereunder in the Trustor's estate for federal and state estate tax purposes; this Section and this Agreement shall be construed in accordance with this stated intent. Notwithstanding any other provision of this Agreement, only a trustee who is not related or subordinate to the Trustor within the meaning of Section 672(c) of the Code, may exercise the powers to reimburse the Trustor granted to the trustee pursuant to this Section. This provision supersedes any otherwise applicable provision of law governing payment or reimbursement of the Trustor's taxes, including any right the Trustor would otherwise have to such payment or reimbursement.

— *The sample language above could be included in all irrevocable grantor trust agreements, regardless of whether the state currently has a grantor trust reimbursement statute. This language also restricts reimbursement to taxes attributable only to the immediately preceding calendar year to limit the total amount that's potentially distributable to the trustor (as such amount could be reached by the trustor's creditors depending on state law) and to protect against estate tax inclusion under IRC Section 2036.*

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beneficiaries. A more nuanced analysis of the trustee's power to reimburse takes into account other factors. For example, if the trustee has the power to reimburse, the trustor may be incentivized to make additional, significant gifts to the trust without the fear that by doing so they'll be overburdened by the income tax liability in future years, particularly if a realization event of a highly appreciated trust asset should occur.

If a trustee is nonetheless concerned about potential liability in connection with exercising its power to reimburse the trustor, there are a few workarounds. First, the trust agreement could be drafted to include exculpatory language specifically in the context of the exercise of the reimbursement power. Another solution is to grant the reimbursement power to an individual designated in the trust agreement who can exercise the power in a nonfiduciary capacity.¹² Last, before exercising the reimbursement power, the trustee could request that the beneficiaries execute a release agreement, releasing the trustee from any liability for breach of fiduciary duty associated with the exercise of the power.¹³ The use of a release agreement may be prudent if the trust agreement doesn't explicitly grant the trustee the power to reimburse and the trust has been migrated to a jurisdiction in which reimbursement is permitted by statute.

Words of Caution

When drafting provisions that allow the trustee to reimburse the trustor for income taxes they've paid, be careful to provide that such reimbursement is within the trustee's *discretion* and isn't mandatory. If the trust agreement provides for mandatory reimbursement, this will cause gross estate inclusion for the trustor under IRC Section 2036(a)(1).¹⁴ In addition, to avoid the same result, there should be no written agreement or other pre-existing arrangement between the trustee and trustor about reimbursement.¹⁵

While grantor trust reimbursement statutes provide a safety net to a trustor with a hefty income tax bill, remind your clients that reimbursement is moving money in the wrong direction. After all, paying the trust's income taxes is the functional equivalent of making tax-free contributions to the trust. If the trustor's goal is maximizing wealth transfers to those individuals nearest and dearest to the trustor, then reimbursing the trustor from the trust's assets decreases

the assets moving to those desired beneficiaries and moves value back to the trustor's estate.

Finally, if the trustee's discretion to reimburse the trustor for income taxes paid is exercised too often, the trustor may risk creditor protection issues. Creditors could argue that if the trustor can access the trust property on demand, then the trustor's creditors can access the trust property as well. Rev. Rul. 2004-64 also cautions in Situation 3 that this could risk an implied or express agreement between the trustee and trustor to be reimbursed. While some states expressly provide that a reimbursement clause doesn't give creditors the right to reach the trust assets, other states may not include similar language. For these reasons, carefully consider the exercise of a trustee's discretion to reimburse the trustor for income taxes. 

Endnotes

1. More specifically, when the trustor is treated as owner of the trust under Internal Revenue Code subpart E, part I, subchapter J, chapter 1.
2. For example, see Arizona (Ariz. Rev. Stat. Section 14-10505); Idaho (Idaho Code Ann. Section 15-7-502); Illinois (760 ILCS 3/505); Iowa (Iowa Code Ann. Section 633A.2304); Kentucky (Ky. Rev. Stat. Ann. Section 386B.5-020); Maryland (Md. Code Ann., Est. and Trusts Section 14.5-1003); Massachusetts (M.G.L.A. 203E Section 505); Montana (M.C.A. Section 72-38-505); North Carolina (N.C. Gen. Stat. Ann. Section 36C-5-505); Pennsylvania (20 Pa.C.S.A. Section 7745); Texas (Tex. Prop. Code Ann. Section 112.035); and Virginia (Va. Code Ann. Section 64.2-747).
3. C.G.S. Section 45a-499fff.
4. Fla. Stat. Section 736.08145.
5. Fla. Stat. Section 736.08145(3).
6. Fla. Stat. Section 736.08145(1)(b).
7. Fla. Stat. Section 736.08145(4).
8. Fla. Stat. Section 736.08145(5).
9. See also Fla. Stat. Section 736.0505(1)(c).
10. Fla. Stat. Section 736.08145(2)(a).
11. Fla. Stat. Section 736.08145(2)(b).
12. The trustee's power to reimburse at the direction of an advisor is specifically authorized by the Delaware and Florida statutes.
13. For example, pursuant to 12 Del C. Section 3588, a beneficiary may release a trustee and such release needn't be supported by consideration.
14. Revenue Ruling 2004-64.
15. *Ibid.*