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Risks and Opportunities when Irrevocable Grantor Trusts Own Pass-Through Entities that Pay State Income Tax for Their Grantors
By: Edwin P. Morrow III

"The vast majority of states have now passed legislation to provide new mechanisms whereby pass-through entities (PTEs) may pay state income tax that would previously have been the tax burden of their owners. This generates an exclusion or a credit for the individual taxpayer to use to offset their state income tax. Thus, it usually does not increase the overall state income tax but allows more of it to be deductible without being limited by the $10,000 cap on itemizable state and local income tax (SALT) deductions. The IRS has signaled in Notice 2020-75 that it will issue proposed regulations to permit this and provide further guidance.

When an irrevocable grantor trust (IGT) owns PTEs, however, the benefit from such PTE tax payments does not inure to the trust at all. It is the grantor who benefits – not the trust and its beneficiaries. Moreover, the grantor often retains control over whether the PTE pays the grantor's state tax bill or whether they pay it themselves. This dynamic may cause several serious transfer tax problems that were neither blessed nor even discussed in IRS Notice 2020-75.

While the IRS may ultimately decide to overlook the gift, estate and generation skipping transfer (GST) tax implications of this optional state tax structure, such payments probably do not come within the current protections of Rev. Rul. 2004-64, and few states have clear laws that protect such payments from causing the IGT to be susceptible to a grantor's creditors. The optional nature of who pays this state tax burden may also create serious implications for GRATs, intervivos marital trusts, or other split-interest trusts such as grantor charitable lead trusts.

It may not be enough to tell clients to simply not make such PTE tax elections, as this may be outside of the client's control, or it may simply be too late. This newsletter outlines the dangers and proposes a solution for states to consider in clarifying their state law regarding application of the rule against self-settled trusts vis a vis such *payments, suggestions for the IRS to consider in their proposed regulations and clauses for practitioners to consider to avoid the various financial, asset protection, litigation and transfer tax risks discussed herein."*

EXECUTIVE SUMMARY:

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FACTS:

This newsletter will briefly describe the various new state pass through entity ("PTE") tax regimes, then describe the transfer tax inefficiencies of such PTE payments when an irrevocable grantor trust (IGT) is an owner before tackling the various gift tax, estate inclusion, asset protection and fiduciary litigation risks that this combination might entail.

We'll examine why such state income tax payments for the grantor may not be within the safe harbor of Rev. Rul. 2004-64, especially considering the inadequacy of many state trust laws in this area, which are summarized with hyperlinks in the endnotes, and the fact that grantors often retain control of the PTE election. We will then explore the potential for such PTE regimes to cause estate inclusion risk, inadvertently disqualify GRATs, intervivos QTIP trusts and grantor charitable lead trusts, as well as create potential issues for non-grantor trusts, unless the IRS clarifies the impact of these on transfer tax issues.

New PTE Regimes Enacted in Response to the Tax Cuts and Jobs Act (TCJA)

Congress enacted a limitation on the itemized deduction for state and local taxes (often referred to as the "SALT" deduction) of $10,000 (not indexed for inflation), for tax years beginning after December 31, 2017, and before January 1, 2026.[1] Because this causes many taxpayers' itemized deductions to fall below the standard deduction, it often has the practical effect of completely eliminating any usable deduction for state income taxes rather than simply reducing it.

Legislatures of states with separate state income taxes were none too happy about this and began to pass various creative solutions for their residents to still avail themselves of the federal tax deduction. Some of these didn't "work". However, in Notice 2020-75, citing Rev. Rul. 58-25 that involved deductibility of a tax paid by a pass-through entity to the City of Cincinnati, the IRS finally gave a green light to the states enacting these PTE taxes and promised to:

> issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction

> limitations…[that] will clarify that Specified Income Tax Payments (as defined in section 3.02(1) of this notice) are deductible by partnerships and S corporations in computing their non-separately stated income or loss.*** Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately*** Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.[2]

Many states, even those traditionally thought of as "no income tax" states such as Texas, Washington, or Tennessee, have entity-level taxes like the city tax discussed in Rev. Rul. 58-25. What is unique and different in these new PTE taxes from the tax in those states or in the tax described in that ruling is the *optional* nature of who pays them (in all states but one) and the *exclusion or credit* that the individual owners receive to offset their state tax.

To summarize the import of Notice 2020-75, pass-through entities (PTEs) making such state income tax payments legally get around the $10,000 SALT limitation because the entity becomes liable for and pays the tax rather than the individual owners and such tax payments reduce the owner's distributive share of Form K-1 income. It basically converts an itemized deduction subject to a $10,000 cap that is often wasted into a much more valuable business expense deduction. These must be taxes owed by and paid by the entity, not merely as a withholding agent for the owners, such as those that a company might pay for non-state-resident owners (sometimes on a composite return). The IRS Notice did not mention PTE payments by disregarded entities, such as a single member LLC taxed as a sole proprietorship (apparently only Rhode Island allows disregarded LLCs to pay a PTE tax – other states require S corporation or partnership tax status).[3]

The vast majority of states with a separate income tax have passed legislation in this regard to allow their business owners to take advantage of this end run around the SALT cap – now up to 36 states and New York City.[4] The AICPA keeps an up-to-date map and spreadsheet with links to the state statutes.[5] Even many "deep red" states have jumped on the PTE SALT cap workaround bandwagon. The Governor of Iowa just signed one into law as recently as May 11, 2023, retroactive to January 1, 2022.[6] Maine, Pennsylvania and Vermont have bills proposed. According to the AICPA, there are only three jurisdictions with an owner-level personal income tax on PTE income that have *not* yet proposed or enacted PTE taxes: Washington, D.C., Delaware, and North Dakota. If you practice in one of those states or in a state without an income tax, you may still have clients who own pass through entities with multi-state business operations that pay PTE tax or state income tax withholding in one of the other states.

These statutes vary considerably but can be loosely divided for purposes of this article into states that mandate a payment and provide owners a credit (apparently only

Connecticut is in this category), states that allow an entity to elect to pay and then its owners receive a credit, deduction or exclusion (the vast majority), and states that allow each owner to separately opt in or opt-out (e.g., California and Arizona are in these respective categories). This newsletter will not scrutinize the reasoning or rationale of the IRS Notice,[7] nor go through the dozens of different state filing requirements and mechanics and will focus only on its potential impact of these state PTE tax regimes to irrevocable trust planning. *None of the issues discussed herein were addressed in IRS Notice 2020-75*.

COMMENT:

It will help us to understand the issues if we start with a simple example to draw from.

Example to illustrate the issue:

> Grantor transfers $5 million worth of S corporation stock and $5 million in LLC (taxed as a partnership) interests to a completed gift, irrevocable grantor trust for spouse and children (what is commonly referred to as a spousal lifetime access trust, or "SLAT").
>
> The LLC does business in only State A where the grantor resides (to keep the example simpler) which has a separate state income tax and PTE tax regime. It makes $500,000 of income for the year attributable to the trust's share that would otherwise be reported on the grantor's income tax return (whether it is reported directly to the grantor's social security number or indirectly through a separate EIN and Form 1041 grantor trust reporting is irrelevant). The entity elects to pay PTE and does so.
>
> To keep the math simple, assume that the entity pays 5% PTE tax to State A, $25,000 total in state income taxes on the trust's share of that income. This reduces the distributable share reported on its Form K-1 by $25,000 (to $475,000). That's the key to the SALT cap avoidance – the $25,000 is not a separately stated itemized deduction subject to the $10,000 cap.
>
> The S corp is similar. It makes the $500,000 of income attributable to the trust's shares, but the entity does *not* elect to pay a PTE tax (it may in most states, but I am presuming it will not or cannot to show the contrast). The grantor is not a resident of where the S corp does business, and the S corp must file a composite return or otherwise withhold 5% state income tax for the grantor in State B.[8] It is usually deemed to be a distribution to a shareholder. Because it is not a PTE tax owed by the S corp, but owed by the shareholder, it does *not* reduce the distributable share by the $25,000 and does not come under Rev. Rul. 58-25/Notice 2020-75. If the grantor had paid $8,000 in other state and local taxes (and still itemizes!), the grantor could only use $2,000 of the $25,000 state tax payment as a deduction.

> When the entities pay the state income tax for their owners, this reduces the amount that would otherwise be distributed or add to the capital account inuring to the trust and its beneficiaries and reduces the grantor's state income tax bill. For the LLC, the grantor will be allowed a $25,000 credit (or equivalent exclusion/deduction) to offset the grantor's state income tax, and this amount does *not* count against the $10,000 ($5,000 if married filing separately) cap on SALT deductions.[9] For the S corp that did *not* elect into the PTE regime, the grantor is credited with having paid the $25,000 already as an individual, just like any other withholding or payment, but this would count towards their $10,000 SALT cap and most if not all of the deduction would likely go wasted.

At first, this technique of having the entity pay the PTE tax sounds like the proverbial "win-win" and "no brainer". Owners get more federal tax deduction indirectly without (usually) paying more in state tax.[10] Furthermore, lowering adjusted gross income and business income is often much better than receiving an itemized deduction even if the itemized deduction were fully allowed – affecting the net investment income tax (NIIT), AMT, Section 199A QBI deduction for specified service business, Roth IRA eligibility, Medicare tax and too many other deductions and credits to count. What's not to love about getting more and better federal tax deductions without paying more state income tax?

Quite a bit, actually. The AICPA has compiled a daunting 5-page single-spaced list of unanswered questions that entities should consider before making the PTE election.[11] There may be uncertainty whether an out-of-state resident can offset the PTE tax against their in-state tax liability, application of AMT, application to self-employment income, and many other uncertainties that are still to be worked out despite the ostensible green light given in IRS Notice 2020-75.

This article will not address any of the AICPA concerns but will focus only on potential tax issues when *an irrevocable trust owns the PTE, especially irrevocable grantor trusts (IGTs)*. Let's start with recognizing the economic inefficiencies of such PTE payments from a transfer tax perspective and then tackle some of the more serious implications of this structure when an IGT is an owner of the entity.

