To Have and To Hold — Related Fiduciaries and Tax Issues

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In this installment of Yadav's column (Tax) Matters of Life and Death, she and Plum aim to break down estate and income risks and identify situations in which a related and subordinate trustee may act in a manner that allows the grantor — and their tax advisers — peace of mind.

As is perhaps implicit in the name, choosing a trustee for an irrevocable trust is a matter of trust for grantors. Often, the first question grantors ask is if they can themselves act as the trustee, or name a close relative, usually a spouse, child, parent, or sibling. Assuming naming these individuals does not cause jurisdictional issues, such as creating a foreign trust,[1] the main issue practitioners often grapple with are the estate and income tax issues that arise if a trustee is "related or subordinate"[2] to the grantor or beneficiary.

Indeed, in some circles, the fear of inadvertently causing estate inclusion of trust assets for the grantor or beneficiary or causing the trust to be treated as a grantor trust,[3] which is disregarded as separate from the grantor for income tax purposes, is so deep that practitioners may insist that all fiduciary roles must be occupied by independent parties. While it is true that an independent fiduciary is the ideal, it runs up against the practical reality that clients are reluctant to hand over control of significant assets to a third-party fiduciary whom they may have never encountered before. Other practitioners use the rule of thumb that limiting trustee decisions to an "ascertainable standard" is an effective countermeasure . . . but is that true in all cases? What about decisions such as investment decisions, which cannot be limited in this way?

This article aims to break down the estate and income risks and identify situations in which a related and subordinate trustee may act in a manner that allows the grantor — and their tax advisers — peace of mind.[4]

[1] *See, e.g.*, Treas. reg. section 301.7701-7(d) which enumerates powers that when held by a non-U.S. person cause a trust to be treated as a foreign trust.

[2] Section 672(c), which defines "related or subordinate" party as "any non-adverse party who is — (1) the grantor's spouse if living with the grantor; (2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive."

[3] *See* sections 671-679.

[4] References to trustee in this article are intended to include all fiduciary roles, even if that role is designated differently such as a power holder or protector.

I. Tax Risks to the Grantor

Transfer tax risk (estate re-inclusion) and income tax risk (grantor trust status) are usually top of mind for tax practitioners when grantors desire to either act as trustees themselves or have a "related or subordinate person" (RSP) in the role. Note, the risk to the grantor arises only if the trustee is an RSP *as to the grantor*. A trustee may be an RSP to the beneficiary and not the grantor (such as a son-in-law or daughter-in-law as trustee when the child/spouse is the beneficiary), and there, any potential risk falls to the beneficiary (see Sections II and III).

A. Estate Inclusion for the Grantor

Generally, practitioners are concerned about estate re-inclusion for the grantor by virtue of retained control over transferred assets directly (if grantor is acting as trustee) or indirectly (if an RSP is acting as trustee). The issues that have frequently caused sleepless nights for practitioners include:

i. power to make discretionary distributions to current income beneficiaries (and, relatedly, power to allocate income and corpus or accumulate trust income);
ii. power to appoint to a class of beneficiaries (which may or may not include current income beneficiaries);
iii. power to add or remove beneficiaries; and
iv. power to make investment decisions over trust assets.

Often, re-inclusion is suspected to occur under IRC sections 2036, 2038, and 2041. Below, we take each power and examine the re-inclusion risk under each of the oft-cited sections.

IRC section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

The most critical aspect of section 2036 is that it is personal to the grantor; that is, rights that are possessed by another, even if that person is an RSP, will usually not trigger an inclusion under this code section. The exception is when the grantor can remove a trustee and designate herself in the role. This is explicitly spelled out in Treas. reg. 20.2036-1(b)(3), which states that the phrase "'right . . . to designate the person or persons who shall possess or enjoy the transferred property or the income therefrom' does not" apply to a power held solely by a person other than the decedent. "But, for example, if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee."

Section 2038 provides that "the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise," in which the enjoyment thereof was subject at his death "to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate," or in which "any such power is relinquished during the three-year period ending on the date of the decedent's death." Sections 2036 and 2038 are usually applied together because their application is similar — section 2036(a)(2) applies to powers of "possession or enjoyment" of property and income and section 2038 applies to powers over "enjoyment" of the transferred property. Like section 2036, section 2038 is also personal to the grantor — that is, it is not triggered if a person other than the grantor holds the power with the exception if the grantor is able to remove a trustee and designate herself.

