ESTATE TAX CONSEQUENCES OF REVENUE RULING 2004-64: SILENCE IN GRANTOR TRUSTS IS ANYTHING BUT GOLDEN

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I. INTRODUCTION

Judge Learned Hand long ago posited that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[1] Arranging one's affairs in such a manner is easier said than done. In a recent revenue ruling,[2] the Internal Revenue Service (IRS) lifted the fog surrounding gift and estate tax consequences of grantor trusts enough to give reasonably reliable guidance pertaining to grantor trusts. The revenue ruling's treatment of the consequences of transfers during life was good news in terms of gift tax; however, the estate tax consequences are not equally lucid, leaving estate planning with lingering doubt as to whether reimbursement provisions will result in the inclusion of the entire value of the trust in a grantor's gross estate.

Revenue Ruling 2004-64 tackled the gift and estate tax consequences of a grantor trust where the grantor is treated as the owner for income tax purposes only.[3] The revenue ruling additionally addressed whether provisions in the trust instrument or applicable state law permit or require the grantor's reimbursement of income taxes paid.[4] The IRS stated that where the trust instrument or applicable local law (or both) are silent, permit, or even require reimbursement, there are no gift tax consequences in any situation because the grantor is legally obligated for their payment.[5] The IRS went on to pronounce that where the instrument or local law requires reimbursement for income taxes, the entire value of the trust would be included under § 2036 of the Revenue Code.[6] However, and more importantly, where the instrument or local law merely *permit* reimbursement, the entire value *may* be included, depending on the presence of such factors as the grantor's ability to remove the trustee and

1. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

2. Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

3. *Id.* at 7.

4. *Id.*

5. *Id.* at 8–9.

6. *Id.* at 9. Section 2036 of the Revenue Code includes in the grantor's gross estate the value of any property transferred by trust where the grantor has retained "possession or enjoyment." I.R.C. § 2036(a)(1) (2000).

appoint himself or where state law permits creditors to reach the assets of the estate.[7] The revenue ruling, surprisingly clear as to gift tax treatment, raises as many questions as answers regarding estate tax consequences. The IRS does not attempt to articulate the test for triggering events which result in the inclusion of the trust in the gross estate and identifies relatively few illustrative markers.

This Note will discuss potential and unarticulated factors the IRS alluded to in the revenue ruling that may or may not result in the inclusion of the trust's value in the gross estate. In particular, Part IV of this Note will focus on creditors' rights under Iowa law and in the Restatement (Second) of Trusts.[8] Part IV attempts to uncover when creditors may reach the value of a trust and, therefore, include it in the gross estate where the grantor retains no right, a discretionary right, or a mandatory right of reimbursement of the income tax paid under the terms of the instrument. The applicable state law regarding intentionally defective grantor trusts is also examined. Finally, Part V will briefly discuss the recent amendment to Iowa Code section 633A.2303, which carved out a narrow exception to prevent the assets of a grantor trust from inclusion in the grantor's gross estate.[9]

II. THE ELEMENTS FOR ANALYSIS

A. *Intentionally Defective Grantor Trust Defined*

An intentionally defective grantor trust (IDGT) is a trust in which the grantor is treated as the owner for income tax purposes. That is, the grantor retains sufficient strings in the trust property to be treated as the owner for income tax, yet not enough to include the trust property in the grantor's gross estate under § 2036 or § 2038 of the Internal Revenue Code.[10] The grantor trust rules in §§ 671–678 of the Internal Revenue Code were enacted after World War II in response to rising litigation concerning the taxable status of trusts in relation to the grantor's degree of control over management of the trust.[11] The grantor rules were enacted by

7. Rev. Rul. 2004-64, 2004-27 I.R.B. 9.

8. *See* discussion *infra* Parts IV.A–B.

9. *See* discussion *infra* Part V.

10. Steven A. Horowitz, *Is an Intentionally Defective Dynasty Trust an Effective Estate Planning Tool?*, PRAC. EST. & FIN. PLAN., June 2000, at 11, 14.

11. Robert T. Danforth, *A Proposal for Integrating the Income and Transfer Taxation of Trusts*, 18 VA. TAX REV. 545, 554 (1999); T. Randolph Harris, IDGT's—When Defective Is Effective 1 (Sept. 18, 2002) (unpublished article, on file with

Congress in part to prevent income from shifting from a higher tax bracket to a lower one while the grantor still retained sufficient strings such that "'[i]n substance his control over the corpus was in all essential respects the same after the trust was created, as before.'"[12] Subpart E of the Internal Revenue Code defines the boundaries in determining whether a trust is considered a grantor trust under the Code, providing as follows:

> No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.[13]