Extinguishing the "Tax Burn" of the Irrevocable Grantor Trust

With possible exceptions for niche tax solutions such as exploiting state trust residency income loopholes, stacking IRC §1202 qualified small business stock exclusions or IRC § 453A interest installment sale caps, shifting or spraying income for non-taxable estates or getting better above the line charitable income tax deductions under IRC §642(c), it is almost always better (i.e., much more transfer and income tax efficient) for irrevocable trusts intended to be completed gifts to be structured as grantor trusts.

It does not take a financial genius or elaborate spreadsheets to realize that a trust is usually going to grow more when someone else is paying the income tax bill (i.e., the grantor), and the grantor's taxable estate will grow less if the grantor is paying the income bills for another (i.e., the trust). The only exception would be in a year when the trust has no taxable income, or even losses.[12]

In our example above, when the grantor pays federal income tax on the $975,000 of income, the $350,000 or so in federal income tax paid indirectly benefits the trust and its beneficiaries. Similarly, if the grantor had paid the $50,000 in state income tax, the trust would have received more wealth. Generally, the more that income over the years is attributed to and paid by the grantor, the greater the transfer tax efficiency of the gift to an irrevocable grantor trust will be. Making the trust a grantor trust also avoids the highly compressed tax brackets applicable to trusts and many other negative ramifications of non-grantor trusts. This same transfer/income tax efficient strategy is increasingly even used after the grantor's death through the use of beneficiary deemed owner trust (BDOT) provisions.[13]

So, for a grantor worried about estate/gift/GST taxes, the grantor's payment of the income tax for the IGT is a good thing. Such payments are not considered taxable gifts to the trust and its beneficiaries, even though from an economic standpoint they achieve the same thing.[14] When a PTE elects to pay the state income tax for the grantor, however, the funds are flowing in the *opposite direction* from what taxpayers with potentially taxable estates are typically trying to do – wealth is flowing back to the grantor, not to the trust. The "tax burn", at least for state income taxes on PTE income, is extinguished. While state income tax rates are usually much lower than federal income tax rates, it is worth noting nonetheless.

Other issues, however, are probably more concerning.

Rev. Rul. 2004-64 and its Potential Application to PTE Payments

Before addressing PTE tax payments and the complexity of analyzing them when an IGT owns the PTE, imagine a prospective client came to you and said, "I'd really like to give away some stock to an irrevocable trust (SLAT, GRAT, IV QTIP, CLAT, etc.) and keep it out of my estate, but I want to keep control over whether I pay or the trust pays my state income tax on the income every year, can I do that?" If your reply is "sure", then don't bother reading the rest of this newsletter. If that question gives you pause, then forge ahead.

Rev. Rul. 2004-64 considers situations in which the trustee reimburses the grantor for taxes paid by the grantor due to the inclusion of all or part of the trust's income in the grantor's income.[15] If, pursuant to the trust's governing instrument or applicable local law, the trustee *must reimburse* the grantor for the income tax payable by the grantor that was attributable to the trust's income, *the IRS claims that the full value of the trust's assets would be includible in the grantor's gross estate under § 2036*.

If, however, the trust's governing instrument or applicable local law merely gave the trustee the *discretion* to reimburse the grantor for that portion of the grantor's income tax liability, the existence of that discretion, by itself, whether or not exercised, *would **not** cause the value of the trust's assets to be includible in the grantor's gross estate*.

However, such discretion *combined with other facts* (including but not limited to: an understanding or pre-existing arrangement between grantor and the trustee regarding the trustee's exercise of this discretion; a power retained by Grantor to remove the trustee and name grantor as successor trustee; or applicable local law subjecting the trust assets to the claims of grantor's creditors) *may cause inclusion* of Trust's assets in grantor's gross estate for federal estate tax purposes.

Many, but not all, states have addressed the creditor access issue that grantor trust reimbursement provisions may cause. However, the vast majority of these statutes focus only on the *trustee's* discretion, and in most instances where the PTE pays state income tax, the trustee won't have any say over the decision and the trustee is not the one making the payment anyway (look up your state statute in the extensive hyperlinked list in the endnotes).[16] Let's apply the reasoning of Rev. Rul. 2004-64 to the three main types of state PTE regimes: 1) where the PTE may opt in (the majority), 2) where the PTE *must* pay, and 3) where each owner of the PTE is given the option.

1) Application to Situations in Which the PTE has the Option. How does Rev. Rul. 2004-64 apply to situations in which the PTE, rather than the trustee, pays state income taxes for the grantor? There is no indication or rationale in the ruling that reimbursement of state income taxes is any different from reimbursing federal income taxes. Further, there is no indication that an indirect reimbursement or payment from a PTE owned by a trust is any different from a direct reimbursement of payment from a trust directly, but we might be able to extrapolate some general rules by analogy.

If the PTE has already decided (either by requiring it in an operating agreement, voting on it or already having made the irrevocable election with the state) to pay the state income tax prior to the transfer to the IGT, or the grantor directly or indirectly controls the PTE (which would be common in many cases), then it seems very similar to the situation in Rev. Rul. 2004-64 that outlines the negative ramifications of a mandatory reimbursement and/or an implied understanding that the grantor would be continue to have their state income taxes paid as causing full estate inclusion under IRC §2036.

In other cases, if the PTE is not required to but an independent trustee later uses its discretion to cause the PTE to opt in to make the PTE payment, it can be argued that this is sufficiently analogous to the trustee in Rev. Rul. 2004-64 having the discretion to reimburse the grantor's income taxes and therefore not trigger any estate inclusion *per se*, as long as no other "bad facts" such as prearrangement, control, or creditor access taint the trust.

It would be common to have situations in between, where the trustee does not control the PTE election but may have a minority vote, and the entity decides to make the PTE election to have the entity pay the tax.

Hopefully, the IRS would be convinced of the analogy between an LLC manager/members using their managerial/voting discretion to pay tax for its owners (or deemed owners for income tax purposes) and a trustee using its discretion to pay income tax for its grantor. Even if this analogy is persuasive, however, there are other traps and arguments the IRS could make – especially in two common instances:

1) where the grantor rather than the trustee often controls (directly or indirectly as investment advisor to the trustee) the PTE's decision to make the election (since the IRS clearly doesn't like the prospect of the grantor controlling the reimbursement as they noted in Rev. Rul. 2004-64); or

2) the applicable state statute or common law does not clearly protect such payments benefitting a grantor from a grantor's creditors under the common law rule against self-settled trusts or the UTC §505's self-settled trust prohibition (which is the vast majority of states, since even most of these statutes that offer some protection only speak to discretionary powers of *trustees*, not powers of *PTEs or other parties, and also usually carve out powers held by grantors themselves – see list of hyperlinked statutes in endnotes*). Even the most debtor-friendly DAPT statutes require that a qualified trustee (e.g. not the grantor) control the purse strings, and in many cases the grantor controls the PTE or the PTE itself is not qualified as a fiduciary, and it's the PTE that controls whether the grantor gets their state tax bill paid or not – might even DAPT statutes be insufficient?

What if the trustee voted *against* opting into the PTE payment and was merely outvoted? In some states, non-voting ownership interests have a say in whether a PTE makes the election and, in some states, only voting shares matter. Non-acquiescence by the trustee may sound like a more favorable fact-pattern, but it's doubtful this clears the gauntlet either, especially if the grantor is still the one making the decision to opt into the PTE regime.

Is it ever prudent for a grantor trust trustee to acquiesce in any PTE election? It can be fiscally prudent (aside from the concerns herein), even if it sounds economically inefficient on the surface, just as reimbursing the grantor for income taxes can be prudent. After all, if the grantor retains the power to cut off grantor trust status entirely, as is often the case, the trustee is merely allowing a trickle of water to escape to prevent the entire dam from bursting. But it's only prudent if this is within their power as trustee to do so (i.e., the trust instrument or state law permits income tax payments or reimbursement for the benefit of grantors) and possibly only if state law protects such payments from a grantor's creditors. Some do but many probably don't, especially if the grantor is the one deciding.

2) Application to Mandatory PTE Tax Regimes. What if the state *requires* the PTE to pay the tax, as in Connecticut? In some ways this is better, but in some ways worse. On the plus side, there is clearly *no voluntary shift* of the burden of paying the state income tax from the owners of the PTE to the PTE itself, even if the grantor completely controls the entity. Neither the entity nor the owners have a choice. We know from Rev. Rul. 2004-64 that there can be *no taxable gift* from the PTE or its owners to the grantor if the PTE *must* pay the tax. This mandatory PTE tax regime is also the one most similar to the entity tax described in Rev. Rul. 58-25.

However, the structure (as well as mandatory withholding for non-state resident owners regardless of PTE tax elections) still strongly resembles the prohibited retention of the right to income tax payments that the IRS ruled caused estate inclusion in Rev. Rul. 2004-64. Unlike ordinary situations where a PTE pays a state or city tax, as in Rev. Rul. 58-25 and traditional state or local taxes on PTEs, the grantor is clearly still receiving an economic benefit under Connecticut's regime. We know that mandatory payments of a grantor's state income tax bill for the irrevocable grantor trust would clearly be outside of the protection of Rev. Rul. 2004-64 and cause estate inclusion. Is the grantor's mandatory receipt of an *equivalent state tax credit* the same thing as having a payment made to or for the grantor's benefit? Economically it certainly is the same.

The Tax Court in *Estate of Wyly* addressed an instance where the question was whether a state law-created right to income benefiting the donor could cause a retained interest under IRC §2036. The answer was "yes".[17] This case, however, was ultimately overruled based on the court's interpretation of Texas community property law that ultimately concluded that there really was no such right to income.[18] Thus, the overruling of that case should probably not provide any confidence that state-mandated PTE payments like Connecticut's that indirectly benefit the grantor would similarly avoid IRC §2036 or come within the protections of Rev. Rul. 2004-64. Getting a credit or exclusion to eliminate your tax smells a lot like having your tax paid. Would you care which you receive if the end benefit is the same?