Importantly, section 2038 is broad and can cover the power to appoint even if that power is not otherwise a general power of appointment (discussed below under IRC section 2041).

Section 2041 addresses estate inclusion by reason of the grantor retaining a general power of appointment at death (or releasing or exercising the same during lifetime). Importantly, estate inclusion occurs only if the power is a general power of appointment[5] and only as to the power holder.[6] Therefore, if the power holder is not the grantor (even if such person is an RSP), this code section would not apply to trigger re-inclusion for the grantor.

As noted in Treas. reg. section 20.2041-1(b), powers of appointment can be interpreted broadly, the crux being the power to affect beneficial enjoyment. For example, the regulations[7] specify all the below as "powers of appointment":

- a power to amend, revoke, or terminate a trust;
- a power to appropriate or consume trust corpus; and
- a power in a donee or decedent to remove or discharge a trustee and appoint himself (but a power to appoint a successor, including self, is not a power of appointment if there is no accompanying power to remove or discharge the trustee at any time).

The same regulation explains:

> Mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, *exercisable in a fiduciary capacity*, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.[8]

Treas. reg. section 20.2041-1(c)(2) provides the key limitation that a power is not considered a general power of appointment if it is limited by an "ascertainable standard" relating to health, education, support, or maintenance. Importantly, however, reg. section 20.2041-1(b)(2) notes that "no provision of section 2041 or of sections 20.2041-1 to 20.2041-3 is to be construed as in any way limiting the application of any other section of the Internal Revenue Code or of these regulations." This means that ascertainable standard limitation only mitigates the risk of estate inclusion under section 2041 but does not affect the applicability of sections 2036 or 2038. Thus, it ends the hopeful "silver bullet" of the ascertainable standard limitation acting.

Applying these rules to the four estate re-inclusion scenarios, we can see that an appointment of an RSP may not be as problematic as widely perceived. Note that if the grantor is also a beneficiary in each of the below scenarios, there is an additional layer of estate re-inclusion risk beyond whether an RSP is acting as trustee. Therefore, for the analysis below we assume the grantor is not a beneficiary (nor can be added as a beneficiary) — but see Section IV, which discusses the issue of "self-settled" trusts and estate re-inclusion by virtue of state law application.

[5] Section 2041(a)(2) (regarding any powers created after October 21, 1942).

[6] Reg. section 20.2041-3(a)(1), limiting inclusion in the gross estate "of the power holder."

[7] Reg. section 20.2041-1(b).

[8] *Id.* (Emphasis added).

Table 1. Estate Inclusion Scenarios

Re-Inclusion Scenario	IRC Sections 2036/2038	IRC Section 2041
Power to make discretionary distributions to current income beneficiaries/power to allocate income and corpus or accumulate trust income	Power to control distributions is a power to control beneficial enjoyment, regardless of whether it is limited by an ascertainable standard. • Problematic if held by the grantor. • Not problematic if held by RSP provided the grantor cannot remove RSP and replace with self.	Not applicable unless the RSP or the grantor (that is, the powerholder) is also a beneficiary.[a]
Power to appoint to a class of beneficiaries (which may or may not include current income beneficiaries)	Power to appoint is a power to control beneficial enjoyment, regardless of whether it is limited by an ascertainable standard. • Problematic if held by the grantor. • Not problematic if held by RSP *provided the grantor cannot remove RSP and replace with self.*	Same as above
Power to add or remove beneficiaries	Power to add or remove beneficiaries is a power to control beneficial enjoyment, regardless of whether it is limited by an ascertainable standard. • Problematic if held by the grantor. • Not problematic if held by RSP *provided the grantor cannot remove RSP and replace with self.*	Same as above
Power to make investment decisions over trust assets	Depends on if power can be viewed as affecting right of beneficiaries, but there are several tax court decisions indicating it should not be regarded as a power that affects the rights of beneficiaries.[b]	Not applicable — not viewed as a power of appointment

[a] If the power holder is a beneficiary, then the power to make discretionary distributions not limited by ascertainable standard could be a general power of appointment. However, even in that case, IRC section 2041(b)(1)(C) and Treas. reg. section 20.2041-3 provide an exception when a power of appointment (created after 1942) is held by more than one person and excludes from the definition of a general power of appointment powers that are exercisable together with an individual with adverse interests or when the creator of the power and the power holder are separate and must act together.