While Congress prevented grantors from shifting income tax from higher bracket owners to lower ones, a presumably unintended benefit to grantors as taxpayers (as well as for beneficiaries) emerged. For example, taxable income of a trust quickly ascends to an ample 39.6% (the highest tax rate for individuals) after reaching a modest sum of $7,500, whereas an individual would not reach that highest income tax bracket until he or she earned $283,150.[14] A grantor potentially benefits the trust beneficiaries two-fold, by not only shifting income on the trust to a lower tax bracket but also via the quasi-forced, tax-free gift from the grantor to the beneficiaries when the grantor pays the income taxes for the trust. But as we will see, the IRS has announced that it will not yet treat this as a gift for gift tax purposes.[15] Additionally, transactions between the grantor and the IDGT are treated as "non-events" for income tax purposes because the grantor, for income tax purposes, is considered the owner.[16] Therefore, the many benefits of the IDGT must be considered in conjunction with the federal estate and gift tax rules. In terms of federal gift tax, the revenue ruling was a welcome explanation. Federal estate tax consequences for

author).

12. Danforth, *supra* note 11, at 554 (quoting Helvering v. Clifford, 309 U.S. 331, 335 (1940)).

13. I.R.C. § 671 (2000).

14. Danforth, *supra* note 11, at 558–59; Harris, *supra* note 11, at 2–3.

15. *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 9.

16. Danforth, *supra* note 11, at 561; Horowitz, *supra* note 10, at 12–14. Transactions between the grantor and the IDGT can circumvent gift and estate tax consequences. If, for example, the grantor sells property to an IDGT, the trust acquires the property with the desired stepped-up basis of transferring property at death while at the same time avoiding its inclusion in the grantor's gross estate. Louis A. Mezzullo, *Freezing Techniques: Installment Sales to Grantor Trusts*, PROB. & PROP., Jan.–Feb. 2000, at 17, 19.

reimbursement provisions, however, are not so clear. The IRS left enough room in the revenue ruling for reimbursement provisions to be included in the grantor's gross estate under state law or with the presence of other factors.

B. *Revenue Ruling 2004-64*

Much to grantors' delight, Revenue Ruling 2004-64 declared not only that income tax payments of IDGT did not constitute a gift from the grantor to the beneficiaries of the IDGT, but also that any repayment of the income tax paid on the trust to the grantor for the grantor's expenses did not constitute a gift from the beneficiaries to the grantor.[17] More significantly, the IRS addressed whether the trust is included in the grantor's gross estate where the grantor is considered the owner for income tax purposes only and, under the terms of the trust or applicable local law, the trustee is required or has the discretion to reimburse the grantor for income tax payments.[18] The IRS provided the following fact scenario to illustrate its holding:

> In Year 1, *A*, a United States citizen, establishes and funds Trust, an irrevocable inter vivos trust, for the benefit of *A*'s descendants. The governing instrument of Trust requires that the trustee be a person not related or subordinate to *A* within the meaning of § 672(c) of the Internal Revenue Code. *A* appoints a trustee that satisfies this requirement. Trust is governed by the laws of State. Under the terms of Trust, *A* retains no beneficial interest in or power over Trust income or corpus that would cause the transfer to Trust to constitute an incomplete gift for federal gift tax purposes, or that would cause Trust corpus to be included in *A*'s gross estate for federal estate tax purposes on *A*'s death. However, *A* retains sufficient powers with respect to Trust so that *A* is treated as the owner of Trust under subpart E.
>
> During Year 1, Trust receives taxable income of $10*x*. Pursuant to § 671, *A* includes the $10*x* in *A*'s taxable income. As a result, *A*'s personal income tax liability for Year 1 increases by $2.5*x*. *A* dies in Year 3. As of the date of *A*'s death, the fair market value of Trust's assets is $150*x*.[19]

The IRS then outlines three situations to apply to the hypothetical

17. Rev. Rul. 2004-64, 2004-27 I.R.B. 9.
18. *Id.*
19. *Id.* at 7.

facts.[20] In the first situation, neither the trust instrument nor state law mentions permitting or requiring the trustee to repay the grantor for the income tax incurred when *A* pays the $2.5*x* liability from her own funds.[21] Under this scenario, the IRS declares that *A*'s payment of the $2.5*x* income tax is not a gift from *A* to the trust beneficiaries because *A* has a legal duty to pay the taxes on the trust under § 671.[22] Furthermore, the IRS established that "no portion of Trust is includible in *A*'s gross estate . . . because *A* has not retained the right to have trust property expended in discharge of *A*'s legal obligation."[23]

The second situation offered indicates that the trust instrument—or state law, for that matter—provides that if *A* is treated as the owner of the trust under the IRC, the trustee *shall* reimburse *A* for any income tax liability incurred for that year due for her personal income tax liability for being the owner of the trust.[24] Under this scenario, *A* incurs and pays $2.5*x* of income tax that year, and the trustee reimburses *A* $2.5*x*.[25] The IRS posits that for gift tax purposes, *A*'s payment of the income tax is still not a gift to the beneficiaries for the same reasons stated in the previous paragraph.[26] Furthermore, the reimbursement provision, either included in the trust instrument or under applicable state law, does not constitute a gift from the beneficiaries of the trust to *A* because the reimbursement is "mandated by the terms of the trust instrument."[27] The IRS takes a more abrasive, less relenting stance as far as estate tax consequences are concerned. In this second scenario, the IRS reasons that because *A* has retained the right to reimbursement (no matter if applicable due to the trust provision or under state law), she has reserved the right to have the trust discharge a legal obligation and the entire value of the estate would be included under § 2036(a)(1) of the Internal Revenue Code.[28] A

20. *Id.* at 7–8.