3) Application to Individual Owner Opt-in, Opt-Out PTE Tax Regimes. Under the two state PTE regimes where the PTE payment is optional for each owner of the PTE, as in California and Arizona, most of the estate inclusion problems are probably solved if the trustee of the IGT opts out and the PTE makes no state tax payment for the grantor.[19] How could there be any retained interest? State taxes *might* be paid, however, and sometimes that discretionary power alone may matter. The conclusion in Rev. Rul. 2004-64 that IRC §2036 does not apply to a discretionary right to payments/reimbursements also depends on whether the state in question clearly protects such a retained discretionary power to reimburse the grantor from a grantor's creditors. Luckily, Arizona and California do protect such a provision from the application of the rule against self-settled trusts, the latter only recently adding this protection effective January 1, 2023 (see the hyperlinked list of statutes in the endnotes).

Oddly, though, an IGT might still benefit from this optional regime even if it opts out, if others opt in. Because S corporations cannot make special allocations as partnerships might, this leads to distortions of the benefit and a windfall for the shareholder opting *out*, if others opt *in*. For example, if an individual 50% owner makes the election and the other 50% owner that is an irrevocable grantor trust does not and the S corporation pays $20,000 of PTE tax, *both* shareholders benefit from reduced federal income tax by $10,000 each. Is it wise for the other shareholder to opt in? Might it be an indirect gift by the opting in shareholder to the IGT?

If the IGT trustee opts *into* the AZ/CA's PTE tax regime, the grantor gets the tax credit.[20] This is obviously a conscious decision by the trustee to financially benefit a non-beneficiary at the expense of the beneficiaries. If there is no trust language permitting this (and the trust is not governed by a different state law where this is allowed by statute), this runs a breach of fiduciary duty risk, and a greater §2036 risk of an implied understanding that the grantor would have their state tax bill paid from the PTE even after transfer to trust. However, if the trust instrument allows the trustee to make discretionary payments of income tax for the grantor, there is a strong argument that an IGT trustee electing into Arizona or California's opt-in PTE regime comes within the Rev. Rul. 2004-64 safe harbor for discretionary payments by the trustee as well as their state statutory creditor protection.

In short, while the regime in Arizona and California may be the one least similar to the entity tax and situation approved of in Rev. Rul. 58-25, it is probably the least likely PTE regime to cause problems to grantors of irrevocable grantor trusts.

How *much* would be included in the estate if the IRS is successful?

In Rev. Rul. 2004-64, the IRS claimed that 100% of a trust is included in a grantor's estate if there is a mandatory income tax payment/reimbursement provision, or a discretionary payment scheme coupled with a preunderstanding or if the discretionary power causes creditor access under applicable state law. If $10 million as in our prior example of PTEs were transferred to an IGT, along with $2 million of publicly traded stocks, bonds and cash, presumably any inclusion would only apply to the $10 million of PTE in our scenario, not the publicly traded stocks, bonds and cash.

The IRS may have been stretching the amount of the trust subject to §2036 estate inclusion argument in its conclusion. Even under the most government-friendly argument, the grantor cannot access *all the income* under any income tax payment or reimbursement regime. At most, the grantor could get 37% + 3.8% NIIT+ state tax rate % of the income and arguably any inclusion should be so limited.[21] The application to a state-only PTE payment regime should be much less – perhaps only the applicable state income tax percentage of the PTE value.

My argument to limit estate inclusion notwithstanding, however, the IRS may reach the same conclusion it did in Rev. Rul. 2004-64 and open its auditing bid with 100% inclusion of the value of the PTE in the grantor's estate (and while they're at it, of course, make their traditional arguments to avoid any valuation discounts on the PTE transferred or purchased).

Ending the IRC §2036 String May Still Create Tail Risk

Perhaps most of this retained interest risk goes away when (if) the states close down their PTE tax regimes when (if) the SALT limitation disappears in 2026. Or the trustee might cleanse the taint by selling the PTE back to the grantor, opting-out of the PTE regime, changing trust situs and applicable law to a more favorable state, amending the trust to require reimbursement by the grantor, etc. (the latter is discussed at the end of this newsletter). Recall that if there is a retained interest under IRC §2036/§2038 that is later cleansed, IRC §2035 may pull back the asset into the estate if the grantor dies within three years of that cessation.[22]

Effect of PTE Tax Regimes on the Valuation of PTEs

Does this new entity-level PTE tax effect the *valuation* of a PTE that is gifted or sold? Presumably it would have something more than a negligible effect, especially in Connecticut where it is mandatory, similar to if the entity were a C corporation that pays its own tax. It effects cash flow, and getting an offsetting exclusion or credit is not guaranteed to every buyer/owner. The hypothetical willing buyer would presumably pay less for entity stuck with a 6% state income tax than one that is not. Even if the PTE tax is optional, it is reasonable to conclude that the value of a minority interest in a PTE should be further depressed by the further lack of control over an important tax election and payments (except in AZ, CA where even minority owners have control), and that a controlling interest may incur a slightly enhanced *premium* through its ability to control an important election. I will leave that to the valuation professionals.

Gift Tax Problems When the Grantor Controls the Switch Determining Who Pays the Tax – A Dangerous Option for Schrödinger's Cat

When taxpayers transfer PTEs to irrevocable trusts, it is *extremely* common for the grantor to continue to control the entity, either by retaining all the voting stock, retaining the voting control, or directing the trustee on the investment. The structure of the optional PTE tax regimes (other than AZ and CA, where each owner has the choice) essentially gives the grantor control over the switch at the Trolly Car tracks, letting them decide whether they pay the state income tax on the transferred PTE income themselves or have the trust indirectly pay for the state tax burden.[23] Adding the adjective "optional" or "elective" to the word "tax" is normally a classic oxymoron, but it's not that the state tax is optional here, the only option involved is *who pays it*. While such a power sounds like a presently exercisable general power of appointment, it would not be (at least not for federal tax law) because it would exercisable only with consent of the creator of the power.[24] It does raise the specter, however, of other estate inclusion strings, as discussed above, but potentially gift tax issues as well.

The power to decide *who pays* a state tax burden between a grantor and a grantor trust is significantly different from other tax election powers that a grantor or PTE may have in filing a Form 1065 partnership or Form 1120S S corporation tax return that indirectly benefits a grantor. A grantor managing a PTE may decide to make a Section 179 election to expense a particular purchase rather than depreciate it, for example. Such an election may provide an indirect benefit to the grantor by reducing the grantor's tax burden in the near term, but it does not shift wealth from the IGT to the grantor as a PTE tax election would.

When a grantor of an IGT who controls the PTE elects *out* of the PTE tax regime, this sounds like the safest solution at first – the hope is that this avoids the issues herein altogether. However, by volunteering to pay a tax that the grantor would not otherwise have to pay (since the grantor could simply decide to have the PTE pay it), is the grantor making a taxable gift by causing the owners (including the grantor) pay the tax on their personal returns rather than the PTE? As the IRS stated in Rev. Rul. 2004-64: “The gift tax applies if one person gratuitously pays the tax liability of another. *Doerr v. United States*, 819 F.2d 162 (7th Cir. 1987)”. Whose tax liability is it before the election is made before the liability is fixed, if it’s optional and could be *either party’s*? The question may remind quantum physics aficionados of *Schrödinger’s Cat*.[25] Is there a tax liability until the decision is made as to whose liability it is?

Take a simple example where a grantor owns 60% of a PTE (S Corp) individually and the grantor’s IGT owns the other 40%. The grantor controls the company and could elect to have the PTE pay the entire $50,000 state income tax burden, 40% of which ($20,000) would be borne by the IGT and only 60% ($30,000) would be borne by the grantor, or elect to have the owners pay their own state income tax as was traditionally done, in which case the grantor owes and bears the burden of the entire $50,000 because the grantor is deemed the owner of the IGT for federal income tax purposes. Let’s assume that the grantor neglects to throw the Trolly Switch and opts out of the PTE regime and pays all $50,000 in state income tax himself, forgoing the option to have $20,000 borne by the IGT.

The grantor has arguably made a taxable gift of $20,000 by electing to pay the state income tax bill for the IGT. But wait!! Rev. Rul. 2004-64 says that payment of income tax (state or federal) by a grantor for an IGT is not a taxable gift! Usually this is true, since the grantor is *required by law* to pay those taxes. But the grantor is not *required* to pay these state income taxes unless they fail to make the election – the grantor could throw the switch and shift the burden to the PTE and hence 40% of the tax burden to the IGT! As the IRS correctly stated in Rev. Rul. 2004-64, an *optional* payment of state income tax for *someone else* would not come under the protection of Rev. Rul. 2004-64. The reason the IRS concluded that the grantor’s payment of federal and state income tax on income from an irrevocable grantor trust is not normally a taxable gift is that the law *forces* this obligation upon the grantor. If the federal grantor trust scheme had been *optional* like these new state PTE regimes, the IRS in Rev. Rul. 2004-64 would surely have concluded that payment of federal income tax for an irrevocable trust would be a taxable gift. Donative intent is not an essential element to whether there is a taxable gift.[26]

If the grantor does not control the PTE, this analysis would be much more complicated. Can the grantor recuse him or herself from the decision by a PTE to make the election? If the state so allows, perhaps, but usually the other owners or managers left would be agents or family members with no disincentive to do the grantor’s bidding.

What if the *trustee* controls the PTE? Let's modify our example above slightly, and assume the grantor's child is trustee of the IGT and owns 60% of the PTE rather than 40%. The trustee decides to opt-in to the PTE tax regime. This choice effectively involves a transfer of wealth from the trust beneficiaries back to the grantor (as discussed in the first section on extinguishing the tax burn).

If the trust instrument or state law grants the trustee the discretion to make such a payment to the grantor, it's arguably no different than any other discretionary trust distribution. But most trusts don't. And most states don't. And certain specialized trusts can't.

Entities and trusts are not subject to gift tax, of course. Treasury regulations deem any such transfer of wealth to be a gift by their owners.[27] So the child/beneficiary/trustee in our example above may arguably be making a gift to the grantor because the transfer of wealth is not subject to ascertainable standards.[28] In most cases the dollar amounts would be minimal, often under the annual exclusion, so it's unlikely that the IRS would ever pursue such PTE choices for the minimal amount of the gift tax alone. However, it's yet another potential complexity and uncertainty of these PTE tax regimes applied to IGTs that few people seem to fully appreciate.

