SENATE JUDICIARY COMMITTEE
Senator Thomas Umberg, Chair
2021-2022 Regular Session

AB 1866 (Chen)
Version: February 8, 2022
Hearing Date: May 31, 2022
Fiscal: No
Urgency: No
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SUBJECT

Irrevocable trusts: limitations

DIGEST

This bill provides that a settlor is not considered to be a beneficiary of an irrevocable trust created by the settlor solely by reason of a discretionary authority vested in the trustee to pay directly or reimburse the settlor for any federal or state income tax on trust income or principal that is payable by the settlor, and that a transferee or creditor of the settlor is not be entitled to reach any amount solely by a reason of that discretionary authority vested in the trustee.

EXECUTIVE SUMMARY

A trust is a means for property to be managed on behalf of, and distributed to, specified beneficiaries in accordance with the wishes of the trust's creator, or "settlor" without going through probate. A revocable trust may be revoked or changed without the consent of the beneficiaries or a court, whereas an irrevocable trust prohibits the settlor from revoking or changing the trust without the consent of the beneficiaries of the trust or the court. Wealthy individuals sometimes use irrevocable trusts as an estate planning tool by transferring property into an irrevocable trust where the settlor is not the beneficiary. Under federal law, this transfer is seen as a gift to the beneficiaries of the irrevocable trust; however, the settlor is still responsible for income taxes on the property transferred. The IRS has held that an irrevocable trust that grants a trustee discretion to reimburse a settlor from trust property for taxes owed on trust property will not have the trust property included under the gross estate of the settlor upon their death, but only if certain caveats are met, such as that state law does not allow the settlor's creditors to reach those trust assets solely by virtue of that discretion vested in the trustee. This bill seeks to ensure California law satisfies that caveat related to creditors reaching trust assets.

The bill is sponsored by the Trusts and Estates Section of the California Lawyers Association. There is no known support or opposition.

PROPOSED CHANGES TO THE LAW

Existing law:

1) Regulates the creation, modification, and termination of trusts, the administration of trusts by trustees on behalf of beneficiaries, and provides for the rights and responsibilities of all parties to a trust, i.e., the settlor (the creator of the trust), trustee, beneficiary, heir, and a third party, such as a creditor. (Prob. Code § 15000 et seq.[1])

2) Provides that, unless a trust is expressly made irrevocable by the trust instrument, the trust is revocable by the settlor. (§ 15400.)

3) Prohibits, except as otherwise provided, transfer of a beneficiary's interest in income under the trust if the trust instrument provides that a beneficiary's interest income is not subject to voluntary or involuntary transfer, and provides that the beneficiary's interest in income is not subject to enforcement of a money judgment until paid to the beneficiary. (§ 15300.)

4) Prohibits, except as otherwise provided, transfer of a beneficiary's interest in principal under the trust if the trust instrument provides that a beneficiary's interest principal is not subject to voluntary or involuntary transfer, and provides that the beneficiary's interest in principal is not subject to enforcement of a money judgment until paid to the beneficiary. (§ 15300.)

5) Provides that if the settlor of a trust is a beneficiary of that trust and the settlor's interest is subject to a provision restraining the voluntary or involuntary transfer of the settlor's interest, the restraint is invalid against transferees or creditors of the settlor. Provides that the invalidity against transfers does not affect the validity of the trust. (§ 15304 (a).)

6) Provides that if the settlor is the beneficiary of a trust created by the settlor and the trust instrument provides that the trustee must pay income or principal, or both, for the education or support of the 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 settlor, a transferee or creditor of the settlor may reach the maximum amount that the trustee could pay to or for the benefit of the settlor under the trust instrument, not exceeding the amount of the settlor's proportionate contribution to the trust. (§ 15304 (b).)

7) Authorizes the court, notwithstanding a restraint on transfer of the beneficiary's interest in the trust and subject to specified limitations, to make an order directing

[1] All further statutory references are to the Probate Code unless stated otherwise.

the trustee to satisfy all or part of the judgment out of the payments to which the beneficiary is entitled under the trust instrument or that the trustee, in the exercise of the trustee's discretion, has determined or determines in the future to pay to the beneficiary upon a judgment creditor's petition under Section 709.010 of the Code of Civil Procedure. (§ 15306.5.)

