Tax Reimbursement Clauses: Drafting and Planning

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Yaser Ali, Martin M. Shenkman, and Jonathan G. Blattmachr explore the complex area of tax reimbursement clauses in irrevocable Grantor trusts. They first review the basics and then dive into the many complexities surrounding these important provisions.

Introduction

A tax reimbursement clause is a common clause in many irrevocable grantor trusts that enables a trustee to reimburse the grantor for taxes paid.

While most tax, estate planning, and allied professionals understand why they are used, these powerful but nettlesome clauses are not always fully appreciated nor adequately administered. This article provides a refresher on the basics of tax reimbursement provisions, outlines their pros and cons (especially in light of a few rather divergent views among some commentators), and discusses various considerations when administering these tax provisions.

Those viewing this background as pedestrian should consider a recent high profile professional liability case which highlighted how important it is to communicate these fundamentals to clients in order to prevent a potential malpractice claim or, at a minimum, significant frustration from the client or future beneficiaries.

Risks To Practitioners

In Estate of Wellen, the decedent's estate alleged that the attorney – who had worked with the decedent for over 10 years on his estate planning –allegedly had failed to inform the decedent of the "risks and consequences" of including a discretionary tax reimbursement clause, to reimburse the grantor for income tax due on income of the trust attributed for income tax purposes to the grantor in an irrevocable grantor trust.[1] In particular, the estate alleged that the decedent was not adequately informed of the details of the consequence of a grantor trust and of the implications of the "tax burn" on the grantor of the trust (meaning how the grantor's payment of the income tax on the trust income imputed to the grantor reduces the value of the grantor's estate because the grantor must pay the income taxes on the income). While the court ultimately only addressed whether a statute of limitations had passed, the case demonstrated the importance of properly explaining and memorializing, in writing, the mechanics of a tax reimbursement clause as part of the counseling process that relates to the establishment of a Grantor Trust.

Might the inclusion of a tax reimbursement clause have mitigated this issue? What if no tax reimbursement clause were included? The trust instrument might expressly state that one

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was not included to avoid any ambiguity that the use of such a clause had been discussed with the grantor. What if the trustee refused to exercise the right to reimburse, or did so to a lesser degree than the grantor wished? What if the beneficiaries of the trust, children from a prior marriage of the grantor, challenged the trustee's decision to reimburse? What if a trust includes a tax reimbursement clause but it is not exercised prudently?

Foundations: What Is a Grantor Trust?

To understand the use and utility of a tax reimbursement clause, the practitioner needs to first understand what a grantor trust is and how it works. Again, some of this discussion may seem introductory to the seasoned practitioner but can be useful to educate clients who are engaging in this type of planning.

An Intentionally Defective Grantor Trust ("IDGT")[2] is a trust which a grantor sets up for the benefit of someone else that is treated as a completed gift for federal estate and gift tax purposes but is treated as still owned by the grantor for federal income tax purposes. The trust is "intentionally defective" because the trust instrument includes one or more retained powers which causes the grantor to include the income, deductions, and credits of the trust on her person tax return despite no longer having access to trust assets.[3] To understand this odd result, a bit of historical context might be helpful. When the marginal income tax rates were much higher than they are today, taxpayers would try to save income taxes by engaging in planning to shift income to a trust that would then pay income tax at a lower rate.[4] In 1953, for example, the lowest tax bracket was set to be 17% and the top bracket at 88%, making income tax shifting extremely valuable.[5] Congress reacted to that type of planning by enacting rules to cause the income of certain trusts to be taxed to the person considered the grantor of the trust. This, in turn, limited many of these types of income tax planning strategies. But these Congressional restrictions on the use of grantor trusts as income tax planning tools were eventually reimagined by creative planners as constructive tools to aid in estate planning.

Grantor Trusts Become a Common Estate Planning Tool

In 1986 when the tax law started taxing non-grantor trusts in a much harsher way, practitioners began using grantor trusts primarily for estate tax planning purposes. By retaining substantial benefits or control with the grantor, tax practitioners realized that what may have seemed to be a negative income tax result could be a powerful estate planning tool that effectively allows for tax free compounding of assets in the trust. Clients who gift or sell assets to an irrevocable trust hope, from an estate tax and " perspective, to freeze the value and have those assets grow inside the trust as rapidly as possible. Because the Grantor is treated as the trust's owner, there are no income tax consequences to the transaction but the structure allows the assets to pass outside the grantor's taxable estate and away from the reach of potential creditors.[6]

If the grantor, rather than the trustee, is able to pay the income tax on the income earned by the trust, the trust corpus compounds even faster. While the reason for this is obvious to practitioners, not all clients will "connect the dots" without guidance. Since the grantor is paying the income tax on trust income, the value of the trust is effectively growing, really compounding, on an income tax-free basis.