This is a minefield that even the IRS would surely rather avoid, as we haven't even examined the various timing differences to make elections and retroactivity that will vary state by state (or year by year), or other complexities. Treasury should clarify in their proposed regulations that the decision to make or not make the PTE election cannot be a taxable gift and just continue running with the fiction that this is a normal business decision rather than a tax dodge, or at least clarify that it cannot be a taxable gift by the trust beneficiaries if the grantor reimburses the trust for the benefit conferred by the PTE payment (discussed further below).

Does the PTE Payment Regime Threaten Grantor Retained Annuity Trust (GRAT) Qualification (as well as continued estate inclusion after the term)?

Grantor retained annuity trusts (GRATs) are irrevocable grantor trusts with particular requirements. They essentially allow a "heads I win, tails I don't lose" strategy where significant wealth can be transferred if the investments in the GRAT clear the §7520 hurdle rate, but don't waste any estate/gift/GST tax exclusion if they don't. Since many people fund GRATs with PTE interests (often for longer than two years so that undiscounted interests can be distributed to pay the annuity), it is important to analyze the potential effect of these regimes.

For example, a taxpayer may gift shares of S corp stock or LLC interests worth $100 million to a Walton-style, zeroed-out GRAT, with the remainder and gift valued at only $10. But what if the PTE elected or elects into a PTE tax regime? As discussed in the above section, this would make the GRAT less economically efficient from a transfer of wealth standpoint by indirectly paying the grantor's state income tax bill.

Might the result be even worse, though? Is IRC §2702 violated by retaining a *non-qualified interest* in the gift? Does the IRS have a colorable argument that the taxpayer accidentally made a $100 million rather than $10 gift because the grantor is entitled to more than just the annuity payment? These are very expensive questions without a clear answer.

Let's start with the Code's harsh admonishment that "The value of any retained interest which is *not* a *qualified interest* shall be treated as being zero."[29] A "qualified interest" is further defined in the statute as including a fixed annuity, a unitrust, and any "noncontingent remainder if all of the other interests in the trust consist [of annuity or unitrust interests]"[30] So, if the grantor's retained interest in the trust is less than or greater than the annuity/unitrust or remainder interest, that interest would arguably not be a "qualified interest" under the statute. If the grantor's interest is not a "qualified interest", it is valued at zero. The retention of any right to state income tax payments (or the exclusion, deduction or credits they generate) for PTE payments would clearly be valued at zero by itself, but this is not where the danger lies.

The tricky question in interpreting the statute is whether, in cases when a grantor can access more than just the unitrust or annuity from the asset transferred, does a grantor have *one retained interest with several characteristics*, or *several distinct retained interests* for this purpose?

The latter interpretation, seeing the rights as *two separate* retained interests, would have a negligible effect. If the only effect is to ignore the non-qualified rights when valuing the grantor's gift, this is no big deal at all – the taxable gift in our example is still only $10.

The former interpretation, however, would be devastating. If the grantor is considered to have only one retained interest in the property transferred, consisting of the annuity or unitrust *plus* the right to state income tax payments to offset their state income tax, then this one retained interest would arguably not be "qualified", and the retained interest is valued at zero, i.e., in our example above, the gift is *$100 million*, not $10. Ouch!

The regulations permit some additional leeway for the grantor to retain additional rights, but not as much as we might hope. A GRAT trustee may be granted the power to pay the income, to the extent it is greater than the annuity, to the grantor. This event would be quite rare in ubiquitous short-term and "zeroed-out" GRATs, but would certainly occur in 99-year GRATs (if someone ever actually creates one). Regulations assure us that the potential access to income beyond the annuity amount would not figure in any calculations of the value of the qualified interest, but would at least not disqualify it:[31]

> Income in excess of the annuity amount. An annuity interest does not fail to be a qualified annuity interest merely because the trust permits income in excess of the amount required to pay the annuity amount to be paid to or for the benefit of the holder of the qualified annuity interest. Nevertheless, the right to receive the

excess income is not a qualified interest and is not taken into account in valuing the qualified annuity interest.

Some may interpret the above paragraph to mean that the grantor can retain any number of other rights (e.g., to be reimbursed federal or state income tax, pay their state income tax burden via PTE payments or even receive discretionary payments for HEMS or of up to the entire amount to terminate the trust), and the only effect would be to ignore these additional rights for valuation purposes but still consider the main annuity interest as a "qualified interest" – that all of these various rights are always viewed as *separate* retained interests. Why should the IRS care, the logical argument goes, if more can come back faster to the *grantor*, if this does not factor into valuation, since this power would not allow any more transfer of wealth to the remaindermen (at least not initially)?

That is an optimistic interpretation, and it may even be the best one and ultimately be proven correct. Some old PLRs are favorable.[32] Logic and looking to the purpose of the statute, however, is not always a sure guide to tax law interpretation, and decades old PLRs cannot be safely relied upon.

A more pessimistic view is to see the regulation quoted above as allowing the additional limited income interest as a safe harbor in which the IRS will still consider the retained interest to be qualified *in spite of* the additional rights beyond the annuity if it is limited to the above situation where income exceeds the annuity, but will consider the interest to ***not*** be qualified if retained interest rights *exceed* this safe harbor– i.e., the retained rights are considered as one retained interest and that interest is certainly not "qualified" under the statute, because it goes well beyond just an annuity or unitrust.

After all, if we could safely permit the trustee to make discretionary distributions above the annuity amount to the grantor, practitioners would be establishing GRATs in DAPT states (to ensure a completed gift) that would *always* include such a clause, to enable early termination of underwater GRATs (i.e., when the investments decline in value post-transfer) and enable infinite "do-overs" without having to wait for it to end on its own.

Most attorneys and available GRAT forms, however, do *not* include a discretionary reimbursement of income tax provision nor any provisions for other discretionary payments to the grantor, despite the general allowance of such clauses without negative impact in other irrevocable grantor trust situations blessed by Rev. Rul. 2004-64. Rev. Rul. 2004-64 did not address the application of such clauses to qualified interests in GRATs nor to other special situations like grantor-CLATs or intervivos marital trusts (discussed further below). While the IRS may ultimately permit this retention, most attorneys probably don't want to risk venturing outside of a cozy GRAT safe harbor, particularly after the IRS smack down on abusive GRATs in its scrutiny of qualified annuity interests in CCA 202152018.[33] Some practitioners may (should?) even go so far as to negate the potential application of state laws that allow grantor income tax reimbursement by statute regardless of whether the trust instrument allows it.[34]

Whether the trustee having the discretion to pay income tax beyond the annuity is safe to include in a GRAT is debatable. However, it seems foolish to risk a large taxable gift in order to eke out a few dollars of additional SALT deduction, especially when the extra payment is completely contrary to the entire point of a GRAT, which is to shift wealth to the remaindermen rather than back to the grantor, which such PTE tax payments do.

Two "solutions" come to mind to further thwart such an argument. First, it may help to make the initial gift in cash or non-PTE interests and then swap the PTE interests into it later. While this may not be a 100% certain fix in light of CCA 202152018's citing the "foot faults" of the *Atkinson* case to disqualify otherwise qualified interests in GRATs, it would make the IRS argument (which is hardly assured to start with) even harder to make. Second, it may help to

Does the Potential for PTE Payments Disqualify an Intervivos Trust from Qualifying for the Marital Deduction?

The gift tax marital deduction for a gift in trust requires that the donee spouse be given a life estate equivalent (e.g., all net income), with no other person able to receive distributions during the donee spouse's lifetime, and either the donee spouse has a general power of appointment or the donor spouse makes a QTIP election on a timely filed gift tax return.[35] If the trust owns a PTE that is electing to pay funds to the state income tax authorities to benefit the *grantor* at the expense of the spouse, does this comply with the requirements for the marital deduction? Would it matter if the spouses filed joint rather than separate income tax returns? How does it comply if there is even the *possibility* that the PTE may elect to make such payments later? Remember that even a *discretionary* power to distribute to non-spouses, even if limited to emergencies, can blow the marital deduction.[36]

Who is comfortable guaranteeing to a client that such a trust qualifies for the marital deduction if payments will ultimately go to the grantor?

This, of course, may also be a problem if a state statute provides that the trustee may reimburse a grantor's income taxes, but most of these state statutes negate their application to marital trusts, even if sometimes obliquely (Delaware recently amended their grantor trust reimbursement statute to address this).[37] But these state statutes, even if they try to protect the marital deduction, don't help prevent the PTE payments from indirectly accomplishing what a trustee of a marital trust cannot do directly.

Does the Potential for PTE Payments Disqualify a Grantor Charitable Lead Trust or Implicate Prohibitions on Self-Dealing?

Charitable Lead Trusts can be either grantor or non-grantor trusts. Many, if not most, charitable lead trusts (CLTs) are established as grantor trusts rather than non-grantor trusts (often to receive an up-front charitable income tax deduction). For very similar reasons noted above regarding intervivos marital trusts and GRATs, CLTs should not be reimbursing a grantor's income tax liability for trust income (or even permit the grantor to make swaps/substitutions, etc.).[38] A CLT should negate any power to reimburse the grantor (and override any state statute that might grant such a power), or power to cause.

The PTE's payment of state income taxes that generates a tax benefit for the grantor, however, may cause a problem even if the trust document omits a discretionary reimbursement power and waives it even if granted under state law, unless it is otherwise addressed. Not only are there the same qualification problems noted above, but even if the initial gift did not cause a problem, the later payment of state income taxes for the grantor would probably implicate prohibitions against self-dealing.[39]

Does the Potential for PTE Payments Jeopardize a Charitable Remainder Trust?

Charitable remainder trusts (CRTs) are probably safe from most of the above arguments, because they are not grantor trusts (the regulations grant an exception for the grantor/spouse's annuity or unitrust interest that would usually trigger IRC §677).[40] Or at least they shouldn't be. No one would transfer an S corporation to a CRT anyway because it would blow the S election, but people might transfer other PTEs taxed as partnerships to them – often in the hope of deferring gains on an anticipated sale.

