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Take Care When Utilizing Tax Reimbursement Clauses in Trusts…Even If You Are a Cross-Border Practitioner

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Until recently, there was a fair amount of comfort amongst practitioners that, when structured correctly, utilizing a tax reimbursement clause for a grantor trust did not produce any negative U.S. gift or estate tax results. That treatment may radically change as a result of a recent IRS memorandum (the "Memo").[1]

Before delving into the specifics, some quick background for context is warranted. Every trust must be classified as either a grantor trust or a nongrantor trust for U.S. federal income tax purposes. In the case of a grantor trust, somebody else (typically, the so-called "grantor") is viewed as owning the assets of the trust and, therefore, is responsible for paying the U.S. income tax owed on the income and gain generated by those assets. The grantor, however, may not want to be economically responsible for payment of such taxes, or may not even be able to practically afford that payment. Enter the tax reimbursement clause.

The IRS has previously opined on the tax issues stemming from including a tax reimbursement clause in a trust instrument, most notably in Revenue Ruling 2004-64. There, the IRS said that if a trust's governing document gives the trustee discretion (and that's the keyword, discretion) to reimburse the grantor for paying income tax on the trust's income, that discretion in and of itself, whether or not exercised, does not cause the assets of the trust to be includible in the grantor's gross estate for U.S. federal estate tax purposes. In a subsequent private letter ruling, the IRS concluded that modifying or amending a trust instrument to include a tax reimbursement clause would not result in a change of beneficial interests in the trust. As a result of the foregoing authorities, it appeared well-settled that whether a tax reimbursement clause was included in a trust document from inception or added later, such action was benign from a U.S. tax perspective, provided other formalities and restrictions were properly in place (for example, allowing only an independent trustee to exercise such power).

As a result of the new IRS pronouncement, the IRS seems to be saying that having a tax reimbursement clause in a trust document from inception is okay, but adding one in later is not. The facts of the Memo can be briefly summarized as follows:

- A (the grantor) creates a trust in Year 1 for A's child and that child's descendants.
- The trust is a grantor trust as to A.

• The trustee must not be "related or subordinate" as to A within the meaning of Section 672(c) of the Internal Revenue Code (and the trustee satisfies that requirement).
• The trust agreement does not allow the trustee to make distributions to A to satisfy A's income tax liability attributable to the trust, and the applicable governing state law likewise does not grant any such authority to the trustee.
• Trustee petitions the relevant state court in Year 2 to modify the terms of the trust to allow discretion to reimburse the grantor for income taxes paid with respect to the trust, and the beneficiaries of the trust consent pursuant to state law.

The IRS concludes that the modification constitutes a taxable gift by the trust beneficiaries to the grantor because the addition of the discretionary power to make tax reimbursement distributions to the grantor is a relinquishment of a portion of the beneficiaries' interest in the trust. The IRS goes on to explain that as a result of the modification, A is deemed to have acquired a beneficial interest in the trust property because A effectively becomes entitled to discretionary distributions of income or principal from the trust (albeit in an amount limited to what is sufficient to reimburse A for the income tax liability paid with respect to the trust due to its grantor trust status). The same outcome would result, explained the IRS, if the relevant state statute provided beneficiaries with a right to notice and a right to object to the modification, and the beneficiaries failed to exercise their objection right.

The resulting gift from the beneficiaries to the grantor is to be valued in accordance with the general rules for valuing interests in property for gift tax purposes, taking into account all relevant valuation principles. Finally, the IRS was clear to note that the ruling here was distinguishable from Revenue Ruling 2004-64, where the original trust document contained a tax reimbursement clause.

The Memo raises concerns in general to be sure, but also some immediate specific questions without any obvious answers, such as:

• What is the amount of the taxable gift deemed to have been made by the beneficiaries?
• Is there a gift only in the year when the trustee exercises discretion to reimburse the grantor?
• Would the same outcome have resulted if the beneficiaries were not required to consent to the modification?
• What if the trust agreement required the consent of somebody else? A non-interested, independent party, such as a Trust Protector?
• The grantor was deemed to have acquired a beneficial interest in the trust because he became entitled to a discretionary distribution, but what does this mean? More broadly speaking, is being entitled to something discretionary and within somebody else's control tantamount to an actual interest? Or is it just a mere expectancy?
• As a result of the gift tax conclusion reached by the Memo, is estate tax inclusion for the grantor on the horizon?

While tax reimbursement clauses may be a planning tool more commonly seen in the domestic setting, international private client practitioners should not disregard or ignore this latest ruling. For example, it's true that due to the manner in which the grantor trust rules work, it is infinitely easier for a trust to be classified as a grantor trust as to a U.S. grantor than it is for a trust to classified as a grantor trust as to a foreign grantor. But in the cross-border setting, one might see this come up in pre-immigration planning, where a common planning tool is for an individual to create a trust and fund it with assets prior to moving to the United States (a so-called 'drop-off' trust). Very likely, that trust would be classified as a nongrantor trust as to the individual while such person is foreign, but then may convert to a grantor trust once the individual moves to the United States and becomes a U.S. income tax resident. Realizing that such individual is now personally liable for income tax owed on the trust's income and gain, the solution might be to add a tax reimbursement clause to the trust instrument if one was not already included.

That modification could now result in potentially significant and consequential gift tax outcomes.

It should also be noted that Florida Statutes expressly authorize reimbursement of taxes paid by a grantor, and unless the governing instrument of a trust provides otherwise, such discretion is vested in the trustee. The law in Florida became effective July 1, 2020, and tracks the basic requirements of Revenue Ruling 2004-64. Notably, the Florida statute provides that "[a] person may not be considered a beneficiary of a trust solely by reason of the application of this section, including for purposes of determining the elective estate." Florida Statutes, in a different section, go on to provide, helpfully, that "…the assets of an irrevocable trust may not be subject to the claims of an existing or subsequent creditor or assignee of the settlor, in whole or in part, solely because of the existence of a discretionary power granted to the trustee by the terms of the trust, or any other provision of law, to pay directly to the taxing authorities or to reimburse the settlor for any tax on trust income or principal which is payable by the settlor under the law imposing such tax."

Accordingly, Florida law presents a landscape different from the facts presented in the Memo. Beneficiary consent is not required as it relates to the trustee's discretion to reimburse the grantor for income tax liability and, further, Florida law explicitly states that the grantor is not deemed to acquire a beneficial interest in the trust as a result of the trustee's reimbursement discretion. Whether or not this will be enough to defend against the taxable gift argument espoused by the IRS in the Memo remains to be seen.

The Memo represents a significant departure by the IRS on its previous rulings in this area with potentially significant tax planning consequences. Private client practitioners, including international private client practitioners, would be well-advised to monitor developments in this area and carefully consider the implications of the Memo.

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[1] ILM 202352018, dated November 28, 2023, and released December 29, 2023.
[2] PLR 201647001.
[3] *See generally* Fla. Stat. § 736.08145, *available at **http://www.leg.state.fl.us/statutes/index.cfm?App_mode=Display_Statute&Search_String=&URL=0700-0799/0736/Sections/0736.08145.html**.*
[4] Fla. