Relocating for Reimbursement

by
Robert V.A. Harra III, Esq.
Mark P. Gordon, Esq.
Gordon, Fournaris & Mammarella, P.A.

House Bill Number 334, which passed the 150th Delaware General Assembly on June 16, 2020, is currently pending approval by Governor John Carney. This legislation marks another milestone in the development of Delaware trust law and signifies the state's continued commitment to improving Title 12 of the Delaware Code (the "Delaware Trust Code"). While focus will soon shift to this new legislation and articles discussing its impact are almost sure to follow, it is important for those of us working in the trust, estate and wealth planning fields in Delaware to not lose sight of one of the key features of last year's legislation. Specifically, the addition of an income tax reimbursement statute to the Delaware Trust Code, which is modeled after the guidance set forth by the Internal Revenue Service ("IRS") in Rev. Rul. 2004-64.

Enacted in 2019, Section 3344 of the Delaware Trust Code (Delaware's "Income Tax Reimbursement Statute")[1], and a related update to Section 3536 of Title 12 of the Delaware Code[2], applies to trusts taxed as grantor trusts that are sitused in Delaware and administered in accordance with Delaware law.

Tax Planning for Grantor Trusts

A trust is taxed as either a grantor trust or a non-grantor trust for federal income tax purposes. In general, if a trust is taxed as a grantor trust under the Internal Revenue Code, the income tax consequences of the trust are attributed to the grantor, or another person, and are reported on the personal income tax return of the grantor or such other person.[3] In other words, the grantor is personally responsible for paying the income tax liability of a grantor trust. Conversely, a non-grantor trust is treated as a separate taxpayer and the trust has responsibility for payment of income tax at the trust level on any taxable income retained by the trust.

There are many factors that should be considered when determining the tax structure of a trust, which are far beyond the scope of this article; however, a grantor trust can serve as an extremely powerful tool in estate planning, especially for high net worth individuals. One of the primary advantages of establishing a grantor trust for those with a taxable estate, is that the grantor's payment of the income tax liability associated with the trust reduces the total size of the grantor's taxable estate without gift tax implications, as confirmed in Rev. Rul. 2004-64.[4] At the same time, the trust has the ability to grow at an accelerated rate, as it is not burdened with income tax payments. Another advantage, is that certain transactions between a grantor and a grantor trust, such as the sale of assets, are disregarded for tax purposes since the taxpayer is the same.

With advantages, there are, of course, disadvantages to structuring a trust as a grantor trust. One disadvantage is often the grantor's continued liability for the payment of state income tax, where, if the trust were a Delaware non-grantor trust, for example, there may not be any state income tax on the trust's income and capital gains that are accumulated and retained in trust for future distributions to non-Delaware resident beneficiaries.[5] Additionally, circumstances may change where the grantor's responsibility for the income tax is no longer practical or desirable. For example, Grantors in high income tax jurisdictions, particularly those who once planned on the ability to deduct state income tax from their federal income tax, are now limited to a total deduction for state and local income, sales and property taxes of $10,000 pursuant to the Tax Cuts and Jobs Act of 2017. The limitation on the state income tax deduction may make grantor trusts less attractive. Likewise, the grantor's assets may be reduced, or the trust's assets may become too great, to a point where it no longer makes economic sense for the grantor to continue to pay the income tax liabilities associated with the trust.

Some of the disadvantages to grantor trusts can be mitigated with flexible drafting. Practitioners often include provisions in a trust instrument whereby the power(s) causing the trust to be taxed as a grantor trust may be released so that the trust will "toggle" to a non-grantor trust. To further account for changes in circumstances and to add flexibility, it is also advisable to include express tax reimbursement language in grantor trusts, while being careful not to trigger unintended estate tax consequences, so that the grantor can, in the discretion of the trustee, be reimbursed for the tax liability associated with the trust.

In addition to clarifying the transfer tax consequences of a grantor paying the income tax liability of a grantor trust, Rev. Rul. 2004-64, provided guidance on income tax reimbursement provisions in connection with estate tax. Specifically, the IRS held that if the trust's governing instrument or applicable state law gives the trustee of a grantor trust the discretion to reimburse the grantor from the trust for the portion of the grantor's income tax liability that is attributable to the trust, then the existence of such discretion alone, regardless of whether or not it is exercised, will not cause the trust to be includible in the grantor's gross estate.[6] However, such discretion coupled with other facts could cause estate tax inclusion.[7] Other factors mentioned by the IRS

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that may cause estate tax inclusion include (i) an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of its discretion regarding reimbursement, (ii) a power retained by the grantor to remove the trustee and name the grantor as the successor trustee, and (iii) a provision in applicable local law that subjects the assets of the trust to claims of creditors.[8]

Delaware's Income Tax Reimbursement Statute

Many trusts are silent as to the trustee's ability to reimburse the grantor from the trust for the portion of the grantor's income tax liability that is attributable to the trust. This issue is compounded by the fact that only a limited number of states have statutes addressing such reimbursement powers. Fortunately, this is where Delaware's Income Tax Reimbursement Statute may be a solution.