Because they're tax-exempt entities, CRTs would usually not pay any state income tax, though apparently New Jersey does tax CRTs, but if they owned PTEs it's possible there would UBTI.[41] When and how, if at all, would making the PTE tax election benefit the CRT beneficiaries? Perhaps never. If a state allows a trustee free reign to allocate the PTE credit between a trust and its beneficiaries regardless of distributions, as some states apparently do, is it appropriate to allocate the entire credit to the individual beneficiaries? Or would this potentially be prohibited self-dealing? If the PTE is opting into a PTE tax that passes right through the CRT and benefits the grantor or the grantor's spouse instead, might this trigger the grantor trust rules outside of the safe harbor cited above and cause the CRT to be disqualified because it is now a grantor trust?[42] The additional fear, of course, is that it may be disqualified *ab initio* rather than only after a payment, as the IRS recently cited *Atkinson* for in disqualifying the GRAT in CCA 202152018, discussed in the above section on GRATs.

If it's unclear whether there would be a benefit, should a trustee of a CRT acquiesce and vote for any PTE payment (in the majority of states where the majority of ownership of the PTE controls)? Does this PTE tax payment harm the CRT only to benefit the other non-CRT owners of the PTE, or harm the charitable beneficiaries and only help the individual ones? And if those other owners are related parties, does the voting to opt-in to the PTE tax indirectly violate the rules against self-dealing that apply to CRTs? It's not clear that CRTs are completely exempt from potential issues if they own PTEs.

Non-grantor CLTs may have similar issues and questions if they own PTEs. Does the credit or exclusion offset unrelated business taxable income (UBTI) that would reduce the charitable tax deduction?

Does the Entity Paying State Income Cause a Second Class of Stock for S Corps?

S corporations may only have one class of stock – every stockholder must get the same economic rights to distribution and liquidation proceeds (though it is permitted to divide between voting and non-voting).[43] When shares (very often non-voting) of an S corporation are transferred to an IGT, and the entity makes a PTE election and pays the state income tax for the grantor, does the IGT have the same economic rights as other shareholders if the other shareholders get an indirect distribution by having their state income tax paid but the IGT receives no corresponding benefit?

Fortunately, there is at least not a problem with second class of stock issues, because an IGT is ignored as a separate taxpayer for federal income tax purposes – the only taxpayer for *income tax purposes* is the grantor. Thus, a PTE payment benefiting a grantor rather than the IGT does not cause any concerns regarding a second class of stock that would disqualify an S corporation, because they are one and the same for income tax purposes. That's not to say that the IRS may not have other "second-class of stock" arguments in some cases, but those are beyond the scope of this article.[44]

Might the Decision to Pay State PTE Tax by the Entity or Trustee Breach Fiduciary Duties if There is no Reimbursement?

LLC managers (or members if member-managed) typically owe duties of care and loyalty to the owners.[45] *Not to the deemed owner for federal income tax purposes*, but to the *actual owners* for state law purposes. In the case of the trust, the trustee is the legal owner and the trust beneficiaries are equitable owners. The *grantor* of the irrevocable trust is not an owner (at least not by virtue of their settling an irrevocable grantor trust) and would not typically be owed any duty at all, by either the LLC or the trust.

Does it violate the duty of care for the PTE to make a PTE election that benefits only certain owners and shifts some of the profits normally inuring to the trust to a non-owner (i.e., the grantor), since the funds going to pay state income taxes would otherwise have passed through to the trust? Probably not – the PTE didn't cause that problem. Besides, in many cases the trustee or investment advisor directing the trustee on the asset (who may be the grantor or a related/subordinate party) is going to agree to the PTE election, which would let the LLC and its other members off the hook.

The greater danger is probably to the trustee, or the investment advisor directing the trustee on the management of the PTE, since they typically have even greater duties to the beneficiaries than a PTE would to its owners. If the trustee does have any ability to thwart the election, or in some states, opt-out, then it would seem to be a breach of fiduciary duty to fail to protect the trust from further depletion by making a PTE election that does not benefit the beneficiaries, unless there was clear discretion to pay/reimburse taxes granted in the trust or under state statute or unless there was a provision or an obligation by the grantor to reimburse the trust.

Application to Non-Grantor Trusts that Own PTEs Paying State Income Tax

Most of the concerns noted above, such as the retained interest risk, disappear for *non-grantor* trusts, especially those established at death. At first glance, we might surmise that the non-grantor trust is its own taxpayer and should receive the benefit of whatever exclusion or credit that the state offers when a PTE it owns pays state income tax. Sounds great – at least it's a win-win for the *non-grantor* trust, right?

Unfortunately, other concerns rise up.

What happens when the trust pays the distributable net income (DNI) to the beneficiaries (assuming it is not an ESBT that is not permitted a distribution deduction and cannot pass out DNI from an S Corp to beneficiaries)?[46] Can the trust use the state exclusions or credits granted to it under the state PTE regime if it has no taxable income? Probably not. How are such exclusions or credits split between the trust and the beneficiaries, if they can be at all? Some states are flexible, but it's still not clear under many state PTE tax regimes whether this state tax credit or exclusion is transferable from the trust to the beneficiaries.[47]

This is similar to the uncertainty mentioned earlier about whether a state (especially a state that has not even passed a PTE law) will even allow their residents to claim a deduction/credit for PTE taxes paid to another state. Some do not. It's tempting to think that the Constitution must require such an offset,[48] but remember that it is the PTE that pays the tax, not the individual. Not as withholding for the owner but on behalf of the entity itself. It may not be Constitutionally required for a state to grant any exclusion or credit to its residents for tax paid to another state when the out of state tax was paid by the PTE rather than the taxpayer.

Thus, it's very possible that a beneficiary may receive *no benefit* against their state income tax. Income beneficiaries may be quite unhappy about the PTE election if their access to distributions is reduced and they're not even getting any tax benefit from it. Moreover, the trustee may also be in the unenviable position of having separate shares for beneficiaries residing in multiple different states where some beneficiaries receive a benefit from PTE tax payments and some don't, which implicates further issues of the duty of fairness owed to beneficiaries. Unless it's clear that the non-grantor trust that makes distributions can shift those state tax benefits of the PTE payment to all the beneficiaries receiving the current distributions, the trustee should probably try to opt-out (if it's even possible).

If not, it may be possible to modify the trust to become a beneficiary deemed owner trust (BDOT), if not as to all the net income, perhaps as to only the income from the PTE, if the non-tax situation would accommodate the granting of an unfettered power over the PTE's taxable income to the beneficiaries.[49] Or, if the PTE is an S corporation or willing to change status to such, the Qualified Subchapter S Trust (QSST) election essentially accomplishes the same thing.[50] QSSTs and BDOTs would not have the same retained interest concerns as other irrevocable grantor trusts because the beneficiary would not be a transferor in such cases.

Proposed Drafting Solution – Is it Really This Easy to Solve?

In light of all the above issues, it's probably preferable to simply opt-out of such PTE regimes when an IGT is an owner, but that may not be possible. Furthermore, required state income tax withholding for out-of-state residents implicates many of the same issues.

Most of the more serious problems noted herein may be drafted around by having the irrevocable grantor trust simply require the grantor to pay back the state income tax benefits that the grantor received by virtue of being deemed the owner of the PTE for income tax purposes. Such payments could be deemed to be a loan to the trust until it is paid back. Such a provision should take the situation back to the *status quo ante* – the practical effect is that, economically from a transfer tax standpoint, it is as if the PTE had never paid the state income tax for the grantor and the grantor was liable for it all along.

This would be more efficient from a gift, estate and generation skipping transfer tax standpoint, because the trust goes back to growing fully income tax-free – reigniting the grantor trust *tax burn* vis a vis the state income tax. More importantly, however, it negates the very real potential for inadvertent retained interests or indirect access to income from causing estate tax inclusion, or disqualifying GRATs, grantor-CLATs or marital trusts – it simply reverses the economic effect of the state tax payments (at least as between the grantor and grantor trust), whether the state requires the payment of PTE tax, makes it optional to the company, or even optional as to each individual owner. If there is a deemed gift through making the election because of the indirect transfer of wealth it causes, then the reimbursement is undoing that effect.

Here is a proposed paragraph to consider adding to a trust, either by itself or to supplement a paragraph permitting trustee reimbursement to the grantor for income taxes incurred on trust income. Hopefully practitioners will improve on this and the IRS would approve of such a solution in their eventual guidance:

> **Sample Clause: Grantor's State Income Tax Reimbursement for Taxes Paid by Pass-Through Entities on Behalf of the Grantor While Grantor Trust – Use at Your Own Risk**
>
> In the event that
>
> > 1) this trust is deemed to be owned by the grantor for federal income tax purposes under IRC §671 *et seq*.; and
> >
> > 2) owns pass through entity interests, such as an entity taxed as an S corporation, partnership or possibly even a single member limited liability

company taxed as a sole proprietorship for federal income tax purposes; and

3) such entity files and pays (either on behalf of the entity itself or as withholding agent on behalf of the owners) state or local income tax for the grantor or that generates a state or local tax benefit for the grantor of this trust due to the grantor's deemed ownership for federal tax purposes;

Then, the grantor shall reimburse the trust for the state or local income tax paid by said entity or entities on behalf of the grantor of the trust as a consequence of the interest in the entity or entities owned by the trust, up to the amount of the benefit received by the grantor.[51] The trustee shall inform the grantor of this amount and shall provide a copy of the pass through entity's Form K-1 and any other state or local income tax form and information regarding such state or local income taxes paid by the entity for its owners. The grantor agrees to reimburse the trustee for this amount and if the total amount due from the grantor (including all loans to the trust) exceeds $10,000, the grantor agrees to pay interest accruing at the applicable federal rate (AFR) or higher, as negotiated between the grantor and trustee."[52]

[If state law permits the trustee to reimburse a grantor's income tax in its discretion without triggering self-settled trust status (see the extensive list of hyperlinked state statutes in endnotes), and the trustee is so qualified (e.g., in many states the trustee cannot be the grantor and, in some states, cannot be a related/subordinate party) then add:]

"The trustee may also, in its sole discretion, waive or decline the right to seek such reimbursement, in whole or in part, for such state or local income taxes, as part of its overall discretionary authority to reimburse the grantor for income taxes attributable to the grantor's deemed ownership for state and federal income tax purposes."