[b] *See, e.g., P. J. Wurts Estate*, 19 TCM 544, Dec. 24, 190(M), T.C. Memo. 1960-102 (Decedent had retained the power to control the investment policy of the trust, but trust was not includible in his estate); *H. L. Johnston Estate*, 2 TCM 299, Dec. 13, 310(M). Pet. for rev. dism'd on stipulation, CA-6, June 2, 1944. (The right to assist the trustee in supervising investments and to add to corpus did not render the transfer taxable.)

B. Income Tax Inclusion for Grantor/Creation of Grantor Trust

From an income tax perspective, retained control by the grantor (or attributable to the grantor through the actions of an RSP) can cause the trust to be treated like a grantor trust and become disregarded as separate from the grantor for income tax purposes. Like the transfer tax rules that cause estate re-inclusion, the income tax rules which can trigger grantor status due to the grantor or RSP acting as trustees also hinge primarily on controlling beneficial enjoyment.

Of particular significance is if the RSP is the grantor's spouse because any power or interest held by a grantor's spouse is imputed to the grantor under section 672(e). Therefore, for purposes of the grantor trust rules, the grantor is treated as holding *any power or interest* held by any individual who was the grantor's spouse at the time of the creation of the power or interest, or any individual who became the grantor's spouse after the creation of the power or interest, but only regarding those time periods after the individual became the grantor's spouse.[9] Therefore, any exception to the application of the grantor trust rules (as discussed below) will *not* apply if the RSP holding the powers in question is the grantor's spouse.

IRC section 674 provides that a trust shall be treated as a grantor trust to the extent of that portion of the trust which is subject to a power of disposition exercisable by the grantor or a non-adverse party without the approval of any adverse party. Therefore, a blanket carveout from grantor trust status under IRC section 674 is obtaining adverse party consent. If there is adverse party consent, no additional exceptions are required, and the grantor or any other RSP can exercise that power without triggering grantor trust status.

In addition, section 674 provides the following additional exceptions which prevent grantor trust status even without adverse party consent:

- A power to distribute trust corpus if limited by a "reasonably definite standard"[10] which is the same as the "ascertainable standard" discussed above;
- A testamentary power of appointment over corpus (not income), but only if the power is solely exercisable by the grantor's will (that is, not by any other written instrument) — practitioners often consider a limited power of appointment to be a blanket exception, but the rules do not provide that to be the case for grantor trust status[11];
- A power to allocate receipts and disbursements as between corpus and income[12];
- A power to distribute income among a class of beneficiaries or pay out corpus (even if not subject to "reasonably definite standard") if exercisable by an independent trustee[13]; and
- A power to distribute income if limited by a "reasonably definite standard" by a trustee who may be an RSP but is not the grantor or the grantor's spouse living with the grantor.[14]

However, a power to add beneficiaries (other than after-born or after-adopted children) is a per se grantor power under IRC section 674 (unless done with adverse party consent).

IRC section 675(4) also provides that certain powers of administration if exercisable *in a nonfiduciary capacity* without the approval of any fiduciary can cause grantor trust status. One of the enumerated powers is the power to control the investments of trust funds. Table 2 contains a summary of these rules.

[9] It is important to note that a person who is married at the time the transfer in trust occurs is deemed to hold the powers and interests in the trust held by his or her spouse, even if the parties later divorce. PLR 9625021 (Mar. 20, 1996). Code section 672(e)'s test for marital status is applied when the trust is created. There is nothing in the law to allow a later retest if there is a change in marital status. If the transfer in trust is made after the dissolution of the marriage, then the parties are considered not married for purposes of the application of the grantor trust rules.

[10] Section 674(b)(5)(A).

[11] Section 674(b)(3).

[12] Section 674(b)(8).

[13] Section 674(c).

[14] Section 674(d).

