

*A newly released memorandum (CCA 202352018) from the Office of Chief Counsel of the Internal Revenue Service concludes that modification of a grantor trust to include an income tax reimbursement provision can result in a taxable gift.*

**Jay D. Waxenberg and Jacob Wonn** provide members with their summary and analysis of this important CCA.

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Here is their commentary:

## **EXECUTIVE SUMMARY:**

On December 29, 2023, the Internal Revenue Service Office of Chief Counsel released CCA 202352018, which concluded that the judicial modification of a grantor trust, with the beneficiaries' consent, to add a tax reimbursement clause would constitute a taxable gift by the beneficiaries to the grantor. Looking beyond the particular facts of the CCA, this new IRS guidance may have far-reaching implications that will force estate planners and their clients to rethink conventional wisdom regarding the gift tax consequences of amending, modifying and decanting irrevocable trusts.

## **FACTS:**

In CCA 202352018, the trustee of an irrevocable grantor trust petitioned a state court to modify the terms of the trust, with the consent of the beneficiaries, to add a discretionary power allowing the trustee to

reimburse the grantor 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. In reviewing this transaction, the CCA concludes, on the basis of applicable provisions of Treasury Regulation Section 25.2511-1 and related authorities, that the judicial modification constituted a taxable gift by the trust beneficiaries to the grantor insofar as it resulted in the "relinquishment of a portion of the beneficiaries' interest in the trust."

The CCA states that this taxable gift must be valued in accordance with the regulations under Section 2512 of the Internal Revenue Code and any other applicable valuation principles under Subtitle B of the Code. However, it is foreseeable that estate planners will be left scratching their heads about how to value such a theoretical gift, particularly given that (a) prior to the trust modification at issue in the CCA, the value of the donor beneficiaries' interests in the trust was already contingent upon the trustee's future exercise of his or her absolute discretion to make or refrain from making distributions of trust income and principal to the beneficiaries, and (b) the portion of the value of said interests transferred to the donee grantor as a result of such modification is itself contingent upon the trustee's future exercise of a discretionary power to reimburse the grantor for income taxes attributable to trust income. While the CCA concedes that the value of such a taxable gift will be "difficult to calculate," it concludes that the donor beneficiaries nevertheless "cannot escape gift tax" on the basis of such difficulties in valuation. In its summary of relevant law, the CCA cites to Treasury Regulation Section 25.2511-1(e), which provides that if a donor's retained interest in the trust is not susceptible of valuation under accepted principles, the gift tax is applicable to the entire property subject to the gift.

Although the judicial modification at issue required the consent of the trust beneficiaries, the CCA notes that the result would have been the same even if the beneficiaries instead merely failed to object to a proposed modification that required them to be provided with notice and an opportunity to object. In either case, the CCA clarifies that the modification of a trust's terms to add a tax reimbursement clause makes the situation at issue distinguishable from the one at issue in Revenue Ruling 2004-64, in which the IRS previously concluded that the inclusion of a tax reimbursement clause in a trust's original governing

instrument would not cause the assets of the trust to be included in the grantor's gross estate for federal estate tax purposes.

The conclusion in CCA 202352018 also represents a conscious reversal of the IRS's prior position expressed in Private Letter Ruling 201647001, in which the IRS concluded that a similar modification of a grantor trust to add such a tax reimbursement clause was a mere administrative change to the trust terms that would not result in a change of beneficial interests in the trust. The CCA includes a footnote which expressly states that the conclusions of Private Letter Ruling 201647001 "no longer reflect the position of this office."

## COMMENT:

The release of CCA 202352018 upends the former prevailing view of the estate planning community that the modification of an irrevocable grantor trust to add a tax reimbursement clause should not be treated as a taxable gift by the trust beneficiaries to the grantor. In the aftermath of this new IRS guidance, estate planners and their clients are likely to be confronted with a host of related issues in other contexts where a proposed alteration to the terms of an existing irrevocable trust could potentially be deemed to result in a taxable gift. The following issues come to mind as being especially significant:

- Whether 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.
- Whether decanting the assets of an existing irrevocable trust to a new trust in a manner that reduces a beneficiary's interest in the original trust will constitute a taxable gift by such beneficiary to the other beneficiaries.
  - In cases where a trust is decanted using a provision in the original trust instrument that does not require any beneficiary to receive notice of or give consent to the decanting, one might reasonably conclude that the decanting should not result in a taxable gift. However, if the beneficiaries later approve (or fail to object to) an accounting by the trustees of the original trust that discloses

such prior decanting, consider whether this would trigger a taxable gift.

- How to appropriately value a taxable gift resulting from a beneficiary's partial relinquishment of a purely discretionary interest in a trust and/or the creation of such a purely discretionary interest.
  - Consider whether a donor beneficiary's continuing interest in the trust, as modified, would constitute a non-qualified retained interest for purposes of Section 2702 of the Code, such that the beneficiary would be treated as having made a taxable gift of his or her entire interest in the trust.
- In cases where an alteration to the terms of a trust constitutes a taxable gift by a class of trust beneficiaries with overlapping interests in the same trust assets, how to determine the value of each class member's gift without "double-counting" the value of any such overlapping interests.
  - If such class includes minor, unborn or unascertained beneficiaries, consider whether each of them should also be deemed to have made a taxable gift.

Final resolution of these issues will need to be hashed out in future judicial decisions and IRS guidance. In the meantime, estate planners and their clients would be well-advised to carefully consider the potential implications of CCA 202352018 in any decanting or other transaction that effectively alters the terms of an irrevocable trust in a manner that could be construed as shifting beneficial interests.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!**

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