This bill:

1) Provides that a settlor is not considered to be a beneficiary of an irrevocable trust created by the settlor solely by reason of a discretionary authority vested in the trustee to pay directly or reimburse the settlor for any federal or state income tax on trust income or principal that is payable by the settlor.

2) Provides that a transferee or creditor of the settlor is not entitled to reach any amount solely by a reason of that discretionary authority vested in the trustee in 1).

COMMENTS

1. Stated need for the bill

The author writes:

> This bill would modernize existing trust law to be in line with other states and incentivize people to continue to have their trust governed by California law. This bill would clarify that if the settlor's sole beneficial interest in a trust is a discretionary right to be reimbursed for income taxes payable by the settlor on the income or principal of the trust that interest, alone, will not subject the assets of the trust to claims of the settlor's creditors.
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> This bill would incentivize settlors to establish irrevocable trusts with California trustees and subject to California law, when they might otherwise look to a different jurisdiction to enjoy this benefit. This would put California creditors and beneficiaries in a better position to exercise their rights with regard to the settlor and the trust. This would increase California tax revenue by encouraging California taxpayer settlors to set up grantor trusts when they might otherwise use non-grantor trusts outside of California to avoid having non-reimbursable tax liability for trust income. Lastly, this would benefit California's fiduciary business due to an increased number of California irrevocable grantor trusts. Similar laws have been enacted in numerous other states, including New York, New Hampshire, Delaware, Virginia, Idaho, and Florida.

2. Background

a. Trusts used as an estate planning tool

As part of estate planning, a person may create a trust into which the person transfers specified property. Trusts are commonly used to avoid probate of the person's estate upon the person's death and may provide certain tax advantages relative to the property. A trust is a means for property to be managed on behalf of, and distributed to, specified beneficiaries in accordance with the wishes of the trust's creator, or "settlor". The settlor typically transfers property into the trust, designates beneficiaries, and establishes guidelines for the management and distribution of the trust assets by a trustee, who has a legal obligation to implement the settlor's intent and make reasonable decisions with regard to the trust property. There are two types of trust estate plans; a testamentary trust, which is written into a will and becomes effective upon death, and a living or inter vivos trust, which is created in a separate document. There are two types of inter vivos trusts, revocable and irrevocable. Unlike a revocable trust, an irrevocable trust generally does not permit the settlor to revoke, alter, or amend the trust without the consent of the beneficiaries of the trust.

b. Trusts cannot be used to protect assets from creditors

Generally, if a trust beneficiary can access or has the right to access the trust's assets then so do the beneficiary's creditors, even if the settlor is the beneficiary. Existing law ensures that a settlor cannot use a trust to guard assets from creditors by providing that if the settlor is a beneficiary of the trust and the settlor's interest is subject to a provision restraining the voluntary or involuntary transfer of the settlor's interest, that restraint is invalid against transferees or creditors of the settlor. (§ 15304 (a).) Furthermore, if the settlor 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 settlor, a transferee or creditor of the settlor may reach the full amount that the trustee could pay to or for the benefit of the settlor under the provisions of the trust. (Section 15304 (b).) Existing law also authorizes a court to make an order directing a trustee to satisfy all or part of a judgment out of the payments to which a beneficiary is entitled under a trust or that the trustee, in their discretion, determines to pay to the beneficiary upon a petition of a judgment creditor of a beneficiary. (§ 15306.5.)

c. Federal tax law and trusts

Under federal tax law, the value of a deceased person's gross estate includes the value of all property that the decedent has transferred, by trust or otherwise, under which the decedent retains for life or any period not ascertainable without reference to the decedent's death, or for any period which does not in fact end before death of the decedent: (1) the possession or enjoyment of, or the right to the income from, the transferred property; or (2) the right, either alone or in conjunction with any person, to designate who will possess or enjoy the property or income therefrom. (26 U.S.C. § 2036(a).) Essentially, if property is transferred by a settlor to a trust and the settlor retains any rights to the property it is included in the decedent's estate at the time of death and subject to taxation.

