

COMMITTEE ON ESTATE AND GIFT TAXATION

A.7254
S.3441

M. of A. O'Donnell
Sen. DeFrancisco

THIS BILL IS APPROVED

INTRODUCTION

The Committee on Estate and Gift Taxation of the Association of the Bar of the City of New York supports the amendment of Section 7-3.1 of the Estates, Powers and Trusts Law (“EPTL”), by the addition of a new paragraph (d), which would clarify existing law that a trustee's discretionary authority to pay or reimburse the creator of an express trust for taxes imposed on trust income or principal is not a disposition that comes within the provisions of EPTL Section 7-3.1(a), and, therefore, is not a disposition that is, or causes the trust to be, void as against existing or subsequent creditors of the trust creator.

DISCUSSION

The convergence of EPTL Sections 7-3.1(a) and 7-1.11(a), Internal Revenue Code (“IRC”) Section 2036(a)(1), and Revenue Ruling 2004-64, 2004-27 I.R.B. 7 has generated concern whether the authority of a trustee to pay from trust principal to the creator of the trust an amount equal to the taxes owed by the trust but charged to the trust creator could cause the trust to be void as against the creator's existing or subsequent creditors, resulting in the assets of the trust being includible in the creator's gross estate for federal estate tax purposes under IRC Section 2036(a)(1).

EPTL Section 7-3.1(a) provides that a “disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator.” This principle, first codified in 1787, is the firmly established law of New York State. *See* Margaret Valentine Turano, *Practice Commentaries*, EPTL 7-3.1 (McKinney's 2002), and the cases cited therein.

EPTL Section 7-1.11(a), enacted in 1969, provides that, unless the trust instrument expressly provides to the contrary, a trustee of an express trust may “pay from principal of the trust to the creator of such trust an amount equal to any income taxes on any portion of the trust principal” that is charged to the trust creator.

EPTL Section 7-3.1(a) does not specifically address whether the discretionary power of a trustee under EPTL Section 7-1.11(a), or similar authority granted in the governing trust agreement, would be deemed a disposition in trust for the use of the creator. In addition, no New York court has ever held (nor does any case report that any litigant has ever argued) that such discretionary reimbursement authority causes a trust to fall within the scope of EPTL Section 7-3.1(a) when the creator retains no other

beneficial interests in the trust. Moreover, such a result is inconsistent with legislative intent.¹

On July 6, 2004, however, with the publication of Revenue Ruling 2004-64, 2004-27, I.R.B. 7, the Internal Revenue Service raised the issue whether, in the context of IRC Sections 671, 2511(a), 2511(b), 2036(a)(1),² the discretion of a trustee to reimburse the trust creator combined with other facts including, but not limited to, applicable local law subjecting the trust assets to the claims of the trust creator's creditors, may cause inclusion of the trust's assets in the trust creator's gross estate for federal estate tax purposes.

The Revenue Ruling holds that the payment by the trustee of trust income taxes attributed to the “grantor” of the trust is not a transfer for gift tax purposes. However, the ruling raises concern over the application of IRC Section 2036(a)(1) where the trustee has the discretion to pay or reimburse the trust creator for trust taxes charged to the trust creator. In pertinent part, the ruling provides as follows (bold for emphasis):

¹ The 1969 Memorandum in Support of Senate 47 (the bill that enacted EPTL Section 7-1.11) states that the bill was intended to codify case law (Matter of Goldman, NYLJ April 7, 1964 (Sup. Ct. NY Co.); Matter of Cowen, NYLJ Feb. 13, 1964 (Sup. Ct. NY Co.)) that had permitted such reimbursement. Nowhere in the Memorandum or in any other part of the legislative history is there a reference to this legislation having the effect of subjecting trust assets to the claims of the creator's creditors. Clearly such a result was not intended.

² In pertinent part, the Revenue Ruling sets forth the following IRC and Treasury Regulations Sections:

Section 671 provides that if a creator of a trust is treated as the owner of any portion of the trust under subpart E of Subchapter J of the Internal Revenue Code (Sections 671-679), those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust must be included in computing the taxable income of the grantor.

Section 2501 imposes a tax on the transfer of property by gift by an individual, resident or nonresident.

Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(b) provides that the gift tax applies only to the extent that property is transferred for less than an adequate and full consideration in money or money's worth. (Section 25.2511-2(b) of the Gift Tax Regulations provides that a gift is complete and subject to gift tax to the extent the donor has so parted with dominion and control as to leave in the donor no power to change the disposition of the property, whether for the benefit of the donor, or any other person.)

Section 25.2511-1(c)(1) provides that the gift tax applies with respect to any transaction in which an interest in property is gratuitously passed or conferred on another regardless of the means or device employed. Thus, the gift tax may apply if one party forgives or fails to collect on the indebtedness of another.

Section 2036(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which the decedent has retained for life or for any period not ascertainable without reference to the decedent's death or for any period that does not in fact end before death the possession or enjoyment of, or the right to the income from, the property.

Section 20.2036-1(b)(2) of the Estate Tax Regulations provides that the use, possession, right to income, or other enjoyment of transferred property is treated as having been retained by the decedent to the extent that the transferred property is to be applied towards the discharge of a legal obligation of the decedent.

