

# IRS Asserts the Beneficiaries of an Irrevocable Trust Made Gifts When the Trust Was Modified to Add a Tax Reimbursement Provision



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On December 29, 2023, the Internal Revenue Service (IRS) released a memo, in which it took the position that the beneficiaries of an irrevocable trust made gifts when the trust agreement was judicially modified to add a provision allowing the trustee to reimburse the settlor for income taxes attributable to the trust.<sup>1</sup> The IRS's rationale for the position it took in this memo could have sweeping implications for the modification, decanting, and administration of existing irrevocable trusts. While the memo isn't official guidance, it articulates the IRS's interpretation of the law, and it can thus be instructive.

## Background

Some years ago, an individual created an irrevocable trust for the benefit of a child and the child's descendants. The trustee was independent. (More precisely, the trustee wasn't related or subordinate to the settlor.) Under the terms of the trust, the trustee could distribute trust property to the beneficiaries for any reason. The trust was designed as a grantor trust with respect to the settlor. The settlor had retained a power to cause the trust to be a grantor trust, but the IRS didn't identify which power the settlor retained.

Since the trust was a grantor trust with respect to the settlor, the settlor had to report the trust's income, deductions, and credits on their personal income tax return. Under state law, the trustee didn't have the discretionary power to reimburse the settlor for the income taxes attributable to the trust. In addition, as originally drafted, the trust agreement didn't contain a tax reimbursement provision granting the trustee the discretionary power to reimburse the settlor for the income taxes attributable to the trust.<sup>2</sup>

In some year after the trust's creation, the trustee petitioned a court to modify the terms of the trust. In its petition, the trustee asked the court to add a tax reimbursement provision. The beneficiaries consented to the modification. The court subsequently granted the petition and modified the terms of the trust, adding the tax reimbursement provision.

The IRS concluded that the modification resulted in each beneficiary making a gift of an interest in the trust, because it was a "relinquishment of a portion of the beneficiaries' interest in the trust" and "in substance" was "a transfer by (the beneficiaries) to (the settlor)." In a footnote, the IRS acknowledged that it may be hard to value these gifts. The IRS's analysis didn't rest

on the beneficiaries taking the voluntary, affirmative step of consenting to the modification. Although it wasn't relevant to its analysis, the IRS asserted that each beneficiary would've made a gift even if, instead of consenting to the judicial modification, they had failed to object to a nonjudicial modification.

Notably, in reaching its conclusion, the IRS repudiated the position it took in an earlier ruling. In the earlier ruling, the IRS ruled that the judicial modification of an irrevocable trust to add a tax reimbursement provision wouldn't result in a gift by the beneficiaries.<sup>3</sup> The trust was a grantor trust with respect to the settlors, and the independent trustee sought judicial modification because the income taxes attributable to the trust had become unduly burdensome for the settlors. Under the modified terms of the trust, the independent trustee would have the discretionary power to reimburse the settlors for the income taxes attributable to the trust.<sup>4</sup> The IRS concluded that the modification to add the tax reimbursement provision was administrative in nature, wouldn't result in a change in beneficial interests in the trust, and thus wouldn't result in a gift by the beneficiaries.

<sup>1</sup> CCA 202352018 (December 29, 2023).

<sup>2</sup> There are a few possible reasons why the trust agreement didn't contain a tax reimbursement provision. The settlor may have created the trust before the IRS issued Rev. Rul. 2004-64, in which it concluded that (1) the inclusion of a tax reimbursement provision wouldn't cause the trust property to be includable in the settlor's estate for estate tax purposes (so long as the trustee's reimbursement power was discretionary) and (2) the reimbursement of the settlor for the taxes attributable to the trust wouldn't be a gift from the beneficiaries to the settlor. Or the settlor may have been concerned the inclusion of a tax reimbursement provision might enable the settlor's creditors to reach the trust property, which in turn might create a risk the trust property would be includable in the settlor's estate for estate tax purposes. Or the omission of a tax reimbursement provision may have been inadvertent.

<sup>3</sup> PLR 201647001 (November 18, 2016). The modification also included other changes to the terms of the trust.

<sup>4</sup> Importantly, under the terms of the trust (both before and after the modification), only the independent trustee had the power to make discretionary distributions, and the beneficiaries could replace an independent trustee only with another independent trustee. This avoided a potentially unfavorable result, shielding the beneficiaries from having too much control over the trust for gift and estate tax purposes.



## Potential implications

The memo addressed the singular issue of whether a trust's beneficiaries made a gift when the terms of the trust were modified to add the tax reimbursement provision. Although the memo was limited to that issue, the IRS's rationale seemingly could apply in other situations involving the modification, decanting, or administration of a trust. This may be particularly so given its position equating a failure to object with consent. Unfortunately, the memo raises more questions than it answers.