For many wealthy clients there is a second benefit associated with this structure. Since the client pays the income tax on trust income, not only does the trust grow faster, but the value of the grantor's taxable estate is concurrently reduced by the amount of the income tax payments. That reduction in the client's estate – effectively tax-free annual gifts – sometimes referred to as "tax burn," can be a positive benefit as it reduces the assets subject to estate tax and places them out of the reach of creditors. But the moniker "burn" is appropriate as too much of a good thing, i.e., too heavy a tax cost borne by the client post transfer to the trust, may come to be viewed by the client as a hardship or negative result (even if it, in fact, remains a positive result in terms of effectuating wealth transfer).

Further, and critical to this benefit, is that the grantor's payment of income taxes on trust income is not deemed to constitute an additional gift to the trust or utilization of the grantor's annual exclusion or lifetime exemption because the grantor was liable under the tax laws to pay that income tax.

Tax Burn Can Grow to become A Negative Feature to the Grantor

Grantor trusts thus increase growth outside of the client's estate and reduce what is left in the estate. So, if this may all be advantageous, why would anyone want to restrict or limit these benefits?

A grantor trust burn may become an excessive burden for the grantor, for example, if an asset inside the trust balloons in value. For example, a speculative investment in a private equity deal balloons in value and is then sold, resulting in a large capital gain. A well-drafted trust may include an option to toggle off the grantor trust status either by action of a trust protector or other named or identified person, or by various persons renouncing or turning off the powers that create grantor trust characterization. Or perhaps this type of issue could be ameliorated by swapping in cash or other assets for the position before the substantial growth occurs, or before a sale occurs confirming a higher value. But neither approach may be a good option or the right plan from an estate planning perspective. In other instances, it is possible that they grantor may not have fully grasped the implications of the tax burn of a grantor trust until after paying for the increased income tax costs for several years.

One approach to address this potential concern in advance might be to have forecasts completed modeling what the impact to the settlor might be of grantor trust burn under different scenarios. That may be particularly helpful as a

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settlor's conceptual understanding may fall short of what the actual implications might be. Further, with longevity, years, even decades of compounding of grantor trust burn can over time and depending on the circumstances significantly erode the settlor's remaining non-trust estate. Also, with the desire of some clients to shift large portions of their wealth into such trusts for perceived asset protection or estate tax benefits (e.g., to use exemption before it is reduced in 2026 by legislation already enacted) that may exacerbate the impact on the settlor's remaining estate from the tax burn. If forecasting is used, and too often clients simply refuse to take the recommended step, practitioners might consider the assumptions used in the model. For example, what will the growth and income of assets be, what will marginally tax rates be changed to over time, and what might the impact of a linear model be?

Regardless of the causal factor, if the grantor trust burn becomes too burdensome in the view of the grantor, what can be done? What if the grantor simply does not wish to continue paying the income tax on a trust's earnings? What if the grantor does not have the cash to pay the income taxes due on trust income?

A tax reimbursement clause enables the trustee to reimburse the grantor for the income taxes paid on trust income, which can offer a solution to the grantor's cash flow concerns. Further, because no client transfers all of their wealth to a grantor trust, a second, seemingly counterintuitive result is attained by the inclusion and exercise of a tax reimbursement clause: by reimbursing the grantor for income taxes paid on trust income, more assets will be left in the grantor's taxable estate for the grantor's beneficiaries – who may or may not be the same beneficiaries of the grantor trust.

The fact that a tax reimbursement may add to a client's estate, the opposite result of what the initial wealth transfer plan may seek to accomplish, should be considered by practitioners when explaining the possible application of a tax reimbursement clause to the grantor during the planning stages of the trust, and again before any application or use of the tax reimbursement provision after the trust is funded.

These pros and cons could be incorporated into a discussion with a client evaluating whether or not to include a tax reimbursement clause in a trust, or if the client has a trust with such a clause, whether or not and when it should be used.

Should a Tax Reimbursement Clause be Included in Every New Grantor Trust?