21. *Id.*

22. *Id.* at 8.

23. *Id.*; *see, e.g.*, Estate of Gokey v. Comm'r, 72 T.C. 721, 725–28 (1979) (holding that no portion includible because grantor was legally obligated to support his children).

24. Rev. Rul. 2004-64, 2004-27 I.R.B. 8.

25. *Id.*

26. *Id.*

27. *Id.* In this second scenario, the mandatory reimbursement provision is more problematic in terms of valuation than whether it constitutes a gift. At creation of the trust, the grantor has not given up "dominion and control" of the amount allocated to her for repayment of income taxes paid.

28. *Id.*; *see, e.g.*, *Estate of Gokey*, 72 T.C. at 725–28 (stating that where the grantor reserved himself the power to take out corpus for the support of his children,

mandatory reimbursement, whether as a provision in the instrument or operational by way of state law, is obviously very important because it triggers § 2036 and likely includes the entire value of the trust, not just the income tax reimbursement interest.[29] The IRS demonstrates that not only does a retained interest make it a grantor trust, but a mandatory reimbursement also brings it within the reach of the estate tax under § 2036(a).[30]

In the third and final scenario, the IRS considers gift and estate tax implications of a more problematic provision which neither forbids nor mandates repayment of grantor's income tax liability of the IDGT.[31] The line between interests retained by the grantor for income tax purposes and estate tax purposes becomes inexact in this scenario. The IRS treats the gift tax analysis the same as in the first and second scenarios, holding that there is no gift tax liability for the grantor paying the income tax or the trustee reimbursing the grantor for the income taxes the grantor paid.[32] However, the IRS's very ambiguous treatment of a discretionary reimbursement provision, whether created in the instrument or by effect under state law, is definitely noteworthy. The IRS held that, barring an agreement, whether express or implied, "between *A* and the trustee regarding the trustee's exercise of discretion," a discretionary power on its own would not dispositively include the entire trust amount into *A*'s estate for federal estate tax purposes.[33] The IRS further held that this will be without regard to whether the trustee in fact reimbursed the grantor.[34] The IRS, however, leaves sufficient ambiguity in its explanation of discretionary provisions to include the entire trust value for, perhaps, any subjective reason. It put forth the notion that although a discretionary provision—again, under the instrument or applicable law—may not include the trust assets in the gross estate, other peripheral facts may bring the entire value of the trust within the reach of § 2036(a)(1).[35] Such examples are a "pre-existing arrangement between [the grantor] and the trustee regarding the trustee's exercise of this [reimbursement] discretion;[36] a power retained by

this was a legal obligation and therefore includible in his gross estate).

29. *Compare* I.R.C. § 2036 (2000) (including the entire value of the property), *with* I.R.C. § 2038 (2000) (including only the value of the interest).

30. Rev. Rul. 2004-64, 2004-27 I.R.B. 8.

31. *Id.*

32. *Id.* at 9.

33. *Id.*

34. *Id.*

35. *Id.*

36. *See, e.g.*, Estate of Maxwell v. Comm'r, 3 F.3d 591, 593–94 (2d Cir. 1993).

[grantor] to remove the trustee and name [himself] as successor trustee;[37] or [where] applicable [state] law subjecting the trust assets to the claims of [the grantor]'s creditors."[38]

III. STATE LAW WHICH DETERMINES WHETHER GRANTOR MAY BE REIMBURSED

A. *State Statutes Affecting the Trustee's Discretion to Reimburse Grantor for Income Tax Liability*

Where the instrument is silent, the revenue ruling offers that state law may determine whether the trust assets are included in the grantor's estate.[39] Under the revenue ruling, if the instrument is silent as to whether the grantor is to be reimbursed for income taxes paid, state law permitting the trustee to reimburse the grantor for those income taxes may result in the inclusion of the trust assets in the grantor's estate if other conditions are also present.[40] The discretionary power of the trustee to reimburse the grantor alone, according to the ruling likely, will not result in the inclusion of the trust assets in the grantor's gross estate.[41] The following sections discuss state statutes that permit or prohibit reimbursement to the creator of a grantor trust and apply the effects of local law on the treatment of a

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The court asked the essential question of whether the grantor retained possession or enjoyment such that the value was properly within the estate under § 2036(a)(1), and noted that courts have held the value of such property to be included in the decedent's estate if the decedent retained the actual possession or enjoyment thereof, even though the decedent may not have had an enforceable right to do so. *Id.* at 593–94 (citing Estate of Honigman v. Comm'r, 66 T.C. 1080, 1082 (1976); Estate of Linderme v. Comm'r, 52 T.C. 305, 308 (1969)). *Maxwell* further imposed a burden on the decedent to prove the absence of an implied agreement. *Id*. at 594. The court in *Maxwell* looked at circumstantial evidence—such as the decedent's advanced age, medical condition, and the overall result of the sale and lease of the property—and noted that the arrangement was "merely window dressing." *Id.* at 594 (quotation omitted).