In *Situation 3*, the governing instrument of Trust provides the trustee with the discretion to reimburse A [the trust Creator] from Trust's assets for the amount of income tax A pays that is attributable to Trust's income. As is the case in *Situation 1* and *Situation 2*, A's payment of the \$ 2.5x income tax liability does not constitute a gift by A because A is liable for the income tax. Further, the \$ 2.5x paid to A from Trust as reimbursement for A's income tax payment was distributed pursuant to the exercise of the trustee's discretionary authority granted under the terms of the trust instrument. Accordingly, this payment is not a gift by the trust beneficiaries to A. In addition, assuming there is no understanding, express or implied, between A and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy A's obligation would not alone cause the inclusion of the trust in A's gross estate for federal estate tax purposes. This is the case regardless of whether or not the trustee actually reimburses A from Trust assets for the amount of income tax A pays that is attributable to Trust's income. The result would be the same if the trustee's discretion to reimburse A for this income tax is granted under applicable state law rather than under the governing instrument. **However, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between A and the trustee regarding the trustee's exercise of this discretion; a power retained by A to remove the trustee and name A as successor trustee; or applicable local law subjecting the trust assets to the claims of A's creditors) may cause inclusion of Trust's assets in A's gross estate for federal estate tax purposes.**

The "Situation 3" language has raised a concern that the reimbursement authority granted under EPTL Section 7-1.11(a) may be treated as a disposition in trust for the use of the creator under EPTL Section 7-3.1(a). This could potentially subject the trust assets to claims of the trust creator's creditors and subject the trust assets to inclusion in the creator's estate under IRC Section 2036(a)(1). There is a further concern that Section 2036(a)(1) may apply in additional situations: for example, if a trust instrument grants discretionary authority to a trustee to pay or reimburse the trust creator for any and all taxes or the authority to pay the taxing authorities directly. Currently, New York law does not address these scenarios.

Estate tax inclusion based on reimbursement powers granted under EPTL Section 7-1.11(a) (or similar authority in the governing instrument) is inconsistent with legislative intent and the purpose of the statute. If the application of EPTL Section 7-1.11(a) causes a trust to fall within the scope of EPTL Section 7-3.1(a), then virtually all New York grantor trusts created since 1969 would have been included under IRC Section 2036(a)(1) – an absurd result that the legislature could not have intended.

In addition, if New York does not clarify the law, this issue, until it is resolved by the Court of Appeals, could result in time consuming and expensive litigation between New York taxpayers and the I.R.S. See Commissioner v. Estate of Bosch, 387 US 456 (1967). Such a period of uncertainty would likely cause a loss of trust business to other states, such as Delaware, that provide legislative safeguards to avoid this result.

CONCLUSION

For the foregoing reasons, the Committee supports the bill proposing that the following language be added to EPTL Section 7-3.1 as a new paragraph (d):

EPTL 7-3.1(d) A disposition in trust shall not be considered to be for the use of the creator under paragraph (a) by reason of the trustee's authority to pay trust principal to the creator pursuant to section 7-1.11. Nor shall a disposition in trust be considered to be

for the use of the creator under paragraph (a) where the trustee is authorized under the trust instrument or any other provision of law to pay to or reimburse the creator for any tax on trust income or trust principal that is payable by the creator under the law imposing such tax or to pay any such tax directly to the taxing authorities. No creditor of a trust creator shall be entitled to reach any trust property based on the discretionary powers described in the preceding sentences.

The amendment would be declarative of existing law that EPTL Section 7-3.1(a) is inapplicable to trusts in which the trust creator retains no beneficial interest in the trust, but the trustee has the discretionary authority to (i) reimburse the trust creator for income tax liability on the trust assets or (ii) pay taxes directly to the taxing authority on behalf of the trust creator, either pursuant to EPTL Section 7-1.11(a) or by specific provision in the governing trust instrument.

The proposed amendment is revenue neutral. EPTL Section 7-3.1(a) was never intended to apply (and has never been applied to) situations in which a trustee could directly or indirectly reimburse the trust creator for taxes charged to the trust creator.³

The amendment would take effect upon enactment and would apply both prospectively and retroactively.

March 16, 2005
New York, New York

Respectfully Submitted,

Ronni G. Davidowitz
Chair, Committee on Estate & Gift Taxation

³ The 1969 Budget Report on Senate 47 (the bill that enacted EPTL Section 7-1.11(a)) described the budget implications of the proposed bill as "None."

Committee:

Ronni G. Davidowitz, Chair
Kara B. Schissler, Secretary
Hon. Joan B. Lobis, Executive Committee Liaison
Karin J. Barkhorn, Esq.
Barry S. Berger, Esq.
Susan F. Bloom, Esq.
Ian W. MacLean, Esq.*
Elizabeth L. Mathieu, Esq.
Anthony S. Park, Esq.
Cordelia S. Ryan, Esq.
Tara L. Sacharoff, Esq.*
Lynn Saidenberg, Esq.
Nancy R. Stone, Esq.
Ronald J. Weiss, Esq.*
Michael Ben-Jacob, Esq.
David P. Callahan, Esq.
Donald A. Goldsmith, Esq.
Mildred Kalik, Esq.
Ann B. Lesk, Esq.
Douglas Moore, Esq.
Ingrid E. Morning, Esq.
Elizabeth P. Munson, Esq.
Michelle L. Orlowski, Esq.
Richard S. Rothberg, Esq.
Gideon Rothschild, Esq.
Jordan A. Sprechman, Esq.
Rozlyn L. Anderson, Esq.
Susan T. Baer, Esq.
Gail E. Cohen, Esq.
Prof. Bridget J. Crawford
William H. Forsyth, Jr., Esq.
Genevieve L. Fraiman, Esq.
Alan H. Hirschfeld, Esq.
R. Scott Johnston, Esq.
Cecily P. Maguire, Esq.
Philip J. Michaels, Esq.
Anita S. Rosenbloom, Esq.
Barbara E. Shiers, Esq.
Paul E. Van Horn, Esq., Adjunct Member
Kevin T. Matz, Esq., Auditor

*Sub-committee members who drafted the Report.