Be Wary of Imputed Gifts

Take-Away: Proceed with caution in pursuing trust modifications or a trust decanting since the IRS appears to be eager to find a taxable gift by the trust beneficiaries.

Background: Gifts are broadly defined in the Tax Code and its implementing Regulations. [Regulation 25.2511-1.] The gift tax is an excise tax imposed on the *privilege* of transferring property during lifetime. Donative intent is considered important. Where donative intent is not found, the Tax Court will not impose a gift tax. But that position may be changing. If an act is completely involuntary, presumably no taxable gift occurs. Less clear, however, is when the *putative* donor could have prevented the transfer; inaction, or the failure to preserve a right by inaction, apparently is a taxable transfer by the IRS. The IRS's focus these days can be discerned from the positions it has taken in a recent Chief Counsel Advisory and the positions the IRS has taken in the Tax Court.

Chief Counsel Advisory 202352018: This advisory was previously covered in a couple of missives earlier this year. It was a case where the family members agreed in probate court proceedings to modify a *grantor* trust to add a provision that empowered the trustee to reimburse the grantor for the trust's income tax liability that the grantor had to pay. The remainder beneficiaries of that *grantor* trust, the settlor's children, agreed to the trust's modification. The CCA concluded that the trust's modification resulted in a taxable gift by the settlor's children when they consented to the provision that gave the trustee the discretion to reimburse the settlor for his income tax liability. The CCA went even further to suggest that a trust decanting that achieved the same result would also be a taxable gift by the trust's beneficiaries. Coming as no surprise, the CCA did not indicate how the beneficiary's gift was to be valued for reporting the gift tax, e.g., unknown future income taxes; the trustee's discretion to reimburse or not reimburse; the settlor's life expectancy; presence of limited powers of appointment. Arguably it was easy for the CCA to find a taxable gift, but then fail to tell the putative donors how to go about valuing their gift. Accordingly, this CCA raises the concern as to whether there will be additional efforts by the IRS to characterize trust modifications, or a decanting, as gifts by the trust beneficiaries. It also makes one wonder if a trustee exercises its powers to reimburse the settlor for income taxes associated with the *grantor* trust, whether that exercise of discretion is a breach of the trustee's duty of loyalty, since the reimbursement is a diversion of trust assets away from the trust beneficiaries to a non-trust beneficiary, i.e., the settlor/*grantor*.

Annenberg v. Commissioner: As was summarized in an earlier missive, a QTIP trusts were terminated by agreement among the widow lifetime beneficiary and her step-children who were the QTIP trusts' beneficiaries who consented to the trusts' terminations. All trust assets were then distributed to the widow. She then made gifts of shares to her step-children, and she sold the step-children the remaining trust assets in exchange for promissory notes. The widow only reported as a gift her gifts to the step-children, but not the sale in exchange for the promissory notes. The IRS issued a Notice of Deficiency, claiming that the termination of the QTIP trusts and the sale of trust assets was a taxable disposition under IRC 2519. The Tax Court disagreed, finding that the termination of the QTIP trusts was not a taxable gift by the widow under IRC 2519, nor was her sale of the distributed assets to her step-children. The point was that the IRS attempted to find a gift via a constrained interpretation of IRC 2519, when the widow ended up owning all of the former QTIP trust assets, and hence those assets would be included in her taxable estate, which is why IRC 2519 is in the Tax Code, to make sure that the deferral of estate taxes with the use of a QTIP election would ultimately be taxed in the surviving spouse's estate.

McDougall v. Commissioner, 163 Tax Court 5 (September 17, 2024): Again, much like Anneberg, there was a QTIP trust created on the death of the wife. The husband had an income interest for life in the QTIP trust, with his two children as the QTIP trust remainder beneficiaries. The father and his children entered into an agreement where the QTIP trust assets were distributed to the father. He then sold some of the former QTIP trust assets to another trust created for the benefit of his children in exchange for promissory notes. Gift taxes were filed reporting these transactions as offsetting reciprocal gifts. The IRS disagreed finding that a commutation of interests occurred, resulting in a gift from the father to his children, and a gift from the children to their father of their remainder interest in the QTIP trust. The Tax Court held that the transfer of property under IRC 2519 when the QTIP trust was commuted was not a taxable gift under IRC 2501 because the father made no gratuitous transfer (the QTIP Trust assets were to be taxed in his estate, as if he owned them, so the termination of the QTIP trust placing title to the assets in the father's name alone was not a taxable transfer. Nor was the transfer of the former QTIP trust assets to a new trust in exchange for promissory notes- that was a sale and exchange for consideration. However, the agreement to commute the QTIP trust resulting in taxable gifts by the children to their father under IRC 2511. Now the battle will be fought over how to value the children’s gift to their father, because the father had a testamentary limited power of appointment over the QTIP trust assets to or among his descendants. What would an independent buyer pay the children for their remainder interest in the QTIP trust knowing that the lifetime beneficiary’s exercise of that testamentary power of appointment could divest the buyer of his/her entire interest in the trust.

Trust Commutation: Under **Private Letter Ruling 201932001-10** the parties agreed to terminate a trust via a commutation. The state probate court agreed that there was no gift that resulted from the trust’s commutation, where each beneficiary was distributed by the trustee the current actuarial value of their respective share of the trust’s assets. The IRS agreed with this conclusion, noting “*this is in substance a sale or exchange”* citing Revenue Ruling 69-486, but this Revenue Ruling is not really on point to support the IRS’s conclusion. If the commutation resulted in the parties receiving entirely different interests in the trust, then the commutation would result in a taxable disposition.

In an earlier ***Private Letter Ruling 200723014,*** the IRS held that if *under local law*, the trustee is authorized to terminate a marital trust and distribute its assets to the remainder and lifetime beneficiaries, the proposed termination and distribution will be by *operation of law,* and it will not be treated as a sale or disposition by the trust beneficiaries.

Trust Decanting: The IRS has placed trust decanting transactions on its ‘no ruling’ list with respect to changes in beneficial interests that might result from the trust decanting.

Practical Concerns with Trust Modifications (or Decantings): As trusts become modified, or trustees engage in a trust decanting, it will be important to remember that any potential shrinkage of a beneficiary’s interest in the trust may invite a taxable gift, despite the challenge of placing a value on that gift:

Release: The release of a general power of appointment is considered a gift. Revenue Ruling 86-39.

Extending the Trust's Duration: The acquiescence of a trust beneficiary to extend the terms of a trust is a transfer for federal gift tax purposes. *Sexton v. U.S. 300 F.2d 490 (7th Circuit, 1962) cert denied 371 U.S. 820 (1962).*

Eliminating an Ascertainable Standard: An agreement to remove a 'health, education, maintenance and support' (HEMS) distribution standard from a trust is probably a taxable transfer.

Creating Powers of Appointment: The procurement or active acquiescence to create a general power of appointment, and maybe even a limited power of appointment that *could divest* a trust beneficiary of his/her interest in the trust is likely a taxable transfer.

Asset Protection: Any change to a trust that enhances the trust's asset protection features might be considered a taxable transfer, e.g., converting an existing trust to a Michigan Qualified Dispositions in Trust.

Conclusion: It is clear that the IRS is renewing its efforts to find taxable gifts when trusts are either modified or terminated. Reducing the beneficiaries' involvement in any action that substantially changes their beneficial interests is probably the best way to proceed. If possible, independent trustees should be used along with an independent trust director who, acting in a fiduciary capacity, holds the equivalent of a power of amendment to make the necessary changes without the consent of trust beneficiaries, or even their acquiescence.

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