37. *See, e.g.*, Estate of Farrel v. United States, 553 F.2d 637, 640–43 (Ct. Cl. 1977) (holding that the trustee's discretionary power to distribute to any beneficiary is imputed to the grantor where, under the trust instrument—or applicable state law, for that matter—the grantor can appoint herself successor trustee).

38. Rev. Rul. 2004-64, 2004-27 I.R.B. 9.

39. *Id.*

40. *Id.* The other factors listed by the IRS include but are not limited to "an understanding or pre-existing arrangement between [the grantor] and the trustee regarding the trustee's exercise of this discretion; a power retained by [the grantor] to remove the trustee and name [herself] as successor trustee; or applicable local law subjecting the trust assets to the claims of [grantor's] creditors." *Id.*

41. *Id.*

grantor trust where the instrument is silent concerning reimbursement for income taxes paid.[42]

1. *New York*

A grantor trust established under New York law must consider the effects of not having a provision in the trust instrument concerning income tax reimbursement. In the absence of any express prohibition, New York expressly provides for discretionary reimbursements.[43] The statute authorizing reimbursement to the grantor reads as follows:

> (a) Notwithstanding any contrary provision of law, 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.[44]

The accompanying commentary to the statute states that a "trustee can reimburse the grantor from principal for income taxes on trust principal, unless the trust instrument provides otherwise."[45] Even before the statute was enacted, New York courts permitted such discretionary reimbursements.[46] Of course, the statute alone, according to the IRS, will not cause inclusion of the trust assets in the grantor's gross estate;[47] however, other provisions in the trust instrument in combination with the statute may.[48] For example, if the grantor were to include a provision in the trust which allowed her to remove the trustee and name herself, absent any statute to the contrary, the full value of a trust created under New York law likely would be included in the grantor's gross estate.[49]

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42. For a discussion of other consequences state law may have where the trust instrument is silent, see Mitchell M. Gans et al., *Some Good News About Grantor Trusts: Rev. Rul. 2004-64*, 31 EST. PLAN. 467, 472–74 (2004).

43. N.Y. EST. POWERS & TRUSTS LAW § 7-1.11 (McKinney 2002).

44. *Id.*

45. Margaret Valentine Turano, *Practice Commentaries*, *in* N.Y. EST. POWERS & TRUSTS LAW § 7-1.11 (McKinney 2002).

46. *In re* Davies, 559 N.Y.S.2d 933, 935 (N.Y. Sur. Ct. 1990).

47. Rev. Rul. 2004-64, 2004-27 I.R.B. 9.

48. *See id.*

49. Gans et al., *supra* note 42, at 476–77. The trust assets would be includible under § 2036(a)(1) "because it is possible that the entire corpus of the trust could be used to reimburse the grantor for income taxes attributable to the trust's income." *Id.* at 476. Not only will the grantor's interest be included, the *entire* property over which the decedent had an interest is included. 26 C.F.R. § 20.2036-1(a) (2005). For other

A grantor trust established under law similar to New York, therefore, needs to consider the potential effects of not including a provision in the trust which specifically prohibits reimbursement. If the grantor wishes to avoid the trust's inclusion in the grantor's estate yet retain the possibility of reimbursement for income tax liability, careful consideration must be taken not only of other statutes, but of the trust provisions and as well as default common law.[50]

2. *Arkansas, Idaho, and Washington*

Some state legislatures have enacted statutes which would permit discretionary reimbursement for income tax payments, but expressly deny reimbursement for irrevocable grantor trusts. As an example, the relevant Idaho statute provides:

> (a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:
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> (1) Elections and decisions, other than those described in subsection (b) of this section, that the fiduciary makes from time to time regarding tax matters;
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> (2) An income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from, the estate or trust; or
>
> (3) The ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or beneficiary.[51]

The commentary accompanying the statute openly states that the trustee does not have the authority to pay principal to the grantor on an irrevocable grantor trust for her income tax liability as a result that is imposed by the grantor trust rules.[52] The commentary states that although often this is a desired result of such a trust, some trusts are unintentionally

matters concerning the grantor's removal power over the trustee with possible inclusion results, see Gans et al., *supra* note 42, at 476–77.