Table 2. Grantor Trust Status Scenarios

Power Over Income/Corpus	Power Holders That Do Not Trigger Grantor Trust Status (Assuming No Adverse Party Consent)
Distributions of income *not* subject to an ascertainable standard	An independent trustee
Power to distribute corpus *not* subject to an ascertainable standard	An independent trustee
Power to distribute income subject to an ascertainable standard	Anyone other than grantor/grantor's spouse (including RSPs)[a]
Power to distribute corpus (which may or may not include distributions to current income beneficiaries) subject to an ascertainable standard	Anyone — including the grantor[b]
Power to accumulate trust income	Anyone — including the grantor[c]
Power to allocate income and corpus	Anyone — including the grantor[d]
Power to appoint to a class of beneficiaries (which may or may not include current income beneficiaries)	Per se grantor trust power under section 674 (excluded from all exceptions) unless to provide for after-born children or after-adopted children; therefore, problematic if anyone holds this power without adverse party consent
Power to add or remove beneficiaries	Per se grantor trust power under section 674 (excluded from all exceptions) unless to provide for after-born children or after-adopted children; therefore, problematic if anyone holds this power without adverse party consent
Power to make investment decisions over trust assets	Grantor/spouse or other RSP can hold power if held in fiduciary capacity; issue arises if held in nonfiduciary capacity without requiring consent of a fiduciary

[a]Section 674(d). But note estate re-inclusion risk if grantor can remove/replace the RSP.
[b]Section 674(b)(5)(A). But note, these powers may cause estate re-inclusion for the grantor.
[c]Section 674(b)(6). But note, these powers may cause estate re-inclusion for the grantor.
[d]Section 674(b)(8). But note, these powers may cause estate re-inclusion for the grantor.

II. Tax Risks to the Beneficiary (During Grantor's Lifetime)

A. Potential Income Tax Consequences to Beneficiary

If the trust in question is a grantor trust, that status is determinative and the income tax consequences lay solely with the grantor. If the trust is a non-grantor trust while the grantor is living, an RSP to the grantor can inadvertently create a grantor trust, as discussed above. However, the fiduciary appointment of an RSP to a beneficiary should not cause income tax issues with respect to that beneficiary. The only way a beneficiary might be liable for a trust's income taxes while the grantor is living would be the result of the beneficiary holding powers of withdrawal or the application of section 678,[15] both of which are outside the scope of this article.

B. Potential Estate Tax Consequences to Beneficiary

During the grantor's life, trust assets might also be included in the estate of a beneficiary if the beneficiary is deemed to have a power of appointment under section 2041.[16] As noted above, section 2041 applies to powers over

[15]IRC section 678(b) only to the extent that the grantor of the trust is not otherwise treated as the owner of that income under the other grantor trust rules of IRC sections 673-677 and 679.

[16]Estate inclusion under IRC section 2041 applies to individuals with powers over property that do not cause estate inclusion under sections 2036 and 2038, which are exclusively applicable to the grantor.

property *that do not cause estate inclusion under sections 2036 to 2038*.[17] Therefore, the powers of individuals *other than the grantor* are analyzed under section 2041. The mechanics and application of IRC section 2041 are discussed in greater detail in Section III below.

III. Tax Risks to the Beneficiary (Upon Grantor's Death)

A. Overview

After the death of the grantor, trustee appointments continue to play an important role for most clients, as the question of who they can trust after their death is arguably more daunting than while they are alive. In terms of tax risks, after the grantor's death, the trust cannot become a grantor trust by way of the choice of trustee. The only way in which the trust is disregarded for income tax purposes is if the trust was created as a section 678 trust. The choice of trustee does not affect this categorization, and if the trust was not initially formed as a section 678 trust, section 678 will not become operative because of the grantor's death.[18]

Further, pertaining to the risk of estate inclusion, the only way in which the trust assets become includable in the beneficiary's estate is when the beneficiary possesses (or is deemed to possess) a general power of appointment under section 2041.[19] The most common 2041 risk stems from a beneficiary's authority to make distributions of trust property to themselves; however, a general power of appointment can be broadly described and can be deemed to exist because of some administrative powers. For example, a power to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment that would trigger estate inclusion.[20] Also, powers to invest, to determine what is income and what is corpus, and to vote stock of a closely held family corporation, if vested in the beneficiary, may be deemed general powers of appointment for estate tax purposes.[21] It is immaterial whether these powers are granted to the beneficiary in a fiduciary capacity or not.