Some tax advisers insist that a tax reimbursement clause be included in every grantor trust. On the opposite end of the spectrum, other tax advisers recommend that a tax reimbursement clause should never be used out of concern that this type of clause – if improperly used – may increase the risk of all trust assets being included in the grantor's estate as a result of the tax reimbursement clause being viewed as a retained right in the trust or as the grantor being a beneficiary of the trust which under some state laws could result in estate inclusion.[7]

The IRS published its position on the matter in Revenue Ruling 2004-64[8] in which it held that (a) a mandatory tax reimbursement clause would cause the full value of the trust's assets to be includible in the grantor's gross estate under Internal Revenue Code Section 2036(a)(1), (b) a provision that granted the trustee discretion to reimburse the grantor for taxes paid – regardless of whether or not it is exercised – would not cause the trust assets to be included in the grantor's estate, and (c) the trust's governing instrument or applicable local law would be instructive in determining whether the assets would be included in the grantor's estate and thus accessible to creditors.

Importantly, the Ruling warns that even a discretionary reimbursement power may result in estate inclusion in certain cases. These situations may include a pre-existing explicit agreement between the grantor and trustee, or an implied understanding based upon the frequent exercise of the clause.

As a result of this Ruling, one would imagine many states would pass laws clarifying their position but so far (as of the date of this publication) only six states have enacted legislation authorizing reimbursement clauses and twelve others have passed laws preventing a grantor's creditors from reaching the assets inside of a grantor trust based simply on the inclusion of such clauses.[9]

Advising Clients

If you are assisting a client in planning a new grantor trust, you should discuss with the client and his or her advisory team the pros and cons of including a tax reimbursement clause in the trust. Each of the trust officer, wealth adviser, CPA and estate planning attorney may have different perspectives on what might be the advisable course of action for the particular trust being planned. The key, perhaps, especially in light of the allegations in Estate of Wellen, is that whatever is done should be a thoughtfully considered decision. For practitioners, it may be advisable to record or otherwise memorialize the discussion with the client so that whatever option is pursued, if a complaint is later rendered by the client or a beneficiary of the trust, there will be a means for the practitioner to deflect that challenge.

Many advisers recommend that financial modeling be done before a client creates a trust. The wealth adviser may be able to forecast results based on life expectancies and expected investment returns and illustrate the impact of tax burn and reimbursement. While that analysis is likely beneficial to have done in all instances, at minimum it may help the client and advisory team to better understand potential or possible economic implications of the plan. But a forecast, while useful in theory, is unlikely to depict how the financial future may actually play out. Thus, even with robust Monte Carlo simulations, the grantor may still not be able to determine with certainty the potential future financial status and tax consequences. There will always be uncertainties. Since no one can predict

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accurately inflation or investment returns over the long term, or a myriad of other factors, perhaps including a tax reimbursement clause as a safety valve might be a good measure.

Including a discretionary tax reimbursement clause, if not trigger creditor attachment under state law, seems prudent, but emphasizing that it may not need to be utilized unless it becomes absolutely necessary may be advisable. Also, practitioners might explain to clients that the clause is in fact discretionary, and a trustee may not view exercise as appropriate in the same circumstances, or to the same degree, as the client might wish.

What If Your Grantor Trust Does Not Have a Tax Reimbursement Clause?

If the client has an irrevocable grantor trust that does not include a tax reimbursement clause, and the client no longer wishes to continue paying income taxes on trust income, it may be feasible, according to some commentators, to decant (merge) the trust into a new trust and in that process add a tax reimbursement clause (in some cases, only if court approval can be obtained).[10] In some instances it may be necessary to first migrate or decant to a jurisdiction with a favorable trust reimbursement statute.

Another option, if someone holds a power of appointment, might be to have a powerholder exercise the power directing the property to be added to another trust, perhaps, even to a trust that has a tax reimbursement provision. The powerholder may be able to exercise the power of appointment and direct that the current trust be poured into a new trust that is identical to the current trust but which also includes a tax reimbursement clause.

A third approach might be to turn off grantor trust status (although that might be difficult if not impossible to achieve). If the trust is no longer a grantor trust, then the grantor will no longer have to pay the income tax on trust income. But such a conversion is not always a simple or a cost-free step. If the grantor trust has liabilities in excess of basis, conversion could trigger gain.[11] But it may not be a simple matter to convert a grantor trust into a non-grantor trust. If, for example, the grantor's spouse is a beneficiary that may not be possible (unless, of course, distributions to the spouse have to be approved by an adverse party).

Should A Trust's Tax Reimbursement Clause Be Used?

Whether or not a tax reimbursement clause should be used may depend on the grantor's current and future tax and economic circumstances. Reimbursing the grantor for income taxes paid on trust income may not be an advantageous estate planning or asset protection result as it results in more value being included in the grantor's estate. This may reduce the purpose of the client having created the trust plan in the first place. So, maybe, the general rule is to avoid using a tax reimbursement clause even if included in the client's irrevocable trust. But if the client really must use the tax reimbursement clause, e.g., because of a large capital gain, the advisory team should evaluate that use, assure the formalities discussed below are considered, and use it as infrequently and to the least degree possible.