50. Rev. Rul. 2004-64, 2004-27 I.R.B. 9.

51. IDAHO CODE ANN. § 68-10-506 (Supp. 2004).

52. *Id.* cmt.

subject to the rule.[53]

> The Act does not require or authorize a trustee to distribute funds from the trust to the settlor in these cases because it is difficult to establish a rule that applies only to trusts where this tax result is unintended and does not apply to trusts where the tax result is intended.[54]

Offering rationale for exclusion for IDGTs, the commentary states the following:

> Settlors who intend this tax result rarely state it as an objective in the terms of the trust, but instead rely on the operation of the tax law to produce the desired result. As a result it may not be possible to determine from the terms of the trust if the result was intentional or unintentional. If the drafter of such a trust wants the trustee to have the authority to distribute principal or income to the settlor to reimburse the settlor for taxes paid on the trust's income or capital gains, such a provision should be placed in the terms of the trust.[55]

As a result, trusts which are constructed under trust law similar to Idaho[56] that do not expressly mandate or authorize discretionary reimbursement would not be as susceptible to the inclusion of the assets of an IDGT because reimbursement is not authorized under law.

In conclusion, whether or not state law permits discretionary reimbursement could have a significant impact on a grantor's estate tax liability. Where the instrument is silent, whether the trust assets will be includible will depend on the application of not only state law, but upon other factors in the trust instrument. In the absence of any statutory guidance, even a "state's common law may permit reimbursement."[57]

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53. *Id.*

54. *Id.*

55. *Id.*

56. For example, Arkansas and Washington have statutes, identical to Idaho's, which do not authorize reimbursement for IDGTs. *See* ARK. CODE. ANN. § 28-70-506 (2004); WASH. REV. CODE ANN. § 11.104A.300 (West Supp. 2006).

57. Gans et al., *supra* note 42, at 472.

IV. WHERE GRANTOR REIMBURSEMENT IS DISCRETIONARY, STATUTORY, OR COMMON LAW, CREDITOR RIGHTS MAY CAUSE INCLUSION OF TRUST ASSETS IN GRANTOR'S ESTATE

Because the revenue ruling states that where local law subjects trust assets to the claims of creditors, the trust assets may be includible in the grantor's gross estate when the trustee has discretion to reimburse the grantor,[58] statutory and common law rights of creditors need to be carefully considered when drafting an IDGT if the grantor wishes to avoid the trust's inclusion in her gross estate. The revenue ruling provides that if the instrument or local law permits the trustee to reimburse the grantor, that in itself would not result in the inclusion of the trust assets in the grantor's estate under § 2036, but may if other factors are also present.[59] The following sections identify creditor rights as determined by state statute, common law, and under the Restatement.

A. *Statutory Creditor Rights*

1. *Iowa Creditor Statute*

Iowa has no provision addressing the trustee's discretion to repay the grantor for the grantor's income tax liability. Therefore, a trust created under Iowa law which contains no provision reimbursing the grantor for income taxes attributable to her need not be concerned as to whether creditor rights would cause inclusion.[60] Only where the trust instrument expressly mandates or permits the trustee to reimburse the grantor will creditor rights be determinative.[61]

The Iowa statute addressing the amount reachable by creditors of a grantor provids that "[i]f a settlor is a beneficiary of a trust created by the settlor, a transferee or creditor of the settlor may reach the maximum amount that the trustee could pay to or for the settlor's benefit."[62] The question then becomes whether a settlor of a grantor trust who is reimbursed for her income tax liability is considered a beneficiary. Iowa defines a trust beneficiary as "a person who has any present or future interest in the trust, vested or contingent, and also includes the owner of an

58. Rev. Rul. 2004-64, 2004-27 I.R.B. 9.
59. *Id.*
60. *See id.*
61. *Id.*
62. IOWA CODE ANN. § 633A.2303(1) (West Supp. 2006).

interest by assignment or other transfer."[63] Therefore, where a grantor provides in the trust instrument that the trustee is authorized or required to reimburse her for taxes she paid, the grantor arguably is a beneficiary and the amount of her income taxes each year is within the reach of her creditors.

In summary, under Iowa law, for purposes of this discussion, the assets of an IDGT are not includible where the trust instrument does not include a reimbursement provision.[64] If the grantor requires repayment under the terms of the trust, the entire amount will be includible for reasons previously stated in the revenue ruling.[65] If the grantor includes a provision that the trustee may reimburse her for income taxes, under prior Iowa law, it is likely that the grantor's reserved right to satisfy her legal obligation to pay the income taxes, coupled with the creditors' right to reach the assets of the trust to the extent of grantor's interest, would cause inclusion of the entire trust in her gross estate under the guidance given by the revenue ruling.

