Forbes.com

Tax Reimbursement Clauses: What They Are And Why You Need to Know

Introduction

Tax reimbursement clauses are a common clause in many trusts. Why are they used? Why are they important for you to understand?

What is A Grantor Trust?

To understand the use of a tax reimbursement clause you need to first understand what a grantor trust is and how it works.

When a trust is characterized under the income tax laws as a "grantor" trust that means that the settlor, the person creating the trust (also called trustor or grantor), is responsible to pay the income tax on the income earned by the trust. 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. Congress reacted to that type of planning by enacted rules to cause the income of certain trusts to be taxed to the person considered the grantor of the trust. That limited many types of income tax planning taxpayers had engaged in. But tax geeks are a creative bunch. These restrictions on income tax planning were reimagined as constructive tools to aid estate planning.

Grantor Trusts Become The Estate Planning Holy Grail

In 1986 grantor trusts started to be used intentionally for estate tax planning purposes. Tax folks realized that what seemed like a lousy income tax result could be a powerful estate planning tool. When you shift assets into a trust you want, from an estate tax and asset protection perspective, to have those assets grow as rapidly as possible in that protective trust envelope. The increase of those assets inside the trust means more assets outside your estate and more assets outside the reach of your creditors. If you pay the income tax on the income earned by the trust that grows faster. Why? Because with your paying the income tax on trust income the value of the trust is effectively growing, really compounding, on an income tax free basis. That is powerful. And there is a double benefit if you will. As you pay income tax on trust income not only does the trust grow faster, but the assets in and value of your remaining estate is reduced more by that tax cost. That reduction in your estate, called "tax burn," can be a positive benefit as it reduces the assets subject to estate tax or the reach of creditors.

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

All that Glitters May Not Always Be Tax Gold

Grantor trusts thus foster more growth outside of your estate and reduce what is left in your estate. So, if this is all so groovy why would anyone want to negate these benefits? Ahh, that is a good question and really should be considered when you evaluate including a tax reimbursement clause in a trust, or if you have one, whether or not it should be used.

Now you can understand the purpose of a tax reimbursement clause. What if the grantor trust burn becomes too much of a good thing? What if you just don't want to keep paying the income tax on a trust's earnings? What if you don't have the dough to pay the tax? Ouch!

If the trust can reimburse you for the income tax you paid that might offer a solution to your cash flow concerns. If your trust includes a tax reimbursement clause that may be feasible.

Should You Include a Tax Reimbursement Clause in Your New Grantor Trust?

Maybe.

If you are planning a new trust, perhaps you should discuss with your advisor team the pros and cons of including a tax reimbursement clause in your trust.

Some tax advisers go so far as to insist that a tax reimbursement clause be included in every grantor trust. Period. Other tax advisers never use tax reimbursement clauses out of fear that they might increase the risk of all trust assets being included in your estate as a result of the tax reimbursement clause being viewed as a retained right in the trust or as you being a beneficiary of the trust which under some state laws will result in estate inclusion. Perhaps as with many tax issues the truth may be somewhere in between the two end point opinions. It is certainly does not seem that either extreme is correct. Certainly, the improper use of a tax reimbursement clause might cause estate inclusion so there should be care exercised in using it (see below). On the other hand, there have been so many situations of taxpayers misusing tax reimbursement clauses that not including them, so long as it is a reasoned decision, may also make sense. The key perhaps is that whatever is done should be a thoughtful considered decision.

Some folks might suggest that if you have financial modeling done before your trust is created (always a good move) you can forecast results and be confident that you should not need to use a tax reimbursement clause. That is great in theory but the reality is rarely if ever does anyone's financial future play out exactly as predicted in one forecast. And if you are using Monte Carlo simulation you don't have "a prediction" but an array of predictions of which anyone of perhaps a thousand model results might actually come to pass. No one can predict inflation or investment returns over the long term, so perhaps including a tax reimbursement clause as a safety valve might be a good measure (although some pundits would say otherwise).

Perhaps for a new trust you include a tax reimbursement clause but with the intent to avoid it being used as above.

