Folks:

Take-Away: The IRS recently concluded that modifying a *grantor* Trust to add an income tax reimbursement provision that benefits the trust settlor results in a taxable gift by the trust beneficiaries.

Background: A staple of sophisticated estate planning is a *grantor* Trust. Since Revenue Ruling 2004-64, the IRS has held that a tax reimbursement clause in a *grantor* Trust would not cause the trust assets to be included in the grantor/settlor's gross estate for federal estate tax purposes. Later, in a Private Letter Ruling [PLR 201647001] the IRS found that the modification to an existing *grantor* Trust to add a tax reimbursement clause that benefits the grantor/settlor is not a change of beneficial interests in the Trust. However, these positions just changed with a Chief Counsel Advisory (CCA) just released.

Chief Counsel Advisory 202352018, December 29, 2023

New Position: This CCA concludes that the judicial modification of a *grantor* Trust, with the beneficiaries' consent, to add a tax reimbursement clause constitutes a taxable gift by the beneficiaries to the grantor/settlor.

- **Facts:** The trustee of a *grantor* Trust petitioned a state court to modify the terms of the Trust, with the consent of the trust beneficiaries, to add a discretionary power to allow the trustee to reimburse the grantor/settlor from the income and principal of the Trust for income taxes attributable to the inclusion of the Trust's income in the grantor's taxable income.
- **Regulations:** The IRS relied on Regulation 25.2511-1 to reach the conclusion that the judicial modification constituted a taxable gift by

the trust beneficiaries to the grantor/settlor because it resulted in the *"relinquishment of a portion of the beneficiaries interest in the trust."*

- **Going Further:** The IRS also added in the CCA that even if the trust beneficiaries instead merely failed to object to a proposed trust modification that required them to be provided with notice and an opportunity to object, the result will be the same, meaning a taxable gift by the beneficiary.

Practical Implications: This surprising CCA raises many questions that need to be answered.

Valuation Challenges: How will such a theorical gift be valued? Prior to the Trust's modification, the value of the trust beneficiaries' interest in the Trust was already contingent upon the trustee's future exercise of his/her absolute discretion to make or refrain from making distributions of trust principal or income. Moreover, the theoretical portion of the value of the beneficiaries' interest allegedly transferred to the grantor/settlor resulting from the trust modification is itself contingent on the trustee's future exercise of the discretionary power to reimburse the grantor/settlor for taxes.

In addition, while the IRS conceded that the value of the gift will be 'difficult to calculate', it also cited Regulation 25.2511-1(e) which provides that if the donor's retained interest in the Trust is not susceptible of valuation under accepted valuation principles, the gift tax is applicable to the entire property interest that is subject to the gift.

Yet another worry is whether the donor-beneficiary's continuing interest in the *grantor* Trust constitutes a non-qualified retained interest for purposes of IRC 2702. If that is the case, the beneficiary would be treated as having made a taxable gift of his/her entire interest in the Trust.

What about the situation where there is a class of beneficiaries of the *grantor* Trust? Such a gift would be made by the class, which might include minor or unborn or unascertained trust beneficiaries. Will each of them be

deemed to have made a taxable gift resulting from the Trust's modification or decanting?

Finally, will a taxable gift be made if the discretionary Trust is in Michigan, which by statute declares that the beneficiary of a discretionary Trust does not possess a *property* interest in the Trust.

Drafting a *Grantor* Trust: Revenue Procedure 2004-64 says that it is permissible for a *grantor* Trust to initially contain a grantor/settlor tax reimbursement provision. Apparently, that is still 'good law' so that including a tax reimbursement in the initial *grantor* Trust instrument should avoid any theoretical gift by the trust beneficiaries. It is the modification of an existing Trust instrument to add the tax reimbursement provision that creates the theoretical gift by the trust beneficiaries.

Silent Trusts: A beneficiary's failure to object to a proposed alteration to the terms of a Trust generally should be treated as equivalent to the beneficiary's consent to such alteration for purposes of determining whether a taxable gift has occurred. It will be difficult to keep an interest in a *silent* Trust 'silent' if the trust beneficiary is treated as making a taxable gift when their consent is imputed to them (when they were unaware that they actually had an interest in the *silent* Trust.)

Trust Decanting: Both of Michigan's decanting statutes require notice to be given to the trust beneficiaries of the proposed decanting of trust assets. Apparently receiving notice of the that intent to decant, which might be just to add a tax reimbursement clause to the existing *grantor* Trust instrument, might be sufficient for the IRS to impose a gift tax. This might be sufficient reason for a new Trust to use its own decanting authorization, omitting notice to the trust beneficiaries, without relying on the two Michigan statutes.

Conclusion: As noted earlier, the IRS in this CCA reversed its earlier position from a 2016 Private Letter Ruling. It also seems to be backing away from its earlier clear position in Revenue Ruling 2004-64 that seemed

to say that tax reimbursement provisions in a *grantor* Trust were not problematic. As *grantor* Trusts remain popular, and wealth continues to grow inside of them, it is likely that more and more *grantor* Trusts that were created without a tax reimbursement provision may have their grantor/settlors asking to be reimbursed due to their increasing income tax liability. This CCA seems to present a large roadblock to either modifying or decanting an existing *grantor* Trust to assist the grantor/settlor with his/her increasing income tax liabilities.

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