Notably, if a beneficiary possesses a power of appointment limited by an "ascertainable standard," that is no longer considered a general power of appointment and avoids estate inclusion. Further, if an RSP (to the beneficiary) is appointed as trustee, this does not trigger estate inclusion even if the trustee's powers are not limited by an ascertainable standard because the ascertainable standard requirement under IRC section 2041 is explicitly applicable to any power granted to beneficiaries over distributions to themselves.[22] In fact, the only circumstance under which the appointment of an RSP (to the beneficiary) would trigger estate inclusion, would be if the RSP was appointed as a replacement to a trustee that the beneficiary was authorized to remove.[23]

It is worth noting that, if there is any agreement or understanding between a beneficiary and the trustee (whether independent or an RSP) that the trustee will exercise his judgment as trustee in favor of a beneficiary or in accordance with the wishes of the beneficiary, adverse estate tax consequences may result to the beneficiary because the powers of the trustee would be considered held by the beneficiary.

B. Power to Remove and Replace Trustees

As noted above, the risk of inadvertently triggering estate inclusion because of an appointment of an RSP (to the beneficiary) is most prominent in connection with a

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[17] Treas. reg. section 20.2041-1(b)(2).

[18] The IRS's most recent ruling on the matter suggests that IRC section 678 would not become operative upon the grantor's death, but little rationale was provided, and further discussion of section 678(a) is outside of the scope of this article.

[19] Estate inclusion under IRC section 2041 applies to individuals with powers over property that do not cause estate inclusion under sections 2036 and 2038, which are exclusively applicable to the grantor.

[20] Treas. reg. section 20.2041-1(b)(1).

[21] Reg. section 20.2041-1(b)(1). This would occur if the powers were exercisable in the beneficiary's uncontrolled discretion and permit them to shift the beneficial interests in the trust property.

[22] Mason Walsh Jr., "The Irrevocable Inter Vivos Trust: Income and Estate Tax Consequences to the Donor and the Trustee," 4 *Duq. L. Rev.* 303 (1965).

[23] Rev. Rul. 95-58, 1995-2 C.B. 191.

beneficiary's power to remove and replace trustees. Treas. reg. section 20.2041-1(b)(1) provides that if, under the terms of a trust instrument, the trustee had the power to appoint the principal for the benefit of individuals including himself or herself and the decedent had the unrestricted power to discharge the trustee at any time and appoint any other person including himself or herself as trustee, the decedent is considered as having a power of appointment.[24] A safe harbor to this rule applies under Rev. Rul. 95-58 if the replaced trustee is an independent trustee (that is, not an RSP). Although this revenue ruling speaks directly to powers held by a grantor, subsequent IRS rulings have applied the same safe harbor to a beneficiary holding the power to remove and replace trustees.[25]

[24] Reg. section 20.2041-1(b)(1).

[25] PLR 199909016; PLR 9746007.

Table 3. Trustee Appointment Considerations and Consequences

Power to Distribute Income or Principal	Held by Beneficiary Directly	Held by RSP	Held by Beneficiary Trustee and Co-Trustee With Substantial Interest That Is Adverse To Beneficiary	Held by An Independent Trustee[a]
Limited by ascertainable standard	No issue	No issue	Never an issue — under an exception under IRC section 2041(b)(1)(C)[b] Many practitioners are cautious of relying on this exception without clearly applying an ascertainable standard the beneficiary-co-trustee's distribution powers because if the adverse trustee resigns, the beneficiary might step into a position that allows them to make discretionary distributions to themselves.	No issue
Not limited by ascertainable standard	Estate inclusion under section 2041	Estate inclusion under section 2041 only if the RSP is appointed via remove/replace exercisable by the beneficiary.		

[a] Rev. Rul. 76-368, 1976-2 C.B. 271; It is important to note that the appointment of an independent trustee as a co-trustee does not negate the requirement that any power held by a beneficiary to appoint trust property to himself or herself must still be limited by an ascertainable standard.

[b] This exception applies to either an individual with a substantial interest in the property that is averse to the exercise of the power in favor of the beneficiary or to a co-trustee who is the grantor. The practical result of this would most often be that another beneficiary would have to be appointed as trustee, which can cause other nontax complications regarding inter-family disputes about distribution amounts. In the absence of other alternatives, many clients would prefer to appoint a beneficiary as sole trustee (subject to an ascertainable standard) than risk conflict between beneficiaries.

IV. State Tax/Creditor Protection

State tax treatment of a trust will follow federal tax rules. Therefore, if one has estate re-inclusion and the grantor dies while the resident of a state that has a state estate tax, both state and federal estate tax consequences will be triggered. Further, if one inadvertently creates a grantor trust, the grantor's state of residence will tax the grantor on all trust income in accordance with that state's income tax rules.[26]

Creditor protection is another important component of irrevocable trust drafting, and the powers granted to a grantor, or a beneficiary, can pose risks in that regard.