A similar provision might be inserted as a condition of a sale (often on installment) of a PTE to an IGT.

Required state income tax withholding outside of the PTE tax regime context is also covered above. Such withholding often occurs when an S corp does business in State Y and the Shareholder lives in State Z. State Y requires the S corp to withhold x% state income tax for the non-resident shareholders and the S corp may often file a composite return for non-resident shareholders so they don't have to bother with filing a return in that state themselves. As discussed at the beginning of this newsletter, such tax withholding is different from a PTE tax for deductibility purposes under Rev. Rul. 58-25 and Notice 2020-75, because the entity is not the one liable for the tax, it is merely acting as a withholding agent. States vary in whether a PTE tax filing obviates the need for withholding/returns.

Withholding from an IGT's distribution rights to pay a state income tax on behalf of an owner presents a very similar problem for IGTs, however, because the corporation's withholding for the grantor is reducing the trust's wealth and making a payment that directly benefits the grantor - unless the grantor reimburses the trust pursuant to a clause similar to above.

How certain is something like the above clause to "work" and fix the issue? Unfortunately, nothing is completely certain. While it is likely to repair any retained interest taint, *the IRS could try to argue that a reimbursement is just another gift to the trust*. Would the IRS want to penalize a provision that simply restores the *status quo ante*? Probably not, but it would be great to have confirmation either way from the IRS. Such a reimbursement would be quite different from another new gift transfer in several ways, but it's not a simple analysis *at all*.

There is no gift when someone receives an amount equal in value in an exchange or reimburses someone for an expense paid. Starting with a simple example, if the grantor rents property at fair market value from the trust, that rental payment is not a new gift, because there is equal value received in return. If the trustee buys plane tickets for the grantor, spouse, children of a SLAT and then the grantor reimburses it for the grantor's portion, this reimbursement is not a gift, because it is in exchange for the equal payment made by the trustee.

What would the grantor receive in exchange if they pay back the trust for state tax withholding or PTE payments that the PTE made? After all, the grantor received the benefits legally, fair and square, under state statute – and no state law specifically requires the grantor to pay it back. There may or may not have been a taxable gift back to the grantor through such a payment – if there were, it would simply be returning/disclaiming that gift. But there may still be the satisfaction of a claim in *equity* of equal value. The trustee may have a colorable argument to seek reimbursement from the grantor for unjust enrichment, even in cases of mandatory state income tax withholding for out of state owners.[53]

Equitable remedies like constructive trusts, resulting trusts and unjust enrichment do not necessarily require any *wrongdoing* on the part of the defendant, they are meant to correct unfairness. Readers are undoubtedly familiar with the many cases where one person (often an ex-spouse) might *legally* be the beneficiary/owner of an asset under ERISA law, but state courts sitting in *equity* may ultimately decide that the *equitable owner* is someone else and provide a constructive trust or other equitable remedy, even if the *legal* owner was in no way "at fault".[54]

Similar reasoning applies here to create an equitable claim for reimbursement. After all, the elements of this remedy seem to be met: 1) the would-be defendant (Grantor) was enriched; 2) at the expense of the would-be plaintiff (the IGT); and 3) it was unjust, because the grantor receives a windfall at the expense of the trust when the grantor is not even an equitable owner of the asset any longer, and the trust receives less distributions or equity because of it, and usually the trustee could not have prevented the transfer or do anything about it other than seek reimbursement. Often it's the grantor that causes it. Irrevocable trusts typically have a clause whereby the settlor agrees to give up any and all rights in the property transferred (as do purchase agreements on installment sales). To keep a further benefit from it would involve the grantor reneging on that prior promise to the trustee.

A provision in the trust about the potential for reimbursement for such unjust enrichment alerts the parties to this issue. If the PTE is transferred to the IGT via sale, a provision may also be placed in the sale agreement.

Despite the cogent arguments that grantor reimbursements such as described above are just returning the benefit the grantor unjustly received and should not be further taxable gifts, this is all very untested. Not only is the transfer tax effect of the original withholding/PTE transfers uncertain, but even a reasonable attempt to *undo* the transfer of wealth is uncertain! If the IRS were to find that such a reimbursement is a taxable gift, however, it would usually be quite small and certainly the lesser of two evils. Specialized IGTs such as GRATs and CLATs that can't accept new gifts often (should?) have a clause providing that any additional transfer deemed to be a gift is not added to the existing annuity trust but is instead held as a new and separate GRAT/CLAT or incomplete gift trust. Other trusts could borrow from this concept to address that remote contingency.

The IRS promised in Notice 2020-75 to issue regulations that would be taxpayer-favorable (at least on the *above the line v. itemized deductibility* issue), effective for PTE payments made after November 9, 2020. It's mid-2023 now, and one glance at the AICPA list of compiled issues (which don't even include the issues discussed herein) leads one to conclude that it's unlikely we'll see most of *those* tax questions answered in the next couple years, much less the issues surrounding irrevocable grantor trusts discussed herein.

Conclusion – *Chicken Little* or *Cassandra*?

The issues herein are extremely easy to overlook, because the accountants working on the state income tax filings for a PTE are probably not talking to the estate planning counsel for the various owners, and estate planning attorneys are probably not talking to the accountants for the PTEs. It's the classic case of "falling through the cracks." The topic seems to have escaped the bar entirely.

No doubt some readers think my assessment of some of the risks noted herein is exaggerated. Indeed, I admit that the IRS may ultimately use its discretion to simply ignore any potential transfer tax ramifications of PTE tax regimes, and they probably don't want to analyze this complexity any more than taxpayers do.

But what if these beautiful above-the-line PTE tax deductions are just a *Trojan Horse* that stealthily lures a taxpayer into incurring more dangerous *transfer tax* problems that could destroy the entire foundation of an estate plan? If you are dealing with millions of dollars of estate, gift, and GST tax potential (which is usually the case for those establishing IGTs), do you want to take even a *small risk* of incurring millions of dollars of tax to get a relatively *miniscule* income tax deduction?

The PTE tax scheme is an extremely complex minefield of income and transfer tax issues that wealth planners would surely prefer to avoid, but may not be able to. An IGT trustee rarely controls the PTE. Sometimes the grantor doesn't either. If such payments benefitting the grantor cannot be avoided, consider whether including something like the sample clause discussed herein might avoid the potentially devastating transfer tax risks. Encourage your state bar and legislature to clarify state debtor/creditor law as suggested in the endnotes. For a large amount at stake, maybe even consider asking for private letter ruling (PLR).

Whatever you do, don't inadvertently become the guarantor for your client by overpromising or neglecting to inform them of the risks. Think twice about whether any trust, grantor or non-grantor, should opt into such PTE elections unless the risks and benefits are weighed and worst-case negative scenarios mitigated.

CITATIONS:

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[1] IRC § 164(b)(6).

[2] IRS Notice 2020-75.

[3] R.I. Gen. Laws § 44-11-2.3(a)(4).

[4] For a few examples of these state forms, here are links to Ohio and California's: https://tax.ohio.gov/static/forms/pass-through_entities/2022/pte-4738-fi.pdf; https://www.ftb.ca.gov/forms/2022/2022-3804.pdf

[5] AICPA Map: States with Enacted or Proposed Pass-Through Entity (PTE) Level Tax

Links to States' Pass-Through Entity (PTE) Tax Legislation and Tax Authorities' Information and Guidance

[6] HF 352

[7] There was curiously no discussion of the assignment of income doctrine first enunciated in *Lucas v. Earl*, 281 U.S. 111 (1930), in IRS Notice 2020-75. The doctrine does *not* directly apply, since these optional state PTE regimes are not allowing the assignment of income for *federal* income tax purposes, but only for *state* income tax purposes and the state can certainly collect their tax from either the owners or entity as they wish. But it would have been worth analyzing why the *optional* PTE regimes also come within the ambit of Rev. Rul. 58-25, since the optional nature of who pays the state tax indirectly allows for the assignment of a federal income tax *deduction* (from the owners to the PTE, where it is more valuable). The IRS could have arguably taken a different position but it's reasonable for them to have simply acquiesced on this point since, once it is paid, it is a state tax paid by the entity like any other. The question is whether the IRS will ignore the transfer tax implications of that choice when it shifts wealth between parties and permits additional back-end benefits to the grantor when an IGT is the owner. It will be years before we know what the full impact of these new PTE regimes may be, by which time we may well have a different administration (perhaps led by a President from a state such as Florida with no income tax, who may be more hostile, if not outright vengeful, to perceived "blue state" SALT deductions).

[8] The overlap of these types of payments can be confusing and will vary state to state. In some states if the PTE elects to pay PTE tax it does not have to withhold for non-resident owners and the non-resident owners do not have to file a state tax return, but in other states it may still be required.

[9] IRC §164(b)(6)(B).

[10] The majority of states that have enacted the PTE regime make it revenue neutral, but there are apparently at least two states, Connecticut and Massachusetts, that ask for a little slice of the federal tax deduction workaround pie by crediting the taxpaying owners with slightly less than what was paid in PTE tax to generate a bit more revenue. Similarly, some states may have a slightly higher PTE tax rate than top individual rates – e.g., Wisconsin. A few states actually have lower rates. Some states also have a progressive tax rate structure for individuals but use the top or at least close to the top rates for the PTE tax (e.g., CA uses 9.3%, which is less than their top

rate, but higher than if a married couple made less than their 9.3% bracket which is from $132,591 to $677,278 in 2022). However, if the deduction is fully available, it would usually be more advantageous to have the PTE pay the tax even if the overall state income tax paid is a bit more, since the federal tax would be reduced by a greater margin.

[11] *Taxpayer and Practitioner Considerations for Whether to Elect into a State Pass-Through Entity (PTE)* Tax, *AICPA, July 19, 2022*

[12] If the trust assets dramatically decline after being gifted, one might discuss with the donee trustee and/or beneficiaries to consider a qualified disclaimer that might if structured properly undo the gift altogether. See *How Donees Can Undo Taxable Gifts*, LISI Estate Planning Newsletter #2831 (October 19, 2020).

13 In particular, see *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)*. Available at SSRN: https://ssrn.com/abstract=3165592.