How To Administer a Tax Reimbursement Clause

There are several requirements and other suggested practices on how to use tax reimbursement clauses in a manner that might reduce the risk of causing the entire trust to be included in the grantor's gross estate, or enabling the grantor's creditors to reach the trust assets.[12] The pundits that advocate for not using tax reimbursement clauses might be concerned about the fact that trustees, especially family or individual as contrasted with corporate or professional trustees, often trip up over one or more of these rules or recommendations. Perhaps those saying that tax reimbursement clauses should always be included in trusts presume that trustees will handle a tax reimbursement mechanism properly.

As a preliminary matter, as outlined in See Rev. Rul. 2004-64, it is essential that if a tax reimbursement clause is included in a trust agreement, the trustee must not be mandated by the trust to reimburse the grantor for taxes paid on trust income. The action of reimbursing must be discretionary in the trustee. Draftspersons should be certain that the trust instrument uses appropriate language.[13]

State law should not permit a creditor of the grantor to reach trust assets as a result of the tax reimbursement clause or act. While some states have enacted legislation permitting reimbursement without subjecting trust assets to the grantor's creditor's claims, practitioners should confirm that before forming a trust with a tax reimbursement clause. If state law does not support the desired result, consider creating the trust in a state that has favorable law on this point, or moving the situs and governing law of a trust in a jurisdiction that is not supportive to the clause already in the trust instrument.

If a tax reimbursement clause is to be used, the trustee and anyone else involved should consult with the advisory team for the trust before implementation. The attorney for the trust should confirm that the exercise of the tax reimbursement clause complies with the terms of the governing instrument. In too many situations the clients/trustees without input from counsel exercise a reimbursement clause in a manner that does not comport with the requirements of the governing instrument. The accountant for the grantor should be involved and should calculate what tax the grantor has incurred on trust income and that should be documented. Consider having the grantor's Certified Public Accountant calculate and document what that tax cost is, including any calculations and assumptions used in those calculations. That calculation should address whether the tax reimbursement amount is being calculated on an average or marginal basis and which-

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ever approach is used should be consistent with the terms of the instrument. That documentation could be part of the trustee's records in determining how much the reimbursement will be. There might also be records of the trustee confirming that the trustee made an independent discretionary decision to reimburse the grantor for taxes (e.g., the meeting minutes of trustee committee charged with this decision). Consider that any reimbursement of the grantor for income taxes is detrimental economically to the beneficiaries of the trust to whom the trustee owes a fiduciary duty. That may be important for the trustee to consider, and to document accordingly any considerations made.

When selecting the trustee of a trust, it is appropriate to consider who will be the trustee if a tax reimbursement is going to be acted upon. If a family member or friend of the grantor is named as trustee, then perhaps that trustee should be replaced by an independent person, and ideally a professional trustee, before a tax reimbursement is made pursuant to the trust instrument. Using a corporate trustee may be even safer.

There should probably not be a pattern of tax reimbursements being made. If a tax reimbursement is made on a regular or periodic basis that may look as if there was an implied agreement between the grantor and the trustee to fund tax reimbursements. That could be problematic. One thought might be to start with A as trustee but then have A resign and have B, who was not involved with the setup of the trust, become the trustee before any tax reimbursement payments are made. That approach would seem to negate a challenge that there was an understanding as between the trustee and the grantor from inception of the trust.[14]

This suggestion is also consistent with an earlier acknowledgement that each exercise of a tax reimbursement mechanism reduces the assets removed from the grantor's estate, which may be contrary to the intent for the trust plan.

Possible Other Approaches to Consider Besides a Tax Reimbursement

Finally, while tax reimbursement clauses are an enticing and powerful technique to account for situations where Grantors are unintentionally left with large tax bills, there are several alternate potential solutions besides a tax reimbursement mechanism which should be considered as well, a few of which are outlined below:

- Swap out the asset, or portion of that asset, which starts to realize significant appreciation, or before a realization event fixing the value at a higher amount then may be supportable at an earlier date.
- Turn off grantor trust status to eliminate the tax liability to the grantor.
- Loan the grantor funds if the trust includes provisions permitting such a loan.
- Make distributions to the grantor if the grantor is then a beneficiary of the trust and if permitted under the terms of the trust and state law (e.g., in a domestic asset protection trust (DAPT) or hybrid DAPT, but the latter would first require adding the grantor back as a beneficiary) or if the trust were formed as a Special Power of Appointment Trust or SPAT.[15]
- Make distributions to the grantor's spouse if the grantor is married and if permitted under the terms of the trust (e.g., in a SLAT).

