The Newest Safe Harbor from Gift Taxes

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The IRS recently ruled that no gift is made, for federal gift tax purposes, when the grantor of a so-called "grantor trust" reports the trust's income in his or her personal income tax return and pays the resulting income tax liability.

Almost invariably when a taxpayer (the grantor) creates an irrevocable trust, he or she complies with rules which ensure that contributions will be treated as completed gifts, for gift tax purposes, but the value of the trust property, and any subsequent appreciation in its value, will be excluded from his or her estate for estate tax purposes.

However, somewhat more expansive rules determine whether the grantor must be treated, during his or her lifetime, as the owner of the trust property for federal *income* tax purposes. Such "grantor trust" income rules were enacted decades ago, when top marginal rates were as high as 91%. In response, in certain cases a taxpayer would transfer assets to dozens of trusts, each treated as a separate taxpayer, so that each trust would report modest amounts of income, subject to tax rates well below the grantor's personal income tax rate. The grantor trust rules were enacted as a reform feature to compel such a taxpayer to report any such trust's income as his or her own, whenever he or she retained certain powers over disposition of the trust's income, even if such powers were insufficient to cause re-inclusion of the trust property in his or her estate for estate tax purposes.

In recent years, high net worth taxpayers who create irrevocable trusts have often added administrative provisions to subject such trusts *intentionally* to the grantor trust rules. The taxpayer then reports the trust's income in his or her personal income tax return, even though the income is distributed (or held for future distribution) to the trust's beneficiaries. The economic result is the same as if (1) the trust or its beneficiaries paid such income taxes and (2) the grantor made additional contributions to the trust to reimburse the trust (or its beneficiaries) for such income tax payments.

The IRS has now resolved perhaps the most important unanswered question regarding the tax consequences of such grantor trusts. Specifically, the grantor's payment of such income taxes is *not* a gift for federal gift tax purposes. This result obtains whether or not the trustee has discretion (or even an obligation) to reimburse the grantor for the income tax payment, provided only that the trustee is not "related or subordinate" to the grantor. Furthermore, no such reimbursement to the grantor will be treated as a gift back to the grantor from the trust's beneficiaries.

However, if the trust's provisions *require* reimbursement to the grantor of such income tax payments (or if state law requires such reimbursement, in the absence of contrary provisions in the trust instrument), the result is disastrous: the trust property will be re-included in the grantor's estate tax for *estate tax* purposes. Taxpayers should, therefore, consult with their legal counsel in determining when, if ever, to confer on the trustee a power--whether discretionary or mandatory--to reimburse the grantor for such income tax payments.

Transition Rule: Even if a trustee is compelled to reimburse the trust's grantor for such income tax payments, no federal estate tax will be assessed with respect to the assets of such a trust, if the trust is created *prior to* October 4, 2004. For those taxpayers interested, a window of opportunity will remain open until then. For all high net worth taxpayers, however, the IRS has resolved in their favor any lingering doubt that the full range of tax benefits attributable to use of such grantor trusts can be obtained without incurring any gift tax liability.