In the memo, the IRS asserted that the settlor acquired a beneficial interest in the trust when it was modified to add the tax reimbursement provision. What if the trustee decants a trust (i.e., distributes trust property from the trust to another trust) and the terms of the (new) decanted trust include a tax reimbursement provision? What if the

trust's principal place of administration changes to a state in which, under state law, a trustee has the discretionary power to reimburse a settlor for income taxes attributable to the trust? In both cases, the result is substantively similar to the situation described in the memo, so it seems the IRS might come to the same conclusion.

What if the settlor releases the powers that cause the trust to be a grantor trust with respect to the settlor, causing the trust to become a nongrantor trust? Would the IRS assert that, by reason of the settlor's action, the beneficiaries relinquished a portion of their interest in the trust and they thus made a gift? (For gift tax purposes, it isn't necessary to have an identifiable or ascertainable donee.) What if the trust owns an interest in a pass-through entity (PTE) and the trustee makes or joins in making an

election to subject the PTE to a state's PTE tax? Since the election causes the incidence of tax to shift from the settlor to the PTE that's owned in part by the trust, would the IRS view the beneficiaries as having relinquished a portion of their interest in the trust?

The IRS's rationale might also apply in other situations, too. For example, what if, under the terms of the trust, the trustee has a power to add beneficiaries, and the trustee exercises the power? What if a decanting accelerates a beneficiary's interest (e.g., makes a contingent remainder beneficiary a current beneficiary)? What if a decanting eliminates a beneficiary? In each instance, there seemingly would be one or more beneficiaries who, under the IRS's rationale, would have relinquished an interest in the trust.

## Weighing the import of the memo

When deciding how much weight to give the memo when evaluating the potential tax implications of a modification, decanting, or other action involving an irrevocable trust, some context may be helpful. The memo was a chief counsel advice, which is written legal advice from the national office of the IRS's Office of Chief Counsel to certain other IRS employees.<sup>5</sup> (In this case, it was advice to an IRS attorney in Portland and an IRS attorney in Austin.) It isn't official guidance (like regulations). The IRS can't cite a chief counsel advice as authority, and taxpayers can't rely on a chief counsel advice.<sup>6</sup>

The earlier ruling that the IRS now rejects was a private letter ruling, which is a written determination that interprets and applies federal tax law to a taxpayer's specific set of facts.

A private letter ruling is issued to the taxpayer in response to the taxpayer's request.<sup>7</sup> The taxpayer who requested the private letter ruling generally can rely on it, but other taxpayers can't.<sup>8</sup> Thus, neither a chief counsel advice nor a private letter ruling has precedential value. In contrast, a published decision from a court has precedential value and is thus relevant when deciding a case involving similar facts or legal issues.

A chief counsel advice reflects the IRS's interpretation of the law. If presented with similar facts, a court may interpret the law differently. This happened not long ago in another situation involving an irrevocable trust. In a 2012 chief counsel advice, the IRS concluded that the beneficiaries' withdrawal rights weren't legally enforceable and were illusory, because the trust instrument contained an arbitration provision and a no-contest provision.<sup>9</sup> In a case

decided in 2015 and involving nearly identical facts, the IRS made that argument, but the United States Tax Court disagreed. The court held the beneficiaries' withdrawal rights were legally enforceable and weren't illusory despite the trust instrument containing an arbitration provision and a no-contest provision.<sup>10</sup>

## Conclusion

The memo is valuable because it offers insight into the IRS's thinking. Ultimately, the courts may address the issues raised in the memo. Meanwhile, as the issues and questions swirling around the memo underscore, the modification, decanting, and administration of an existing irrevocable trust continue to warrant thoughtful consideration of any potential gift, estate, and other tax implications.

<sup>5</sup> IRC § 6110(i)(1).

<sup>6</sup> IRC § 6110(k)(3).

<sup>7</sup> Treas. Reg. §§ 301.6110-2(d) and 601.201(a)(2).

<sup>8</sup> IRC § 6110(k)(3). A taxpayer, however, can rely on any private letter ruling issued after October 31, 1976, for purposes of determining whether there's substantial authority for a reporting position (and thus determining whether the taxpayer potentially can avoid certain accuracy-related penalties). Treas. Reg. §§ 1.6662-4(d)(3)(i), (ii), and (iii).

<sup>9</sup> CCA 201208026 (February 24, 2012).

<sup>10</sup> *Mikel v. Commissioner*, T.C. Memo. 2015-64.

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