2. *New Jersey Creditor Statute*

Similar to Iowa's definition, New Jersey defines a beneficiary as "a person who has any present or future interest, vested or contingent, and also includes the owner of an interest by assignment or other transfer and as it relates to a charitable trust, and includes any person entitled to enforce the trust."[66] Assuming a grantor who may receive trust assets to satisfy a legal obligation is a beneficiary, a trust created under New Jersey law which permits repayment to the grantor for taxes likely would be subject to the same treatment for estate tax purposes as a trust established in Iowa. The New Jersey statute provides that where a beneficiary is also the settlor, "[t]he right of any creator of a trust to receive either the income or the principal of the trust or any part of either thereof, presently or in the future, shall be freely alienable and shall be subject to the claims of his creditors."[67]

Therefore, under New Jersey creditor law, if the settlor permits the trustee to reimburse her for income taxes in the instrument, presumably this would subject the trust assets to the claims of creditors and cause

63. *Id.* § 633A.1102(2).
64. *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 9; IOWA CODE § 633.2303 (2005).
65. Rev. Rul. 2004-64, 2004-27 I.R.B. 9.
66. N.J. STAT. ANN. § 3B:1-1 (West Supp. 2005).
67. *Id.* § 3B:11-1 (West 1983).

inclusion for reasons stated in the revenue ruling.[68] Grantor trusts created under New Jersey law therefore need to take into consideration the provisions of the trust which permit reimbursement and realize the potential for its inclusion in the grantor's estate.

3. *New York Creditor Statute*

Similar to Iowa and New Jersey, New York courts have interpreted EPTL Section 7-3.1(a) to subject any of the trust assets to the claims of her creditors. In *Case v. Fargnoli*,[69] the court recognized as precedent cases that interpreted the statute to mean "any amount which the trustees are empowered to pay to the settlor of a trust, under any circumstance, is within the reach of creditors."[70] The court discussed whether or not creditors had the ability to reach the full amount of the trust assets.[71] The court held that where there was no standard limiting the potential for the grantor to have access to the trust assets, creditors could reach the full amount of the assets.[72]

In a more recent New York case, the court held that whether the grantor had the right to demand payment for such an amount was not controlling; creditors could reach the maximum amount that *could* be paid to the grantor under the terms of the trust.[73]

Trusts established under New York law, therefore, face the potential for inclusion of an IDGT unless the terms of the trust prohibit such a transfer. In situation one of the revenue ruling, where the trust instrument contains no reimbursement provision by statute, the trustee is authorized to repay the grantor for tax liability.[74] Therefore, a trust containing no provision will receive the same treatment as a trust which authorized such payments to the grantor. Again, assuming the grantor is considered a

68. Rev. Rul. 2004-64, 2004-27 I.R.B. 9.

69. Case v. Fargnoli, 702 N.Y.S.2d 764 (N.Y. Sup. Ct. 1999).

70. *Id.* at 767 (citing State v. Coyle, 575 N.Y.S.2d 975 (App. Div. 1991); Vanderbilt Credit Corp. v. Chase Manhattan Bank, 473 N.Y.S.2d 242 (App. Div. 1984)).

71. *Id.*

72. *Id.* For a discussion of whether the amount includible in the grantor's estate is limited to the entire trust or only the amount equal to the right of reimbursement, see Gans et al., *supra* note 42, at 476–77.

73. United Presbyterian House at Syosset, Inc. v. Lincks, No. 14242/01, 2003 WL 2004182, at *3 (N.Y. Sup. Ct. Feb. 11, 2003). The court determined that this would be the result regardless of whether the grantor intended to defraud creditors. *Id.*

74. *See* discussion *supra* Part III.A.1.

beneficiary, the trust assets are subject to the claims of the grantor's creditors.[75] Under Revenue Ruling 2004-64, this arguably would trigger inclusion in the grantor's gross estate. The only IDGT which would not be included in the grantor's estate is one which strictly prohibits tax reimbursement.[76]

4. *Alaska and Delaware Creditor Rights*

Some states have enacted statutes that restrict creditors' rights to reach the assets of a settlor where she is also a beneficiary of a trust.[77] Alaska's statute provides in part:

> A person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust, including a beneficiary who is the settlor of the trust, may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee.[78]

Presumably, if the trust instrument permits the trustee to reimburse the settlor for income taxes, creditors will not be able to reach trust assets. As a result, an IDGT created under Alaska law likely would not result in inclusion of the amount in the grantor's estate unless the trustee was *required* to reimburse the grantor. There are, of course, exceptions which permit creditors of the settlor to reach assets in certain circumstances.[79] This raises the issue of whether the rights of *any* creditors to reach the trust assets are enough to include the trust in the grantor's estate.[80]

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75. *See* discussion *supra* Part IV.A.1.

76. Rev. Rul. 2004-64, 2004-27 I.R.B. 9.

77. *See* ALASKA STAT. § 34.40.110 (2004); DEL. CODE ANN. tit. 12, § 3571 (2001); *see also* Richard W. Nenno, *Delaware Law Offers Asset Protection and Estate Planning Benefits*, 26 EST. PLAN. 3, 6–11 (1999) (discussing Delaware trusts regarding protection of assets).