It is likely common knowledge to the reader that the creditors of the grantor of a revocable trust can reach the assets, whereas creditors generally cannot reach the assets of the grantor's *irrevocable* trust. Specifically, absent a fraudulent transfer of property into the trust (that is, a finding that an irrevocable trust was established for the purpose of shielding assets from expected legal action) a creditor's claim to assets held in an irrevocable trust is generally limited by the terms of the trust documents. In California, for example, Probate Code section 15300 provides that if a beneficiary's interest principal is not subject to voluntary or involuntary transfer, that interest is not subject to enforcement of a money judgment until distributed to the beneficiary.

However, creditor protection fails to protect a trust beneficiary if the beneficiary has access or the right to access the trust's assets, for example, a withdrawal right or a demand right (which can both be viewed as powers of appointment). These powers, if held by the beneficiary, allow the creditors to also access the trust's assets to the same extent. Therefore, from a state law creditor protection perspective, retention of powers affecting beneficial enjoyment can create adverse effects other than for tax purposes.

Also, existing law ensures that a grantor cannot use a trust to guard assets from creditors by providing that if the grantor is a beneficiary of the trust and the grantor's interest is subject to a provision restraining the voluntary or involuntary transfer of the grantor's interest, that restraint is invalid against creditors of the grantor.[27] Also, under Cal. Prob. Code section 15304(b), if the grantor is a beneficiary and the trust provides that the trustee must pay income or principal, or both, for the education or support of a beneficiary or gives the trustee discretion to determine the amount of income or principal, or both, to be paid to or for the benefit of the grantor, a creditor of the grantor may reach the full amount that the trustee could pay to or for the benefit of the grantor under the provisions of the trust.

These rules are particularly important in the context of income tax reimbursement for grantors (in case of grantor trusts). If a grantor holds the power to appoint trust assets to himself for tax reimbursement, that would generally cause re-inclusion under section 2036(a)(1), but if the power is held by an independent trustee, based on the analysis under Section II of this article, one would not expect any issues with re-inclusion. However, the interplay of state creditor laws can potentially change this analysis. Specifically, the issue arises if state laws allow the grantor's creditors to reach the trust assets.

In Rev. Rul. 2004-64, C.B. 7 the IRS addressed this issue, and opined if an independent trustee had discretion to distribute trust assets to the settlor to reimburse the settlor for payment of income taxes attributable to the trust that discretionary power alone (as opposed to a mandatory distribution requirement) would not result in inclusion in the decedent's estate tax under section 2036(a). However, the IRS provided that the result would likely be different if the applicable state law subjected the trust assets to any claims of the settlor's creditors.

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[26] Every state addresses the taxation of non-grantor trusts differently. Regardless of the situs chosen, some states will apply their income taxes to trusts that have a trustee or beneficiary residing in that state, and others will apply taxes based on the situs of a trust's assets. Fiduciary appointments and asset selection should always be made with this in mind. Further, source of income is important to consider. Income sourced from high-income tax states (such as California or New York) is taxable regardless of the situs of the trust.

[27] Cal. Prob. Code section 15304(a).

In California, for example, if the reimbursement right causes the grantor to be considered a "beneficiary" of the trust, the application of Cal. Prob. Code section 15304(a) can cause the grantor's creditors to reach that portion of a trust's assets with respect to which the grantor is a beneficiary and cause estate re-inclusion with respect to that share of trust assets. *Estate of Paxton*[28] discussed this issue at length in the context of a Washington state self-settled trust and held that the application of state law, which allowed creditors to reach the entire amount that could be distributed to the grantor/beneficiary, caused estate re-inclusion as to the entire trust assets.

V. Conclusion

We hope this article has given readers some sense of relief. It is undeniable that the appointment of an independent trustee makes things simpler for income and estate tax planning both during the grantor's life and after. However, as practitioners are keenly aware, that is not always the preferred route, and as discussed above, it is not quite as necessary as many might think. Not only can an RSP hold many powers over a trust's income and corpus without triggering income or estate tax consequences, but a fiduciary's status as an RSP (to the grantor or the beneficiary) is not in itself what causes the need for an ascertainable standard to be applied, which is often how many practitioners tend to draft. ■

[28] *Estate of Paxton v. Commissioner of Internal Revenue*, 86 T.C. 785 (1986).