

THE MOST SIGNIFICANT IRS RELEASE IN DECADES. IS IT THE DEATH OF IRREVOCABLE TRUST DECANTINGS?

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Towards the end of 2023, the Office of Chief Counsel at the IRS issued a memorandum — CCA 202352018 — in which it concluded that modifying an irrevocable grantor trust to include a tax reimbursement clause constitutes a taxable gift by the beneficiaries. This revealed a change in the way the IRS views certain trust actions. While some have called the memorandum the “death of irrevocable trust decantings,” or “the most significant IRS release in decades,” the true impact of the memorandum (and the IRS’s position reversal) has yet to be determined.

CCA 202352018 addresses the issue of gift tax consequences for beneficiaries when the trustee of an irrevocable grantor trust modifies the trust, with beneficiary consent, to add a tax reimbursement clause that provides the trustee the discretionary power to reimburse the grantor for income tax attributable to the trust. The CCA concludes that such modification does constitute a taxable gift by the beneficiaries.

The trust at issue in the CCA is an irrevocable trust for the benefit of the grantor’s children and descendants. The trustee is not related or subordinate to the grantor, and the trustee has absolute discretion to make distributions. While the CCA does not mention the specific power making the trusts grantor trusts, it does state that the grantor is the deemed owner. The original trust instrument did not provide authority to reimburse the grantor for income tax attributable to inclusion of the trust’s income. The trustee petitioned to modify the terms of the trust to include a discretionary power to reimburse the grantor for income tax, and all beneficiaries consented.

The CCA determined that as a result of the modification, the grantor becomes entitled to discretionary distributions and effectively acquires a beneficial interest in the trust property. Based on this position, the addition

of a beneficial interest constitutes a transfer from the trust beneficiaries to the grantor.

The CCA reflects a reversal in position for the IRS. In PLR 201647001, which was released in 2016, the IRS stated that a trust modification to add a discretionary reimbursement power “is administrative in nature and does not result in a change of beneficial interests in the trust.” The 2023 CCA explicitly states that the conclusions in PLR 201647001 “no longer reflect the position of this office.”

The CCA does not explicitly address the impact of the IRS’s reversal in position on trust decanting. Decanting — the process of transferring assets from an old trust into a new one with updated terms — can have the same end result of trust modification. Because decanting can have the same end results of a modification, it is not unreasonable to conclude that the IRS could view changes in trust provisions through decanting the same way it now views trust modifications.

While the CCA concludes that a grantor reimbursement is a relinquishment of a portion of the beneficiaries’ interest in a trust, it does not broach the idea that a reimbursement provision may be beneficial to the beneficiaries. A grantor may very well be paying income tax at a lower rate than the trust would be subject to if it were not a grantor trust. With a 35% tax rate kicking in at just \$11,150 for 2024, the reimbursement could potentially provide for income or principal to be available to the beneficiaries that would otherwise be going to the IRS to satisfy the trust’s tax liability. Additionally, if the grantor turns off grantor trust status, the beneficiaries’ interests are considerably more burdened than the addition of reimbursement powers, whether through trust modification, decanting, or otherwise.

The IRS determined that under the facts and circumstances outlined in the memorandum, the trust beneficiaries have made a taxable gift.

However, the IRS skirted discussion of how to value such a gift, seemingly punting on the issue by stating “the gift should be valued in accordance with the general rule for valuing interests in property for gift tax purposes.” The IRS also did not address the impact the existence of a statutory reimbursement power would have on whether a taxable gift has been made. Connecticut, Florida, Colorado, Delaware, New Hampshire, and New York have all enacted legislation expressly authorizing reimbursement of taxes paid by the grantor from the trust.

The IRS has previously addressed tax reimbursement clauses via Revenue Ruling. Revenue Ruling 2004-64 held that a reimbursement pursuant to a mandatory or discretionary right to reimbursement for the grantor’s payment of the income tax would not constitute a gift by the trust beneficiaries. CCA 202352018 distinguished the existence of a reimbursement provision in the original trust agreement versus the addition of a reimbursement provision in a modification action. It is helpful to view a CCA as functioning like an IRS attorney’s brief in specified litigation. The issuance of a CCA that abandons a position taken in an earlier letter ruling only revokes the ruling for the specified recipient of that letter ruling. It is important to note that a CCA cannot revoke or overturn a Revenue Ruling, and neither taxpayers nor the IRS may rely on it as authority.

The CCA also states that “the result would be the same if the modification was pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object.” The notion that a failure to object equates to consent could have problematic consequences that the CCA did not address. Has a taxable gift been made if a beneficiary objects and the trustee reimburses anyway? Should beneficiaries have a default position of

objecting to all proposed modifications? Does a trustee owe beneficiaries a duty to modify a trust in order to serve their beneficial interests? The answers to these questions could strain trustee-beneficiary relationships and could clog probate court dockets with hearings that equate to nothing more than a formality as part of a strategy to avoid a taxable gift. In addressing the issue presented in the CCA, the IRS created more questions than it answered.

In light of CCA 202352018, consideration should be given to reimbursement clauses

in trusts during the drafting process. If a grantor would like provisions addressing reimbursement, the ideal time to include relevant language is prior to the execution of the trust. CCA 202352018 marks the beginning of the IRS's change in position regarding trust modifications, and the IRS will likely continue to release additional guidance — some binding and some not — about its new approach. As always, keeping an eye on the IRS's future rules and regulations is a vital part of developing, drafting, and executing estate plans.



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