78. ALASKA STAT. § 34.40.110.

79. *See* Thomas Flynn & Matthew Cronin, *Self-Settled Spendthrift Trusts Move Close to Home*, AM. BANKR. INST. J., Sept. 2000, at 10 (discussing ways creditors and bankruptcy trustees can reach the assets of a self-settled spendthrift trust); Nenno, *supra* note 77, at 8–9 (discussing exceptions such as support or alimony for former spouses and children).

80. Whether the rights of some creditors to reach certain assets will cause inclusion is beyond the scope of this Note. For a closer look at why creditor rights to trust assets results in estate inclusion, see Rev. Rul. 76-103, 1976-1 C.B. 293, which describes an incomplete gift where creditors are permitted under state law to reach the grantor's interest in a self-settled discretionary trust and would be included in the grantor's estate because settlor's ability to relegate trust assets to creditors is a power

B. *Creditor Rights Under Common Law*

1. *Maryland*

Where no statutory authority exists to allow creditors to reach the assets when the settlor is also a beneficiary of the trust, one should turn to state common law for guidance. In Maryland, for example, a court held that where the settlors were also beneficiaries of a self-settled spendthrift trust, their assets were not exempt from the claims of his or her creditors.[81] The court noted that it has long been established that a person cannot create a spendthrift trust for their own benefit.[82] The court noted the decision was in line with the Restatement's view on such trusts.[83] The settlors in that case argued that the general rule had been abrogated and limited in the state by a decision nine years earlier.[84] The court rejected the settlor's argument, distinguishing it by stating that the case cited was not a spendthrift trust, and the settlors reserved a substantial interest in the trust assets because the trustee's discretion was to invade the corpus for their support and care.[85] In holding that the creditors could reach the trust assets to the maximum extent, the trustee could apply to the settlors.[86] Because the trustee could distribute potentially all the trust assets to the settlors, the entire amount of the trust was subject to the claims of their

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to revoke or terminate a trust under § 2038. *But see* I.R.S. Priv. Ltr. Rul. 78-33-062 (May 18, 1978) (stating that a gift may be complete where state law limits creditors rights to actual disbursements, not the amount which may be expended for the benefit of the grantor, where the grantor's rights weren't enforceable, neither were the creditor's); Rev. Rul. 77-378, 1977-2 C.B. 347 (stating that where neither grantor nor her creditors have a right to demand distribution, "a mere expectancy that the trustee will distribute trust assets to the grantor rather than an enforceable interest in the trust . . . does not prevent the completion or reduce the value of the gift" (citing Herzog v. Comm'r, 41 B.T.A. 509 (1940), *aff'd*, 116 F.2d 591 (2d Cir. 1941))).

81. *In re* Robbins, 826 F.2d 293, 295 (4th Cir. 1987).

82. *Id.* at 294.

83. *Id.*

84. *Id.* at 295.

> [A] limited power of appointment of the corpus, coupled with the life estate, the Maryland court concluded, did not give [the grantor] such a property interest in the corpus as to subject it to the claims of his creditors. The tax lien could attach to accruing income during [the grantor]'s lifetime, but not to the corpus so as to authorize the sale of the trust assets to satisfy the income tax indebtedness.

Id.

85. *Id.*

86. *Id.*

creditors.[87] The court noted that "[o]ne may wish to have one's cake and eat it, too, but the law need not bring the wish to fruition."[88]

2. *Hawaii*

Under Hawaii law, where the beneficiary is the source of the funds to establish the trust, any spendthrift provision is invalid as to creditors and they are not prevented from reaching those funds.[89] The result is the same whether the debt was incurred prior to or subsequent to the establishment of the trust or if the settlor is not the only beneficiary of the trust because the entire trust could be applied for the settlor's benefit.[90]

3. *Oregon*

Similarly, Oregon recognizes the creditors' rights to reach the assets of a trust where the settlor retains a beneficial interest. In *Johnson v. Commercial Bank*,[91] the court held where the settlor retained a life estate, as well as the power to revoke, it was similar to a general power of appointment and therefore deserved the same treatment.[92] The Oregon Supreme Court determined that the entire trust assets were subject to the creditors because not only did the settlor retain a life estate, but also a power to revoke and, "[he] did not divest himself of the remainder interest."[93] The defendants argued that only the amount of his life estate was subject to his creditors, but the court held that his interest extended to the entire amount of the trust and, as such, the entire trust was subject to the claims of his creditors.[94]

4. *Pennsylvania*

Pennsylvania similarly holds that a spendthrift clause does not preclude any creditor from reaching the interest of a settlor-beneficiary.[95] A person may not shelter "his own property out of reach of his creditors

