



PROBATE & ESTATE PLANNING SECTION

Supplemental Attachment for

Friday, February 16, 2024

Committee on Special Projects

and

Meeting of the Council of the Probate and Estate Planning Section

at the University Club of Michigan State University
3435 Forest Rd, Lansing, MI 48910

Or *via* Zoom

**Probate & Estate Planning Section of the
State Bar of Michigan**

You are invited to the February meetings of the Committee on Special Projects (CSP) and
the Council of the Probate & Estate Planning Section:

Friday, February 16, beginning at 9 AM
at the University Club of Michigan State University
3435 Forest Rd, Lansing, MI 48910

Remote participation by Zoom will be available. So, you are also invited . . .

to a Zoom meeting.

When: Feb 16, 2024, 09:00 AM Eastern Time (US and Canada)

Register in advance for this meeting:

https://us02web.zoom.us/meeting/register/tZwodOihqTwsHdbdcDFs_2V6i7sxYCvoMqfH

After registering, you will receive a confirmation email containing information about joining the meeting.

If you are calling in by phone, email your name and phone number to Angela Hentkowski

ahentkowski@stewardsheridan.com, *we will put your name in a zoom user list that*

will identify you by name when you call in.

Please note that the Zoom feature of these meetings entails that they will be recorded.

This will be a regular in-person and remote meetings of the Council of the Probate & Estate Planning Section. The Council meeting will be preceded by a meeting of the Council's Committee on Special Projects (CSP), which will begin at 9:00 AM. The CSP meeting will end at about 10:15 AM, and the Council meeting will begin shortly thereafter. The agenda and meeting materials will be posted on the Probate & Estate Planning Section page of the SBM website. Once those things are posted, you should be able to download them from: <http://connect.michbar.org/probate/events/schedule>.

Richard C. Mills
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Supplemental Council Meeting Materials

Supplemental Attachment 1

Tax Committee

interoffice

MEMORANDUM

To: Probate Council

From: Jonathan K. Beer

Date: February 2024

Subject: The Addition of a Tax Reimbursement Clause and Grantor Trusts is a Gift

Brief Summary. The IRS issued ILM 202352018 detailing the IRS' view that a taxable gift occurs when a tax reimbursement clause is added to an irrevocable grantor trust after the trust became irrevocable. Namely, the beneficiaries of the subject trust are making a gift to the trust's settlor. This position reverses the IRS' position previously stated in letter ruling 201647001 and reminds us that the use and application of a tax reimbursement clause should be carefully considered and that we should remind clients that any exercise of a tax reimbursement clause opens the door for the IRS to argue that the assets of the subject trust are includible in the estate of the settlor receiving tax reimbursement.

Background. If the settlor creates a trust and the settlor or the settlor's spouse holds certain powers or interests with respect to such trust, the settlor is treated as the grantor of such trust for income tax purposes and is therefore required to report tax items from the trust's investments on the settlor's personal income tax return per §671 et. seq. of the Internal Revenue Code (the "Code"). Notably, the rules that cause a settlor to be a trust's grantor differ from rules for determining whether a settlor is required to treat the assets of a trust as his or her own for estate tax purposes.

As such, a settlor can create an irrevocable trust that is designed to make the settlor the trust's grantor, thereby owning the trust's assets for income tax purposes but not causing the settlor to own the assets for estate tax purposes (such trust is an "IDGT"). The settlor may then pay income tax on income generated by the IDGT and thereby facilitate asset preservation and growth in the IDGT and simultaneously reduce the settlor's anticipated estate tax liability (assuming the IDGT is administered in a manner that keeps its assets outside of the settlor's estate for estate tax

purposes). In addition, the settlor is not deemed to make a gift of property when paying such taxes (because it is the settlor's duty as grantor).

The planning opportunity described above requires the settlor to have sufficient cashflow to cover income taxes generated by the IDGT. Thus, if the settlor incurs future cashflow issues, the plan may become extremely burdensome. There are several ways to address the settlor's cashflow issue, including the use of the tax reimbursement clause. For purposes of this memo, a tax reimbursement clause means a clause that grants a trustee the discretion to reimburse the trust's settlor for income taxes paid by the settlor as a result of settlor's grantor trust status and such trustee is an independent trustee (meaning that the trustee is neither a related nor a subordinate party with respect to the settlor as defined in §672(c) of the Code).

The IRS provided key guidance related to tax reimbursement clauses in Rev. Rul. 2004-64, which provides the below holdings.