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

If you have an irrevocable grantor trust that does not have a tax reimbursement clause, and you've grown tired of paying income taxes on trust income, all may not be lost. It may be feasible according to some pundits to decant (merge) the trust into a new trust and add a tax reimbursement clause. No doubt many would say that is just not possible as it would be akin to adding a new beneficiary. But there may be a way. Another option might be to have a powerholder (that's someone who holds a power – what a typically useless lawyer definition! Just read on) exercise a power of appointment appointing the existing trust to a new trust that contains a tax reimbursement provision. Say you created an irrevocable grantor trust without a tax reimbursement clause and now want one. Say in the trust agreement you gave a person (the powerholder) the right (power) to pour (appoint) the existing trust into any new trust that benefits anyone other than her creditors, her estate or herself. She might 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 magically has a tax reimbursement clause. Bango presto your problem solved!

Another approach might be to turn off grantor trust status. If the trust is no longer a grantor trust then you don't have to pay the income tax on trust income. Problem solved. Maybe. That is not always a simple or cost-free step. If you turn off grantor trust, depending on the characteristics of the trust balance sheet you might find you've just triggered gain. Also, it is not such a simple matter to make a grantor trust into a non-grantor trust. If your spouse is a beneficiary that may not be possible (unless of course distributions to your spouse have to be approved by an adverse party). So that is not assuredly a slam dunk.

Should Your Tax Reimbursement Clause Be Used?

The bottom line will depend on your current and future circumstances. Reimbursing you for paying income taxes on trust income may be a lousy tax result as it defeats (well at least reduces) the point of your having created the trust plan in the first place. So, perhaps the general rule is to avoid having a tax reimbursement clause triggered even if you have one in your trust. But if you really must use the tax reimbursement clause really evaluate that first and use as infrequently and to the least degree possible. (More on this later).

How To Do Tax Reimbursement Right

There are lots of requirements or suggestions on how to have tax reimbursement clauses used in a manner that might avoid causing the entire trust to be included back in your estate or enabling your creditors to reach the trust. See Revenue Ruling 2004-64, issued July 6, 2004 (2004-27 IRB 7). The pundits that suggest not using tax reimbursement clauses might be concerned about the fact that taxpayers 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 folks will handle a tax reimbursement mechanism properly.

It is essential (not just a suggestion) that if a tax reimbursement clause is included in a trust that the trustee not be mandated by the trust to reimburse the settlor for taxes paid on trust income. The action of reimbursing must be discretionary in the trustee. Be sure that the trust instrument says that.

State law cannot enable a creditor of the settlor to reach trust assets as a result of the reimbursement. While many, perhaps all, states have enacted legislation permitting reimbursement without subject trust assets to the settlor's creditor's claims, you should confirm that before setting up such a trust (or set up the trust in a state that has favorable law on this point).

If a tax reimbursement clause is to be used the trustee and anyone involved should consult with the advisor team for the trust. Speak to the attorney who drafted the trust (or whichever attorney is then representing the trustee) about the nuances of the provision in the document. Every trust document may have its own unique drafting language and the exercise of any tax reimbursement clause should comport with the terms governing that trust. The accountant for the settlor should be involved and should calculate what tax the settlor has incurred on trust income and that should be documented. 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 settlor for taxes (e.g., the meeting minutes of trustee committee charged with this decision). Consider that any reimbursement of the settlor for income taxes is detrimental economically to the beneficiaries of the trust to whom the trustee owes a fiduciary duty. That may be an important for the trustee to consider and even document the considerations made.

When selecting the trustee of a trust consider who will be the trustee if a tax reimbursement is going to be acted upon. If Uncle Joe is named as trustee, perhaps he should be replaced by an independent person, and ideally a professional trustee, before a tax reimbursement is made. Perhaps using a corporate trustee is even safer.

There should never be a pattern of a tax reimbursement 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 settlor and the trustee to fund tax reimbursements. That could be problematic. This suggestion is also consistent with the suggestion earlier that each exercise of a tax reimbursement mechanism reduces the assets removed from the settlor's estate which may be contrary to the intent for the trust plan.

Conclusion

Tax reimbursement clauses can be a valuable and flexible tool to consider including in grantor trusts. That decision may depend on how your tax adviser views your plan and the law. If you do include such a mechanism be careful if it is to be used.