[14] Rev. Rul. 2004-64, 2004-2 C.B. 7.

[15] Rev. Rul. 2004-64, 2004-2 C.B. 7

[16] Generally, if the trustee has the ability to make any payments to the grantor in the trustee's discretion, it's hard to see how they are not a beneficiary. At both the common law and pursuant the Uniform Trust Code §505(a)(2), creditors can access the maximum amount that could be distributed to the settlor. The creditor access and estate inclusion issues become worse over time, since most trust documents (and the state statutes that grant such powers regardless of whether in the instrument) typically do not have any cutoff date. Thus, twenty years later a creditor of a grantor can simply add up the twenty years of accumulated state and federal income tax that is still reimbursable, which might be quite substantial, unless the state protects against this. Creditor access leads to estate inclusion. Many states have changed the common law rule, often amending their version of UTC §505, to negate this risk and protect such tax reimbursement payments from a grantor's creditors. Some protect only if the reimbursement is at the trustee's discretion rather than mandatory. Many require that the trustee not be the grantor. Most do not include protection for payments made from an LLC or S corporation. Here are hyperlinks to state statutes – it is very possible for those states listed as not having protection that there is a state statute that I simply missed – if so, I'd appreciate any correction. Also note that many of the states below may have a parallel domestic asset protection trust (DAPT) statute that, *if the trust qualifies thereunder*, would broadly protect a grantor's discretionary interest in trust, even if the more general statute would not (e.g., see Alabama, Hawai'i, Indiana, West Virginia below):

Alabama (AL Code § 19-3B-505) – version of UTC §505 contains **no protection**

Alabama DAPT: (AL Code § 19-3E-4) – its DAPT provides protection

Alaska (AK Stat. § 34.40.110(m)(2)) – protects discretionary or mandatory right

Arizona (Ariz. Rev. Stat. § 14-10505(A)(2)(a)) – protects discretionary power to reimburse or mandatory right (not just by trustees but by others as well)

Arkansas (AR Code § 28-73-505) – their version of UTC 505 has **no such protection**

California (CA Prob Code § 15304(c)) –protection for trustee discretion

Colorado (Co Code §15-5-818(5)) – protects discretionary or mandatory right

Connecticut (CT Gen Stat § 45a-499fff) – protects discretionary power of trustee

Delaware (12 Del Code § 3536(c)(2)) – protects discretionary power of trustee

District of Columbia (DC Code § 19–1305.05) – contains **no protection**

Florida (Fla Stat. § 736.0505(1)(c)) – protects discretionary power of trustee

Florida (Fla. Stat. §736.08145) – in some cases, grants the trustee the power to pay tax or reimburse even if not granted in the trust instrument.

Georgia (GA Code § 53-12-80) – contains **no protection**

Hawai'i (Haw. Rev. Stat. § 554D-505) – contains **no protection**

Hawai'i (Haw. Rev. Stat. §554G-5(c)(7)) – DAPT statute does have protection

Idaho (Idaho Code Ann. § 15-7-502(4)) – protects discretionary or mandatory right

Illinois (760 ILCS 3/505(a)(3)) – only protects discretionary power of trustee

Iowa (Iowa Code Ann. § 633A.2304) – allows trustee to reimburse settlor

Indiana (DAPT "Legacy Trust" – IC §30-4-8-13) – protects discretionary interest

Kansas (KS Stat. §58a-505) – their version of UTC §505 contains **no protection**

Kentucky (Ky. Rev. Stat. Ann. § 386B.5-020(7)(c)) – protects right to reimburse

Louisiana (LA Rev. Stat. 9:2004) – main statute contains **no protection**

Maine (18-B ME Rev Stat § 505) – does **not provide protection**

Maryland (Md. Code Ann. Estates and Trusts § 14.5-1003(a)(1)) – provides protection (though in an odd way by deeming the settlor not to be a settlor)

Massachusetts (M.G.L.A. 203E § 505(a)(2)) – protects discretionary right

Michigan (MI Comp L § 700.7506(1)(c)(2)) – curiously, protects the discretion for trustee to pay *any* taxes of the grantor, apparently not limited to income tax or even if it's a grantor trust.

Minnesota (Minn. Stat. §501C.0505) – does **not provide protection**

Mississippi (Miss. Code § 91-8-504(c)(1)) – does provide protection

Missouri (RS Mo § 456.5-505) – does **not provide protection**

Montana (M.C.A. § 72-38-505(b)) – does provide protection for discretionary

Nebraska (NE Stat. §30-3850(a)(2)(B)) – does provide protection for discretionary

Nevada (NV Rev Stat § 163.5559(1)(a)) – does provide protection

New Hampshire (NH Rev Stat § 564-B:5-505A(e)(6)) – does provide protection

New Jersey (NJ Rev Stat § 3B:31-39) – does not provide any protection

New Mexico (NM Stat § 46A-5-505) – does not provide any protection

New York (NY EPT § 7-3.1(d)) – does provide protection

North Carolina (N.C. Gen. Stat. Ann. § 36C-5-505(a)(2a)) – provides protection if discretionary

North Dakota (ND Code §59-13-05) – provides **no protection**

Ohio (Ohio R.C. §5805.06(B)(2)(c)) – protects discretionary power to pay income tax or reimburse by a person "other than the settlor", presumably an LLC.

Oklahoma (60 OK Stat § 175.25) – provides no protection

Oklahoma (60 OK Stat. § 175.92(2)) – provides no protection

Oklahoma DAPT (31 OK Stat § 10 et seq) - The Oklahoma Family Wealth Preservation Trust Act may provide protections if qualified

Oregon (ORS §130.315(1)(d)) – protects discretionary power to reimburse

Pennsylvania (20 Pa. C.S.A. § 7745(2)) – protects discretionary power

Rhode Island (RI Gen L § 18-9.2-2) (Note: this is not Rhode Island's main trust statute, if there is one, but its DAPT statute, so qualification under that req.)

South Carolina (SC Code § 62-7-505) – provides **no protection**

South Dakota (SD. Codified L. §55-1-36.1) – protects discretionary power

Tennessee (TN Code § 35-15-505(c)) – protects power to reimburse income tax

Texas (Tex. Prop. Code Ann. § 112.035) – protects if trustee is not settlor

Utah (UT Code §75-7-505) – no protection, but like some other states noted herein, Utah has a separate DAPT statute that a trust might qualify under.

Vermont (14 V.S.A. § 505) – contains **no protection**

Virginia (Va. Code Ann. § 64.2-747(a)(2)) – protects discretionary authority

Washington (RCW §6.32.250) – contains **no protection**

West Virginia (WV Code § §44D-5-505) – contains **no protection**

West Virginia DAPT: (WV Code §44D-5-503c(c)(10)) – DAPT protection

Wisconsin (WI Stat § 701.0505) – contains **no protection**

Wyoming (WY Stat § 4-10-506(c)) – protection for discretionary distribution if trustee not related/subordinate

Anyone working with their particular state bar on these issues, consider whether a clarifying amendment to the above statutes that have tried to protect standard trust reimbursement clauses would help protect your fellow state citizens and clients in the PTE context, such as the following:

> "A pass through entity owned in whole or in part by a trust that is deemed to be owned by the settlor for income tax purposes may also pay state income taxes on behalf of the entity's owners as required withholding, such as on a composite tax return, or pay state income taxes for the entity, which payment indirectly benefits its owners by creating a state income tax exclusion, deduction or credit, in this state or other jurisdictions. Such payments to state or local tax authorities for the benefit of the settlor do not make the settlor a beneficiary of the trust and do not subject the trust to the settlor's creditors, even if the settlor of the trust directly or indirectly controls the pass through entity. In addition, should the trust agreement require the settlor to reimburse the trust for such state or local taxes paid on the settlor's behalf, such reimbursement shall not be consider a transfer [or transaction] under the [applicable state Uniform Fraudulent Transfer Act or Uniform Voidable Transaction Act]"

Different states word their protection slightly differently, so this paragraph would vary considerably from state to state. The point is that, unless explicitly protected, creditors of a grantor of an irrevocable grantor trust (and perhaps a local judge) may conclude that the payment, *or even the ability* to make such payments are "amounts that can be distributed to the grantor" that the common law, restatements and UTC §505 historically provide creditors access to. Something like the above paragraph should clarify that, and further clarify the status of any reimbursements.

[17] *Estate of Wyly v. Comm.*, 69 T.C. 227 (1977), *reversed, see below citations.*

[18] *Estate of Wyly v. Comm.*, 610 F.2d 1282 (5th Cir. 1980), see also Rev. Rul. 81-221

[19] See Arizona Department of Revenue Publication 713: The Arizona Pass-Through Entity Election. While outside the topic of this article, I am skeptical whether this scheme where each owner gets to choose whether the entity pays the tax for their benefit is really an entity-level tax at all that comes within Rev. Rul. 58-25 and IRS Notice 2020-75. At least with the PTE making the choice there is the argument that the entity itself is making a business decision as opposed to the owners merely assigning their state income tax burden to the entity. That said, the IRS will probably allow it.

[20] See Arizona Department of Revenue Publication 713: The Arizona Pass-Through Entity Election: "A grantor trust that is disregarded for federal tax purposes is treated as owned by the grantor (individual taxpayer). The grantor may claim their share of the PTE tax credit."

[21] I may be simplifying here – if a partner would otherwise be subject to employment taxes too, the savings through getting a business expense deduction might be even greater.

[22] IRC §2035(a)(2).

[23] The classic Trolly Car problem, of course, subject of philosophy and ethics courses as well as episodes of *The Good Place*, involves the dilemma of someone given control of a switch and having a choice between letting a trolly continue on its path and kill multiple people, or making the conscious choice to flip the switch and divert the trolly to another track where it will only kill one person. Doing nothing leads to multiple deaths but consciously flipping the switch still causes the death of another. Like the Trolly Car problem, the grantor of an IGT may not like their the differing results from their choice in making the PTE election, unless we can build in a solution, and rescue the *Kobayashi Maru*, as this article will attempt to do in its proposed language and conclusion.

[24] IRC §2514(c)(3)(A). It may be a presently exercisable general power of appointment for state law purposes, however.