87. *Id.*
88. *Id.*
89. Altman v. Comm'r, 83 B.R. 35, 37 (Bankr. D. Haw. 1988).
90. *Id*. (citing Cooke Trust Co. v. Lord, 41 Haw. 198 (1955)).
91. Johnson v. Commercial Bank, 588 P.2d 1096 (Or. 1978).
92. *Id.* at 1099.
93. *Id.*
94. *Id.* at 1099–1100.
95. *See In re* Mogridge's Estate, 20 A.2d 307, 309 (Pa. 1941) (holding that the spendthrift clause was invalid and creditors were able to secure an interest by assignment).

and at the same time enjoy the benefits of that property."[96] Under Pennsylvania law, a creditor "may attach the corpus of the trust even if the settlor has included a spendthrift provision restricting the settlor's interest to an income interest."[97]

5. *Creditor Rights Under the Restatement and Uniform Trust Code*

In the absence of statutory authority or state common law, states may look to the Restatement for guidance. Restatement (Second) of Trusts provides that "[w]here a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."[98] The Restatement (Third) of Trusts provides the following:

> [I]f the terms of a trust provide for a beneficiary to receive distributions in the trustee's discretion, a transferee or creditor of the beneficiary is entitled to receive or attach any distributions the trustee makes or is required to make in the exercise of that discretion after the trustee has knowledge of the transfer or attachment.[99]

States which have adopted the Uniform Trust Code will allow "a creditor or assignee of the settlor [to] reach the maximum amount that can be distributed to or for the settlor's benefit."[100] However, under the Uniform Trust Code, where a trust has multiple settlors, "the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution."[101]

V. STATE LAW SOLUTIONS IN RESPONSE TO THE REVENUE RULING

Section 633A.2303 of the Iowa Trust Code provides that "[i]f a settlor is a beneficiary of a trust created by the settlor, a transferee or *creditor of the settlor may reach the maximum amount that the trustee could pay to or*

96. Posner v. Sheridan, 299 A.2d 309, 314 (Pa. 1973).

97. Fid. Bank v. Commonwealth Marine & Gen. Assurance Co., 581 F. Supp. 999, 1012 (E.D. Pa. 1984). *But see* Austin-Nichols & Co. v. Union Trust Co., 137 A. 461, 463 (Pa. 1927) (refusing to permit the general creditors to reach a trust established for the payment of settlor's taxes).

98. RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959).

99. RESTATEMENT (THIRD) OF TRUSTS § 60 (2003).

100. UNIF. TRUST CODE § 505(a)(2), 7C U.L.A. 258 (Supp. 2005).

101. *Id.*

for the settlor's benefit."[102] Seemingly a legal fiction, the trustee *could* pay the entire corpus of the trust for repayment of income taxes incurred by the grantor. Because this likely is the case, section 633A.2303 would include the value of the entire trust in the gross estate of the grantor upon her death. Realizing the harshness of such an outcome, in 2004 the Iowa Trust Code Committee proposed a change to section 633A.2303, to which the Iowa Legislature subsequently amended in 2005 to include the following subsection:

> The assets of an irrevocable trust shall not become subject to the claims of creditors of the settlor of a trust solely due to a provision in the trust that allows a trustee of the trust to reimburse the settlor for income taxes payable on the income of the trust. This subsection shall not limit the rights of a creditor of the settlor to assert a claim against the assets of the trust due to the retention or grant of any rights to the settlor under the trust instrument or any other beneficial interest of the settlor other than as specifically set forth in this subsection.[103]

The intention of the Iowa statute is to prevent the entire value of an IDGT from being included in the grantor's gross estate for federal estate tax purposes where the grantor has included a discretionary reimbursement provision in the trust instrument.[104]

VI. CONCLUSION

At least for now, creators of grantor trusts can breathe easy, at least when it comes to gift tax consequences of IDGTs. There are no gift tax consequences for the grantor's income tax liability for an IDGT or for any provisions or law that either permit or require the trustee to reimburse the grantor for income taxes paid. Estate tax consequences are much more obscure. According to the revenue ruling, where discretionary reimbursements are made according to either local law or provisions of the trust, the entire value of the trust may or may not be included in the grantor's gross estate depending on the individual facts of the case.[105] In some states, even where the trust instrument is silent, statutory authorization for grantor reimbursement in combination with either statutory or common law creditor rights to reach that interest may cause

102. IOWA CODE ANN. § 633A.2303(1) (West Supp. 2006) (emphasis added).

103. 2005 Iowa Legis. Serv. 133 (West) (codified at IOWA CODE § 633A.2303(3)).

104. *Id.*

105. Rev. Rul. 2004-64, 2004-27 I.R.B. 9.

the entire amount of the trust to be includible in the grantor's estate.[106] To prevent an unintended and costly result, estate planners should include a provision explicitly prohibiting such reimbursement, at least until states enact legislation similar to Iowa's statute quashing creditors, rights in these particular circumstances.

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106. *See* discussion *supra* Part III.A.1.

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