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## Section 2036.—Transfers With Retained Life Estate

*26 CFR 20.2036-1: Transfers with retained life estate.*

What are the gift tax consequences if the grantor of a trust with respect to which the grantor is treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (subpart E), pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, and what are the estate tax consequences if, pursuant to the governing instrument or applicable local law, the grantor may or must be reimbursed by the trust for that income tax? See Rev. Rul. 2004-64, page 7.

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## Section 2501.—Imposition of Tax

What are the gift tax consequences if the grantor of a trust with respect to which the grantor is treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (subpart E), pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, and what are the estate tax consequences if, pursuant to the governing instrument or applicable local law, the grantor may or must be reimbursed by the trust for that income tax? See Rev. Rul. 2004-64, page 7.

## Section 2511.—Transfers in General

*26 CFR 25.2511-1: Transfers in general. (Also §§ 671, 2036, 2501, 2512; 20.2036-1, 25.2511-2.)*

**Tax reimbursement clause.** This ruling addresses issues presented with respect to a trust whose grantor is treated as its owner. It addresses the gift tax consequences when the grantor pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income. It also addresses the estate tax consequences if, pursuant to the governing instrument or applicable local law, the grantor may or must be reimbursed by the trust for that income tax.

## Rev. Rul. 2004-64

### ISSUES

With respect to a trust whose grantor is treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (subpart E), what are the gift tax consequences when the grantor pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, and what are the estate tax consequences if, pursuant to the governing instrument or applicable local law, the grantor may or must be reimbursed by the trust for that income tax?

### FACTS

In Year 1, A, a United States citizen, establishes and funds Trust, an irrevocable inter vivos trust, for the benefit of A's descendants. The governing instrument of Trust requires that the trustee be a person not related or subordinate to A within the meaning of § 672(c) of the Internal Revenue Code. A appoints a trustee that satisfies this requirement. Trust is governed by the laws of State. Under the terms of Trust, A retains no beneficial interest in or power over Trust income or corpus that would cause the transfer to Trust to constitute an incomplete gift for federal gift tax purposes, or that would cause Trust corpus to be included in A's gross estate for federal estate tax purposes on A's death. However, A retains sufficient powers with respect to Trust so that A is treated as the owner of Trust under subpart E.

During Year 1, Trust receives taxable income of \$10x. Pursuant to § 671, A includes the \$10x in A's taxable income. As a result, A's personal income tax liability for Year 1 increases by \$2.5x. A dies in Year 3. As of the date of A's death, the fair market value of Trust's assets is \$150x.

*Situation 1:* Neither State law nor the governing instrument of Trust contains any provision requiring or permitting the trustee to distribute to A amounts sufficient to satisfy A's income tax liability attributable to the inclusion of Trust's income in A's taxable income. Accordingly, A pays

the additional \$2.5x liability from A's own funds.

*Situation 2:* The governing instrument of Trust provides that if A is treated as the owner of any portion of Trust pursuant to the provisions of subpart E for any taxable year, the trustee shall distribute to A for the taxable year, income or principal sufficient to satisfy A's personal income tax liability attributable to the inclusion of all or part of Trust's income in A's taxable income. Accordingly, the trustee distributes \$2.5x to A to reimburse A for the \$2.5x income tax liability.

*Situation 3:* The governing instrument of Trust provides that if A is treated as the owner of any portion of Trust pursuant to the provisions of subpart E for any taxable year, the trustee may, in the trustee's discretion, distribute to A for the taxable year, income or principal sufficient to satisfy A's personal income tax liability attributable to the inclusion of all or part of Trust's income in A's taxable income. Pursuant to the exercise of the trustee's discretionary power, the trustee distributes \$2.5x to A to reimburse A for the \$2.5x income tax liability.

## LAW AND ANALYSIS

Under § 671, if the grantor of a trust is treated as the owner of any portion of the trust under subpart E, those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust must be included in computing the taxable income of the grantor.

Section 2501 imposes a tax on the transfer of property by gift by an individual, resident or nonresident. Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(b) provides that the gift tax applies only to the extent that property is transferred for less than an adequate and full consideration in money or money's worth.

Section 25.2511-2(b) of the Gift Tax Regulations provides that a gift is complete and subject to gift tax to the extent the donor has so parted with dominion and control as to leave in the donor no power to change the disposition of the property,

whether for the benefit of the donor, or any other person.

Section 25.2511-1(c)(1) provides that the gift tax applies with respect to any transaction in which an interest in property is gratuitously passed or conferred on another regardless of the means or device employed. Thus, the gift tax may apply if one party forgives or fails to collect on the indebtedness of another. Section 25.2511-1(a); *Estate of Lang v. Commissioner*, 64 T.C. 404 (1975), *aff'd*, 613 F.2d 770 (9<sup>th</sup> Cir. 1980); Rev. Rul. 81-264, 1981-2 C.B. 185. Similarly, the gift tax applies if one person gratuitously pays the tax liability of another. *Doerr v. United States*, 819 F.2d 162 (7<sup>th</sup> Cir. 1987) (donor's payment of the donee's state gift tax liability constitutes an additional gift to the donee).