In 2004, the IRS addressed whether the ability to reimburse a settlor for income taxes paid on behalf of the trust would result in inclusion in the decedent's estate tax under Section 2036(a). In Revenue Ruling 2004-64, the IRS opined that if the terms of the trust or state law required the trustee to reimburse the settlor of the trust for income taxes, then all of the assets of that trust would be included in the deceased settlor's gross estate and subject to taxation because the settlor retained the right for trust property to be used to pay the settlor's legal obligation in regards to income taxes on behalf of the trust.[2]

The IRS stated that if a 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 would not result in inclusion in the decedent's estate tax under Section 2036(a).[3] However, the IRS provided that there were three caveats: (1) that no pre-existing arrangement or understanding between the settlor and trustee regarding the trustee's exercise of such discretion exists; (2) the settlor does not retain the power to remove the trustee and name themselves as successor trustee; and (3) applicable state law does not subject the trust assets to any claims of the settlor's creditors.[4]

According to the author and sponsor of the bill, under the IRS Revenue Ruling a California settlor could possibly be subject to estate tax inclusion under Section 2036 even if: (1) tax reimbursement to the settlor is discretionary by the trustee; (2) the trust does not grant the settlor the power to remove the trustee and appoint themselves as sole trustee; and (3) no implied agreement exists between the trustee and the settlor that the trustee would reimburse the settlor for income taxes because state law subjects trust assets to claims of the settlor's creditors under Section 15304. The author and sponsor do acknowledge that they are not aware of any case law confirming this possibility, but posit that this ambiguity under state law often leads to Californians seeking to establish an irrevocable grantor trust to establish the trust in another state that allows for discretionary tax reimbursement powers. In response to the IRS Revenue Ruling, several states passed laws providing that a creditor of a settlor cannot satisfy a debt of the settlor from trust property solely because of the existence of discretionary trustee power to reimburse the settlor for income taxes or because a distribution was made to the settlor under that discretionary authority. These states include Florida (Fla. Stat.

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[2] IRS Revenue Ruling 2004-66 (June 1, 2004), available at https://www.irs.gov/irb/2004-27_IRB#RR-2004-64 (as of May 19, 2022).
[3] *Ibid.*
[4] *Ibid.*

Section 736.08145), New York (NYCLS, Estates, Powers and Trust Law Section 10-6.6 (s)(10)), and Virginia (Va. Code section 64.2-747).

In order to address this potential ambiguity under state law, the bill provides that a settlor is not considered a beneficiary of an irrevocable trust created by the settlor solely because of discretionary authority granted in the trustee to pay directly or reimburse the settlor for any federal or state income tax on trust income or principal that is payable by the settlor. Additionally, the bill specifies that a transferee or creditor of the settlor is not entitled to reach any amount of the trust solely by reason of that discretionary authority vested in the trustee.

3. Statements in support

The sponsor of the bill, the Trusts and Estates Section of the California Lawyers Association, writes:

> […] Irrevocable grantor trusts are a commonly used tool in estate planning. AB 1866 modernizes existing trust law and will incentivize people to continue to have their trust governed by California law, while not diminishing the rights of creditors. Specifically, the bill clarifies that if the settlor's sole beneficial interest in a trust is a discretionary right to be reimbursed for income taxes payable by the settlor on the income or principal of the trust then that interest, alone, will not subject the assets of the trust to claims of the settlor's creditors. […]
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> AB 1866 will incentivize settlors to establish irrevocable trusts with California trustees and subject to California law, when they might otherwise look to a different jurisdiction to enjoy this benefit. This will put California creditors and beneficiaries in a better position to exercise their rights with regard to the settlor and the trust; increase California tax revenue by encouraging California taxpayer settlors to set up grantor trusts when they might otherwise use non-grantor trusts outside of California to avoid having non-reimbursable tax liability for trust income; and benefit California fiduciary business due to an increased number of California irrevocable grantor trusts.

SUPPORT

Trusts and Estates Section of the California Lawyers Association (sponsor)

OPPOSITION

None known

RELATED LEGISLATION

Pending Legislation: None known.

Prior Legislation: None known.

PRIOR VOTES:

Assembly Floor (Ayes 72, Noes 0)
Assembly Judiciary Committee (Ayes 10, Noes 0)

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