Tax Reimbursement from a Grantor Trust and Future Trust Modifications

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Take-Away: One wonders if there will be more deemed taxable gifts when irrevocable trusts are modified considering the IRS's recent Chief Counsel Advisory.

Background: There has been a furor over the past two months with the IRS's Chief Counsel Advisory (CCA) 202352018 that found an implied gift by a trust beneficiary who consents to the trust being modified to give the trustee the discretion to reimburse the trust settlor for the settlor's income tax liability associated with a grantor trust. While previous 'missives' have been written on this surprising CCA, I have been asked to dig a bit deeper into the risk of adding, later, an income tax reimbursement provision to a grantor trust, or modifying an irrevocable trust. For example, a spousal lifetime access trust (SLAT) might need to be modified where such a reimbursement clause might be considered when the settlor/spouse is running out of assets as a result of the 'grantor-trust-*burn*' and he/she may not have sufficient assets readily available to either pay the taxes, or make a large gift to the trust in exchange for the addition of a tax reimbursement clause to the SLAT.

CCA 202352018: The IRS takes the position in CCA 202352018 (November 28, 2023) that the right to be reimbursed has a value, and that any trust beneficiary who could have prevented the right to reimbursement from being created after the trust was established has made a taxable gift to the settlor equal to that trust beneficiary's share of the trust assets, multiplied by a percentage that would reflect a lower expectation of overall value to be received by the trust beneficiary.

Revenue Ruling 2004-64: The IRS initially addressed grantor tax reimbursement clauses in Revenue Ruling 2004-64. In this Revenue Ruling the IRS identified three different situations regarding the reimbursement of income taxes associated with a grantor trust.

(1) No Reimbursement Provision or Payment: Neither state law nor the trust instrument contained a provision that required or permitted the trustee to reimburse the settlor for the income taxes paid by reason of the grantor trust status. *The IRS ruled that the payment of income taxes would not constitute a gift by the settlor to the trust to the trust beneficiaries because under the grantor trust rules, the settlor is liable for the taxes and not the trust.*

(2) Reimbursement Required: The trust instrument explicitly provided that the trustee would be required to make a distribution to reimburse the settlor for his/her share of income attributable to the trust's income. *The IRS held that because the trustee was required to reimburse the settlor, the settlor retained an interest in the trust per IRC 2036(a)(1) which causes an inclusion of the entire trust value in the settlor's gross estate. This part of the IRS's ruling applies to all trusts that were formed after October 4, 2004, but not to irrevocable trusts formed prior to that date.*

(3) Reimbursement Was Discretionary: The trust instrument provided that the trustee may, in the trustee's sole discretion, reimburse the settlor for the settlor's share of the income taxes on the trust's income. *With respect to this situation, the IRS ruled that where the trustee had the discretion to reimburse the settlor for the settlor's income taxes attributable to the grantor trust's income does not result in estate tax inclusion, so long as there was not an understanding or preexisting arrangement between the settlor and the trustee with regard to the trustee's exercise of the discretion to reimburse the settlor, and state law would not subject the trust asset to the claims of the settlor's creditors by reason of such discretionary reimbursement provisions.*

IRC 2036(a)(1): Since issuing Revenue Ruling 2004-64 the IRS has not spent much time criticizing income tax reimbursement clauses in grantor trusts, though such clauses may be viewed as a form of 'retained benefit' that would seem to cause inclusion in the settlor's gross estate under IRC 2036(a)(1), particularly if the reimbursement occurs regularly, and more so if the reimbursement occurs shortly after the trust is established, since those facts could be evidence of a preexisting understanding that the settlor would receive such reimbursement. This estate inclusion would probably be based upon the portion of the income that is reimbursed.

Example: The settlor, Dan, is in the 37% marginal federal income tax bracket. Dan may receive an amount equal to 37% of the trust income as reimbursement by the trustee from Dan's grantor trust, which was established for Dan's son, Sam. Thus, only 37% of the trust assets would be subject to federal estate tax on Dan's death under IRC 2036(a)(1). While the trustee going to probate court to add a tax reimbursement clause to Dan's grantor trust could cause the IRS to conclude that Dan had assumed by implied agreement that there would be reimbursement when needed, the IRS has not asserted that position. Rather, the IRS in the CCA concluded that the right to be reimbursed has a value, and that Sam could have prevented the right to reimburse Dan, and thus Sam has made a gift to Dan equal to Sam's share of the trust assets (100%) that reflects a lower expectation of overall value received by Sam from the Trust.

The Future? While this CCA only addressed the issue of the trust beneficiary being deemed to make a gift by consenting to the addition of a tax reimbursement clause to a grantor trust, one wonders if the similar line of reasoning could apply in a situation where the trust beneficiary consents or does not object to the conversion of a grantor trust to a non-grantor trust. With the conversion, that would move the tax liability from an obligation of the settlor to the trust, and presumptively decrease the trust's value. Would this conversion also be considered a gift from the trust beneficiary to the settlor by allowing, or not objecting to, such a conversion? Would it still be a deemed gift by the trust beneficiary if a trust director exercised a power to 'toggle off' a grantor trust power that causes the trust to no longer be taxed as a grantor trust? While apparently the IRS has not taken this position in the past, based on the reasoning using in this CCA it would not be big jump to make by the IRS. Historically the IRS has taken the position that a conversion of a trust from a grantor trust to a non-grantor trust (‘toggling off’) is not considered a gift by the settlor to the trust beneficiaries. That position might now be subject to change.

Conclusion: The Michigan Trust Code contains several provisions, based on the Uniform Trust Code, that authorize the modification of existing trusts, most with notice to, or consent by, trust beneficiaries. Before engaging in a future trust modification, considering this recent CCA, we should proceed to assess if we are, in effect, creating a deemed gift by the trust beneficiary to the trust settlor with the trust modification, or if asked to decant the trust to a new trust.