Modeled after the guidance set forth in Rev. Rul. 2004-64, Delaware's Income Tax Reimbursement Statue provides:

> "(a) 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. The trustee may pay such amount to the trustor directly or may pay such amount to an appropriate taxing authority on the trustor's behalf, as the trustee determines in the trustee's sole discretion. No policy of insurance on the trustor's life held in the trust nor the cash value of any such policy nor the proceeds of any loan secured by an interest in the policy may be used to reimburse the trustor or to pay an appropriate taxing authority on the trustor's behalf. Neither the trustee's power to make payments to, or for the benefit of, the trustor under this section, nor the trustee's decision to exercise such power in favor of the trustor, shall cause the trustor to be treated as a beneficiary of the trust for purposes of § 3536(c) of this title or for other purposes of Delaware law.
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> (b) If the application of this section to a trust would reduce a charitable deduction otherwise available to any person for state or federal income, gift, or estate tax purposes, the provisions of this section shall not apply to the trust."[9]

Accordingly, unless a trust agreement expressly provides otherwise, the trustee of a grantor trust that is administered in Delaware in accordance with Delaware law now clearly has the discretionary power to reimburse a grantor for any amount of the grantor's federal or state income tax liability that is attributable to the trust's taxable income, even where the power is not stated in the trust agreement. In addition, the statute is careful to provide that a life insurance policy on the grantor's life that is held in a trust, the cash value of any such policy, and the proceeds of any loan secured by an interest in such policy, may not be used to reimburse a grantor, as doing so could cause the trust to be includible in the grantor's gross estate.

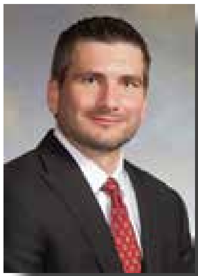
Of equal importance, Delaware's Income Reimbursement Statute explicitly incorporates one of the "other factors" mentioned in Rev. Rul. 2004-64 into the statute, significantly reducing the possibility of estate tax inclusion of the trust in the grantor's estate due to the trustee's reimbursement discretion. This is done by clarifying that neither the trustee's power to make payments to, or for the benefit of, the grantor for purposes of reimbursement, nor the trustee's decision to exercise its reimbursement power, shall subject the trust assets to the claims of the grantor's creditors under applicable local law, specifically referring to Section 3536 of Title 12 of the Delaware Code, which is commonly referred to as Delaware's "Spendthrift Statute".

Delaware's Spendthrift Statute specifically addresses creditor rights in connection with beneficial interests in trusts. The Spendthrift Statute, which was modified to add a reference to Delaware's Income Reimbursement Statute, provides that a grantor is not considered a beneficiary of the trust, and a grantor's creditors may not satisfy their claims from the trust, simply because the trustee, under the terms of the trust's governing instrument or the Income Reimbursement Statute, may, in its discretion (or at the direction of an adviser other than the grantor), reimburse the grantor for any income tax liability attributable to the trust.[10]

Conclusion

So what does Delaware's Income Tax Reimbursement Statute mean to trust, estate and wealth planning practitioners in Delaware? It is yet another tool under Delaware law that can be used to solve a potential issue involving a grantor trust. By relocating a grantor trust that is silent as to income tax reimbursement, or is otherwise in a jurisdiction that does not expressly address income tax reimbursement, to Delaware, a grantor may be able to utilize Delaware's Income Tax Reimbursement Statute without incurring the legal costs associated with modifying the terms of the trust's governing instrument to add a reimbursement provision, and the trustee can avoid uncertainty as to its ability to reimburse the grantor for the grantor's income tax liability associated with the trust if the trust is otherwise silent. Further, this may alleviate the necessity to make a premature decision to "turn off" grantor trust status through the release of a grantor trust power solely due to, or resulting from, income tax consequences or changes to tax laws. Finally, it serves as an additional attractive selling point when speaking with clients about the advantages of Delaware trusts.

Robert V.A. Harra III is a Director at the Wilmington law firm of Gordon, Fournaris and Mammarella, P.A., where his main areas of practice include trusts and estates, business planning, commercial transactions, and taxation. Rob is a graduate of Lynchburg College and Widener University School of Law. He also received his Master of Business Administration from the University of Delaware and his Master of Laws in Taxation from Villanova University School of Law.



Mark P. Gordon is an Associate at the Wilmington law firm of Gordon, Fournaris & Mammarella, P.A. Mark obtained his Bachelor of Science in Business Administration from the College of Charleston and graduated Magna Cum Laude from Widener School of Law. He received his Master of Laws in Taxation from Villanova University School of Law in 2019. Mark is admitted to practice in Delaware and Pennsylvania. Mark is a member of Wilmington Tax Group, the Estate Planning Council of Delaware and the Elder Law, Estates and Trusts and Taxation sections of the Delaware Bar Association.

Notes:

1- 12 Del. C. § 3344.
2- 12 Del. C. § 3536(c)(2).
3- See IRC § 671 et seq.
4- Rev. Rul. 2004-64, 2004-2 C.B. 7 (IRS RRU 2004).
5- 30 Del. C. § 1636(a).
6- Rev. Rul. 2004-64, 2004-2 C.B. 7 (IRS RRU 2004).
7- Id.
8- Id.
9-12 Del. C. § 3344.
10- 12 Del. C. § 3536.