



# CLARITY ON INCOME TAX REIMBURSEMENT FOR GRANTOR TRUSTS IN NEBRASKA

BY NATE PATTERSON & CRAIG BENSON, KOLEY JESSEN

## **In modern wealth transfer planning, strategies**

involving the transfer of assets into irrevocable trusts are commonplace. Many of these irrevocable trusts are referred to as “intentionally defective grantor trusts” (IDGT) and are treated as “grantor trusts” for federal income tax purposes, requiring the grantor to pay all income taxes attributable to such trust despite having no access to the trust’s assets. However, for transfer tax purposes, the IDGT is treated as a separate taxpayer. This difference between income and transfer tax treatment has led the IDGT to be the wealth transfer planning vehicle of choice for many advisors.

The taxation of all trust income to the grantor is an extremely powerful wealth transfer planning tool, essentially allowing the grantor to make tax-free gifts to the trust each year of the taxes paid without the use of the grantor’s annual exclusion or lifetime exemption. However, during times of economic hardship or in tax years with an abnormally high tax bill (e.g., such as upon the sale of a closely held business interest at a premium), the income tax imposed on the grantor can present a tremendous cash flow burden. To deal with this issue, many practitioners seek to include a discretionary power allowing an independent trustee to reimburse

the grantor (or pay directly to the applicable taxing authority) for those income taxes attributable to the assets of the trust (known as Tax Reimbursement Power). A Tax Reimbursement Power does not reduce the amount of income tax due, but rather allows the trustee to shift the burden of paying the tax liability from the grantor to the trust.

Until recently, it remained unclear whether the inclusion of a Tax Reimbursement Power in the terms of a Nebraska trust caused inclusion in the grantor's gross estate following death. The risk of gross estate inclusion arises from operation of IRC § 2036(a) for transfers with a retained life estate because the grantor of the trust retains access to the trust's income through reimbursement distributions. The triggering of IRC § 2036(a) risks total inclusion of the trust's assets, regardless of the amount of income tax liability or distribution made to the grantor for any particular year.

In Revenue Ruling 2004-64, the IRS clarified that although a mandatory Tax Reimbursement Power causes gross estate inclusion, a discretionary Tax Reimbursement Power on its own does not. However, when paired with other factors, inclusion may still be a risk. These factors include, but are not limited to:

- an understanding or pre-existing arrangement between the grantor and trustee to make reimbursement distributions;
- a power retained by the grantor to remove the current trustee and appoint a successor trustee; and
- local law subjecting the trust assets to the claims of the grantor's creditors.

Pursuant to the Revenue Ruling, state law is also determinative on the gross estate inclusion issue. If, under applicable state law, the incorporation of a Tax Reimbursement Power causes the trust to be subject to the grantor's creditors, or to become "self-settled," then the mere insertion of a Tax Reimbursement Power in the trust causes gross estate inclusion following the grantor's death.

Koley Jessen, PC, LLO prepared the draft legislative language and testified before the Banking, Commerce, and Insurance Committee of the Nebraska Legislature in favor of LB 707, which clarifies under Nebraska law that a Tax Reimbursement Power on its own will not cause gross estate inclusion following a grantor's death in accordance with Revenue Ruling 2004-64. The Nebraska Legislature passed LB 707 on April 12, 2022, and the Governor signed the bill into law on April 20, 2022. The effective date of the new law is July 20, 2022.

LB 707 updates the Nebraska Uniform Trust Code (NUTC) to provide clarity necessary to use Tax Reimbursement Powers in Nebraska IDGTs without the risk of gross tax inclusion. The newly updated NUTC provides:

- A trustee's discretionary reimbursement power on its own will not subject the trust's assets to the claims of the grantor's creditors (NUTC § 30-3850(a)(2)(B));
- A trustee's discretionary reimbursement power on its own will not cause the grantor to be considered a beneficiary of the trust (NUTC § 30-3850(a)(2)(C)); and



**The continued and repeated exercise of the power on a routine basis increases the risk of an IRS challenge, so the conservative trustee should show restraint and only exercise the power judiciously.**

- Nebraska trustees have a discretionary reimbursement power, so long as that trustee is not considered a "related or subordinate party" to the grantor of the trust under the "grantor trust" rules of the Internal Revenue Code (NUTC § 30-3881(b)).

Nationally, 26-plus states have adopted similar legislation to provide clarity that the use of Tax Reimbursement Power alone will not cause gross estate inclusion.

It is important to note that the passage of LB 707 only provides advisers and trustees with the platform on which to potentially use a Tax Reimbursement Power. There are other factors to consider when deciding whether to include such a power and the form that power takes within the trust agreement. If drafted incorrectly, a Tax Reimbursement Power may still cause gross estate inclusion.

With that said, the passage of LB 707 is just one more step in modernizing the NUTC and provides advisers and trustees alike with one more tool in their toolbox to add flexibility and value to their wealth transfer planning clients. The advisability on whether a trustee should exercise the Tax Reimbursement Power is fact-specific and should only be determined on a case-by-case basis. The continued and repeated exercise of the power on a routine basis increases the risk of an IRS challenge, so the conservative trustee should show restraint and only exercise the power judiciously. ◀



*Nate Patterson and Craig Benson are attorneys at Koley Jessen, focusing their practices on estate planning and administration, business succession planning, and tax. Patterson and Benson counsel business owners, families, and individuals, and work closely with CPAs in the structuring and implementation of plans to ensure wealth accumulation and protection for their clients through sophisticated tax minimization and mitigation techniques. For more information, contact them at [nathan.patterson@koleyjessen.com](mailto:nathan.patterson@koleyjessen.com) and [craig.benson@koleyjessen.com](mailto:craig.benson@koleyjessen.com), respectively.*