[25] Stephen Hawking is famously quoted as saying "When I hear about Schrödinger's cat, I reach for my gun." Whether this was to use it to shoot the speaker, himself, or the cat I can't say. Regardless, I'm quite sure he would also have felt this way about state PTE tax elections.

If you are not familiar with the weirdness of quantum mechanics and the thought experiment that Erwin Schrödinger discussed with Einstein, you might find the concepts easier to understand than tax law: https://en.wikipedia.org/wiki/Schr%C3%B6dinger%27s_cat

It's anyone's guess whether the IRS will solve all the implications of the PTE tax before physicists solve the riddles of quantum mechanics.

[26] Treas. Reg. §25.2511-1(g)(1).

[27] Treas. Reg. §25.2511-1(h).

[28] Treas. Reg. §25.2511-1(g)(2). Beneficiary/trustee discretionary payments or reimbursements for a grantor's income tax bill can be taxable gifts if not limited by an ascertainable standard, and I have yet to see a trust that has such a limitation or an article that discusses this. It's easy for people to overlook. This is another advantage of independent trustees.

[29] IRC §2702(a)(2)(A).

[30] IRC §2702(b).

[31] Treas. Reg. §25.2702-3(b)(iii) "Income in excess of the annuity amount. An annuity interest does not fail to be a qualified annuity interest merely because the trust permits income in excess of the amount required to pay the annuity amount to be paid to or for the benefit of the holder of the qualified annuity interest. Nevertheless, the right to receive the excess income is not a qualified interest and is not taken into account in valuing the qualified annuity interest."

[32] E.g., in PLR 9504021, the grantor of a GRAT retained the right to be reimbursed (not even in the trustee's discretion) for income taxes paid as a result of the inclusion of the GRAT income in the grantor's tax base, in addition to the annuity payment, and the IRS ruled that the grantor's retained interest was still a qualified interest under §2702(b). The PLRs addressing such clauses were issued before Rev. Rul. 2004-64 and the above PLR contains this curious sentence: "The provision in each trust requiring that the trustee make distributions to the grantor in an amount equal to the excess of the grantor's personal tax liability (assuming that the grantor is the owner of the trust) over the grantor's personal tax liability computed as if the grantor were not the owner of the trust, *relieves the grantor from paying a liability that actually belongs to the trust* (and, consequently, to the remainderman)." It's doubtful the IRS would write that italicized sentence again after Rev. Rul. 2004-64, but maybe they would still ignore other retained rights in GRATs?

[33] CCA 202152018.

[34] Because the trustee or trust protector often has the power to change situs and even applicable law, it may be prudent in drafting specialized grantor trusts (GRATs, CLATs, QPRTs, intervivos QTIP trusts, etc.) for the settlor to waive any income tax reimbursement *regardless* of whether state law would permit it, even if the trust is not initially sitused in such a state, since it can moved or a new law may be passed that does so permit reimbursement, as was recently done in Florida.

[35] IRC §2523.

[36] See, e.g., *Estate of McCabe v. United States*, 475 F.2d 1142, 201 Ct. Cl. 243 (Ct. Cl. 1973). *Estate of Bowling v. Commissioner*, 93 T.C. 286 (T.C. Aug. 31, 1989).

[37] For example, Colorado's C.R.S. §15- 5-818 provides that:

> Unless otherwise provided in the governing instrument, an independent trustee of a trust may, from time to time, in the trustee's discretion, distribute to the settlor an amount equal to any income taxes on any portion of the trust's taxable income for which the settlor is liable.
>
> A trustee shall not exercise or participate in the exercise of discretion pursuant to this section that would cause the inclusion of the trust assets in the settlor's gross taxable estate for federal estate tax purposes at the time of exercise **or in a manner inconsistent with the qualification of all or any portion of the trust for the federal gift or estate tax marital deduction, to the extent the trust is intended to qualify for such deduction**.

Can the trustee reimburse a grantor of a QPRT or GRAT or CLAT or Intervivos QTIP for income taxes? Query whether the IRS and courts will ultimately honor state savings clauses (which are becoming more common) that create self-serving reasoning of "if it has a negative federal tax effect, we didn't allow it."

Florida has similar discretionary reimbursement language attempting to carve out application if there would be a negative tax effect: Fla. Stat. 736.08145.

So does Delaware: 12 DE Code § 3344: "(b) The provisions of this section shall not apply if the application of this section would disqualify a trust for, or reduce the amount of, a marital or charitable deduction otherwise available to any person for state or federal income, gift, or estate tax purposes."

Settlors of trusts governed by Colorado, Delaware or Florida law, however, may be in a better position than those of trusts governed by New York and New Hampshire, that have not addressed the potential application of their statute to marital, charitable or other unique trusts at all:

New York Consolidated Laws, Estates, Powers and Trusts Law - EPT § 7-1.11

NH Rev Stat § 564-B:8-816(c)

Consider opting out of the automatic application of these to unique trusts.

[38] The IRS sample forms for grantor-CLATs have a provision that allows a swap power (power of substitution), but not the grantor, trustee or other disqualified person. See, Rev. Proc. 2007-45, §7, paragraph 11.

[39] IRC §4941 basically prohibits self-dealing between a CLT and disqualified persons, which to no one's surprise, includes the grantor.

[40] Treas. Reg. §1.664-1(a)(4) and examples thereunder.

[41] New Jersey Department of Taxation Memo TB-64 – Issued June 29, 2009

[42] IRC §677(a): "The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be— (1)distributed to the grantor or the grantor's spouse;***"

[43] Treas. Reg. §1.1361-1(l)(1).

[44] If an S corporation makes the PTE election and the owners live in different states and then it makes additional compensating distributions to the disadvantaged out of state shareholders to make up for the fact that resident shareholders get more (if not all) of the PTE tax benefit, this could potentially trigger that. Generally, the IRS should be concerned about whether each share receives the same gross, rather than net after tax, distribution, since taxpayers have different tax characteristics, so the fact that some shareholders may not receive a PTE credit, exclusion or deduction should not raise a concern for second class of stock. But, what if there is an additional "corrective" distribution only for certain shares?

Similarly, what happens when some shareholders (such as in AZ, CA) of an S corporation opt in and some opt out? If there are two shareholders, 50/50, and only one opts to pay $20,000 in PTE tax, *each one* gets a reduction of their taxable income passing through on the Form K-1 by $10,000. This in itself would not cause a second class of stock, but what if the company then awards the opting-in shareholder more to compensate for the windfall that the opting-out shareholder received and the reduced reduction in tax that the opting-in shareholder received? Similar issues may occur when states where various owners reside may not grant a credit or exclusion. The company should probably avoid any compensating distributions to only certain shareholders until the IRS clarifies these issues (which may be never).

[45] See, e.g., Uniform Limited Liability Company Act, §409.

[46] An ESBT can deduct state income tax, however, under IRC §641(c)(2)(C), and hopefully the state where the trust "resides" will allow a credit/exclusion for the PTE tax paid by the entity if paid to another state.

[47] For example, Connecticut allows the trustee to allocate all or a portion of its PTE credit between the trust and its beneficiaries. Connecticut Department of Revenue Services Memo OCG-7.

[48] *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. _____(2015), addressed the unconstitutionality of double taxation of out-of-state income.

[49] For a prior LISI newsletter on using partial BDOT status over specific assets for state income tax advantages, see *Ed Morrow, Jonathan Blattmachr and Marty Shenkman on Using Decanting and BDOT Provisions to Avoid a Peppercorn of Income Potentially Triggering State Income Tax on a Trust's Entire Income,* LISI Income Tax Planning Newsletter #205 (Sept 15, 2020).

[50] For a discussion of the pros/cons and differences between a QSST and a BDOT, and when a QSST beneficiary is not considered the owner for income tax purposes, e.g., sales of the stock or substantially all assets of the company, see Part II.d. of Morrow, Edwin P., *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)* (April 19, 2018). Available at SSRN: https://ssrn.com/abstract=3165592.

[51] There may be a difference in the value by which the trust loses and the value by which the grantor gains when the state takes a cut and only gives a partial exclusion/credit. According to the AICPA chart linked to in endnote #5, state tax scalpers include Connecticut, Iowa, Massachusetts, Maine (proposed), and Vermont. For reasons that will be discussed later herein around the law of restitution, the reimbursement should probably be limited to what the grantor gains.

[52] IRC §1274(d) and IRC §7872.

[53] *Restatement (Third) of Restitution* § 1:

> "A person who is unjustly enriched at the expense of another is subject to liability in restitution. Unjust enrichment exists where the defendant has received a benefit from the plaintiff and it would be inequitable for defendant to retain the benefit without compensating plaintiff for its value."

Whether it is "unjust" will depend on many factors, such as the prior consent or participation of the parties in causing the transfer. The more that the to-be plaintiff had consented or could have prevented the transfer and the less that the to-be defendant caused it, the weaker the case for restitution will be. So, it might be unjust enrichment for the grantor to keep required out-of-state state income tax withholding or to keep the benefit when they caused the payment to happen, but not necessarily "unjust" if the *trustee* voluntarily caused the PTE payment to happen. There are no cases on point to these issues that I know of.

[54] I had this exact situation over twenty years ago when in private practice. The decedent's ex-wife was the *legal* owner of the decedent's pension pursuant to ERISA law and preemption discussed in the Supreme Court case of *Egelhoff v. Egelhoff, 532 U.S. 141 (2001)* because she was still named on the plan's beneficiary designation form, but I convinced a local court (after a year of bouncing to federal court and back) that my client, the decedent's *intended* beneficiary, was the equitable owner of the proceeds *once outside of the ERISA plan* and the local court imposed a constructive trust (an equitable remedy) over the proceeds as they paid out. Justice achieved. Equitable remedies do not necessarily require any *wrongdoing* by a defendant, but they do have to have an element of unfairness and reasons to favor one party over another as the rightful recipient/owner.

When a donor/seller promises to give up all rights to property transferred to a trust, then subsequently arranges to get a back door kickback via PTE payments at the expense of the buyer/donee IGT, this smells like a classic case for an equitable remedy of restitution (reimbursement).