Exploring other possible options to provide cash flow to the grantor for use in paying income tax may be advantageous to consider if:

- The trust does not have a tax reimbursement provision and it is not feasible to add one.
- The trust includes a tax reimbursement provision but the trustee does not choose to exercise such a discretionary provision.
- The trust includes a tax reimbursement provision but the trustee has already used the tax reimbursement provision or there is a concern that it may be exercised too frequently and might be interpreted by the IRS or creditors that there is an implied agreement to use the mechanism as between the grantor and the trustee.

Conclusion

Tax reimbursement clauses can be a valuable and flexible tool to consider including in grantor trusts. The decision to include one or amend a trust to add one may depend on how the advisor team views the plan and the applicable law. If such a mechanism is included in a trust instrument, caution the client to be careful on how it is administered. Practitioners should consider documenting in writing that they have advised the grantor about the risks of not incorporating a tax reimbursement clause if one is not to be used. If one is used, practitioners might consider documenting in writing that the mechanism should only be used infrequently, with care, and under the supervision of the advisory team.

In a recent Chief Counsel Advice (CCA) issued November 28, 2023, the IRS took the position that modification of a grantor trust, with the beneficiaries' consenting to that modification in order to add a discretionary income tax reimbursement provision for the grantor, resulted in a taxable gift by the beneficiaries. A discussion of the CCA and planning considerations relating to it will be published in a subsequent article.

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Endnotes

1. Estate of Wellin v. Farace et al. No 20-1120 (4th Cir. Nov 22, 2021); *See also* Glazier, Shenkman, Blattmachr & Garin, "Wellin v. Nixon, Peabody, LLP - Case Lessons on Defensive Practice," LISI Estate Planning Newsletter #2934 (January 20, 2022)
2. The moniker, "intentionally defective grantor trust," is a misnomer. A trust may be a grantor trust (causing the income, deductions and creditors against tax to be attributed to the grantor) whether that was intended or not. Moreover, although at one time it was viewed that grantor trusts were viewed was "bad" or defective, today they are regarded as a most powerful estate tax planning tool.
3. See IRC §§671 through 679.
4. See e.g., Corliss v. Bowers, 281 U.S. 376 (1930); Lucas v. Earl, 281 U.S. 111 (1930).
5. Understanding Grantor Trusts, Steven Siegel, NAEPC Journal Issue 36
6. See Rev. Rul. 85-13, 1985-1 C.B. 184.
7. Strategies for Mitigating the 'Burn' of Grantor Trust Status, Kristen A. Curatolo and Jennifer E. Smith, Bloomberg Tax (May 11, 2023)
8. Available at https://www.irs.gov/irb/2004-27_IRB#RR-2004-64
9. See Jennifer Smith and Kristen Curatolo, Grantor Trust Reimbursement Statutes, Trusts & Estates, February 2021; Curatolo and Smith, Bloomberg (2023); for further discussion of considerations for tax reimbursement clauses; Kim Kamin, Where Are All The Grantor Trust Reimbursement Statutes? Why Aren't They More Ubiquitous? WealthManagement.com (2018), https://www.wealthmanagement.com/wealth-planning/estate-planning (last visited Feb 16, 2023).
10. Delaware, Todd Flubacher and J. Zachary Haupt, Trusts & Estates August 2019, at p. 49.
11. See, e.g.., Rev. Rul. 77-402.
12. Rev. Rul. 2004-64, issued July 6, 2004 (2004-27 IRB 7).
13. See Samuel A. Donaldson, Burning Questions (and Even Hotter Answers) About Grantor Trusts, NAECP Journal of Estate & Tax Planning (2010), https://www.naepcjournal.org/ (last visited Feb 16, 2023); https://www.wealthmanagement.com/estate-planning/where-are-all-grantor-trust-reimbursement-statutes
14. See Nate Patterson & Craig Benson, Clarity on Income Tax Reimbursement for Grantor Trusts in Nebraska Society of CPAs (2022), http://www.nescpa.org/ (last visited Feb 16, 2023). "The continued and repeated exercise of the power on a routine basis increases the risk of an IRS challenge, so the conservative trustee should show restraint and only exercise the power judicially."
15. See O'Connor, Gans, and Blattmachr, "The SPAT: A Flexible Asset Protection Alternative to DAPTs," 46 Estate Planning 3 (Feb. 2019).

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