- A settlor who, as grantor, pays income tax related to income generated by an IDGT is not making a taxable gift to the IDGT, regardless of whether the IDGT contains a tax reimbursement clause.
- The existence of a tax reimbursement clause in an IDGT alone does not cause the assets of an IDGT to be included in the grantor's estate for estate tax purposes.
- If an IDGT's terms require the trustee to make tax reimbursement payments to the IDGT's grantor, then the IDGT's assets will be fully included in the grantor's estate for estate tax purposes under §2036(a)(1) of the Code.
- If an IDGT provides for discretionary tax reimbursement by an independent trustee and the independent trustee exercises such discretion, such exercise alone will not cause the assets of the IDGT to be included in the grantor's estate for estate tax purposes, though estate inclusion could result depending on other facts and circumstances.

IRS's Prior Position Allowing the Addition of Tax Reimbursement Clauses. In 2016, the IRS released letter ruling 201647001, which affirmed that the IRS did not view the addition of a tax reimbursement clause as a taxable gift. The relevant facts of the ruling were as follows. Two settlors created an IDGT and designated an independent trustee. Over time, unanticipated circumstances causes the income tax burden of grantor trust status to become unduly burdensome for the settlors, and the independent trustee sought court approval to add a tax reimbursement clause to the IDGT that would be contingent upon the independent trustee's ability to obtain a ruling from the IRS that adding a tax reimbursement clause was not a taxable gift.

The letter ruling relied on Rev. Rul. 2004-64 to make this determination, reasoning that if a tax reimbursement clause does not constitute a taxable gift when it is included in a trust instrument or when it is exercised, then there should not be a taxable gift when a tax reimbursement clause is added to a trust instrument. The addition of a tax reimbursement clause is an administrative change to the subject trust that did not affect beneficial interests in the subject trust.

IRS Rationale in Reversing Letter Ruling 201647001. The IRS reversed letter ruling 201647001 with ILM 202352018. The facts of the ILM are essentially the same as the facts in the

letter ruling, though the ILM explicitly states that the beneficiaries consented to modifying the subject trust by adding a tax reimbursement clause. The IRS rests its new position on the following:

- Any gratuitous transfer of an interest in property to a third party is a taxable gift, even if the transfer is indirect, citing §§ 2501(a)(1) and 2511(a) of the Code, as well as Treas. Reg. § 25.2511-1(c)(1).
- Rev. Rul. 67-370 established the IRS's position that a remainder interest in trust that was terminable by a third party was still an interest in property under §2033 of the Code and had to be valued for estate tax purposes.

Based on the above authority, the IRS determined that the addition of a tax reimbursement clause after a trust's creation is a gift because, based on Rev. Rul. 67-370, property has been gratuitously transferred to the settlor by the subject trust's beneficiaries. The IRS distinguishes the ILM from the Rev. Rul. 2004-64 because property is transferred back to the settlor in the ILM. Notably, the IRS did not reverse its positions in Rev. Rul. 2004-64, so the IRS apparently still take the position that tax reimbursement by an independent trustee is not a gift and does not itself cause the assets of an IDGT to be included the estate of the settlor. Thus, even if the tax reimbursement clause is exercised in the year such clause is added to an IDGT, the only gift occurring is a gift of the value of such clause being added to the IDGT.

The ILM does not, however, provide guidance on the immediate question of how to value the gift of adding a tax reimbursement clause to an IDGT. Rather, it pithily states that complex calculations do not exempt donors from gift tax. The ILM leaves practitioners to examine many other questions, including:

- Have the beneficiaries made a gift to the grantor if a tax reimbursement clause or the power to reimburse a grantor for income taxes is added without the consent of the trust beneficiaries?
 - This could potentially be accomplished by a trust protector, by decanting, by merging an IDGT into another trust, or by changing the governing law, for example.
- What other options are available to reduce the cashflow burden on the grantor while maintaining grantor trust status?
- Could the IDGT's grantor trust status be terminated to resolve the issue?

Conclusion. On its face, ILM 202352018 only potentially affects IDGTs that were not initially created with tax reimbursement clauses, but this legal development also serves as a reminder that a trust's tax reimbursement clause is a potential basis for an IRS challenge to undo estate tax planning associated with an IDGT, and that the inclusion of a tax reimbursement clause in an IDGT, as well as its exercise by an independent trustee, require special attention.