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What the IRS Reversal on Tax Reimbursement Clauses in IDGTs Means

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The office of the chief counsel of the Internal Revenue Service (IRS) recently made a 180-degree reversal of the agency's long-held position on tax reimbursement clauses in grantor trusts. The move could have significant tax implications for those who use the trusts as wealth transfer and tax information tools.

The gift-tax consequence of modifying an irrevocable grantor trust to add a tax reimbursement clause is at issue. Such a clause provides the trustee the discretionary power to reimburse the grantor for the tax paid on the trust's taxable income.

Background on IDGTs

Many clients create intentionally defective grantor trusts (IDGTs) and contribute highly appreciating assets for the ultimate benefit of children or descendants. With an IDGT, the grantor or settlor pays income tax on the trust's assets in order that those assets grow as rapidly as possible.

The trusts are intentionally defective because they remove assets from the grantor's gross estate. But the trust includes grantor powers that allow the income generated to be taxed to the original grantor rather than the trust beneficiaries.

These tax payments amount to tax-free gifts to the beneficiaries that bypass any annual or lifetime gift exclusion. This status allows the trust assets to appreciate without being depleted by income tax payments. Therefore they result in additional wealth transferred to the trust beneficiaries.

In time, the grantor may no longer wish to be burdened by the income taxes attributable to the IDGT. Those who draft the trusts often include provisions to allow for ways that the grantor trust status can be toggled on or off.

The trust may reimburse the grantor for income taxes paid at the trustee's discretion. With the discretionary method, the assets of the trust remain outside the grantor's estate. But if the grantor opts for mandatory reimbursement, the full value of the trust's assets could be included in the grantor's gross estate, under IRC section 2036.

That's because the grantor has effectively retained the right to use the trust to pay an income tax obligation.

Irrevocable trusts generally cannot be changed or modified unless all the trust beneficiaries agree. A trust can seek a judicial modification granting the independent trustee the discretion to reimburse a settlor for tax payments attributable to income generated by the trust's assets.

Alternatively, a trust can be decanted into a new trust with different provisions, including a discretionary tax reimbursement clause.

Reversal of the IRS' prior position

In a 2016 private letter ruling (PLR 201647001) the IRS concluded that adding a tax reimbursement clause after the trust's creation was merely administrative in nature. The modification did not result in a change of beneficial interests in the trust. The clause allowed the trustee to reimburse the grantor for taxes paid on trust income. As a result, the reimbursement wouldn't be considered a taxable gift.

Late last year, however, the IRS released a chief counsel advice ruling (CCA 202352018) stating that the conclusions of the previous PLR "no longer reflect the position of this office."

The ruling asserts that a beneficiary makes a taxable gift by consenting (or not objecting) to adding a tax reimbursement clause to an existing trust. The CCA concludes that the modification resulted in a "relinquishment of a portion of the beneficiaries' interest in the trust."

The ruling concedes that the valuation of the gift is difficult to determine. The valuation is contingent upon the trustee's future use of the discretionary power to reimburse the grantor for income taxes attributable to the trust's income.

Note that this is distinguishable from including a trustee's discretionary tax reimbursement clause in a trust's original governing instrument, which would not include the assets in the gross estate for federal estate tax purposes. Revenue ruling 2004-64 offers guidance for when a reimbursement clause is included from the trust's inception. The CCA's conclusion applies to trusts that are modified to add a discretionary trustee power to reimburse.

Implications of the reversal

This new IRS guidance has implications that will force us to rethink the possible gift tax consequences of amending, modifying, and decanting irrevocable trusts. The shift may disrupt existing estate plans that relied on the previous understanding of tax reimbursement clauses.

Advisors and clients would be wise to carefully consider the implications of any transaction that alters the terms of an irrevocable trust that would be seen to alter beneficial interests and potentially result in a taxable gift.

For more information, please contact your advisor.

About the Author

As the Director of Planning & Advice for Key Private Bank, Tina is responsible for managing the Central Planning Team, as well as overseeing the National Advisory Committee, Monthly National Advisory Call, the Key Wealth Institute, and any financial planning literature developed internally and externally. She works with our Regional Directors of Planning to help facilitate our best thinking and advice delivery to clients.

Tina earned a B.S. in Business Administration from the University of Richmond and an M.Tax from Virginia Commonwealth Univ. She is a CFP® certificant, CPA/PFS, and is an AEP®. She is Treasurer of the Put-in-Bay Community Swim & Sail Program. Tina received the 2016 Exceptional Service Award from the Cleveland Estate Planning Council and the Circle of Excellence Award by Key Private Bank in 2016 and 2018.

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