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

Section 20.2036-1(b)(2) of the Estate Tax Regulations provides that the use, possession, right to income, or other enjoyment of transferred property is treated as having been retained by the decedent to the extent that the transferred property is to be applied towards the discharge of a legal obligation of the decedent. *Estate of Prudowsky v. Commissioner*, 55 T.C. 890 (1971), *aff'd*, 465 F.2d 62 (7<sup>th</sup> Cir. 1972) (property held under the state Uniform Gifts to Minors Act was included in the decedent's gross estate under § 2036(a)(1) because decedent, as custodian, retained the power to use the property to satisfy the decedent's legal obligation to support the minor for whose benefit the custodianship was established); *Richards v. Commissioner*, T.C.M. 1965-263, *aff'd*, 375 F.2d 997 (10<sup>th</sup> Cir. 1967) (trust corpus includible in decedent's gross estate under § 2036(a)(1) because mandatory distributions of trust income to the decedent's spouse satisfied the decedent's spousal

support obligation). On the other hand, § 2036 generally does not apply when trust property may be used to satisfy the decedent's legal obligations only in the discretion of the trustee, whether or not the discretion is exercised by the trustee. *Commissioner v. Estate of Douglas*, 143 F.2d 961 (3d Cir. 1944), *acq.* 1944 C.B. 7; *Estate of Mitchell v. Commissioner*, 55 T.C. 576 (1970), *acq.* 1971-2 C.B. 3.

In the present situations, Trust includes provisions that cause A to be treated as the owner of Trust under subpart E and, as a result, to be liable for any income tax attributable to Trust's income. Thus, even though A is not a Trust beneficiary, any income tax A pays that is attributable to Trust's income is paid in discharge of A's own liability, imposed on A by § 671.

In *Situation 1*, A's payment of the \$2.5x income tax liability does not constitute a gift by A to Trust's beneficiaries for federal gift tax purposes because A, not Trust, is liable for the taxes. In contrast, in the situation presented in *Doerr v. United States*, cited above, the donor's payment was for the donee's tax liability and, as a result, the payment constituted an additional gift to the donee. In addition, no portion of Trust is includible in A's gross estate for federal estate tax purposes under § 2036, because A has not retained the right to have trust property expended in discharge of A's legal obligation.

In *Situation 2*, the governing instrument of Trust requires the trustee to reimburse A from Trust's assets for the amount of income tax A pays that is attributable to Trust's income. A's payment of the \$2.5x income tax liability does not constitute a gift by A, because A is liable for the tax. The trustee's distribution of \$2.5x to A as reimbursement for the income tax payment by A is not a gift by the trust beneficiaries to A, because the distribution from Trust is mandated by the terms of the trust instrument.

However, A has retained the right to have trust property expended in discharge of A's legal obligation. A's retained right to receive reimbursement attributable to Trust's income causes the full value of Trust's assets at A's death (\$150x) to be included in A's gross estate under § 2036(a)(1). The result would be the same if, under applicable state law, the trustee must, unless the governing instrument provides otherwise, reimburse A for

A's personal income tax liability attributable to the inclusion of all or part of the Trust's income in A's taxable income, and the governing instrument does not provide otherwise.

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

the trustee regarding the trustee's exercise of this discretion; a power retained by A to remove the trustee and name A as successor trustee; or applicable local law subjecting the trust assets to the claims of A's creditors) may cause inclusion of Trust's assets in A's gross estate for federal estate tax purposes.

## HOLDINGS

When the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries. If, pursuant to the trust's governing instrument or applicable local law, the grantor must be reimbursed by the trust for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets is includible in the grantor's gross estate under § 2036(a)(1). If, however, the trust's governing instrument or applicable local law gives 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) will not cause the value of the trust's assets to be includible in the grantor's gross estate.

## PROSPECTIVE APPLICATION

The Internal Revenue Service will not apply the estate tax holding in *Situation 2* of this revenue ruling adversely to a grantor's estate with respect to any trust created before October 4, 2004.

## DRAFTING INFORMATION

The principal author of this revenue ruling is Elizabeth Madigan of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Ms. Madigan at (202) 622-3090 (not a toll-free call).

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## Section 2512.—Valuation of Gifts

What are the gift tax consequences if the grantor of a trust with respect to which the grantor is treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (subpart E), pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, and what are the estate tax consequences if, pursuant to the governing instrument or applicable local law, the grantor may or must be reimbursed by the trust for that income tax? See Rev. Rul. 2004-64, page 7.

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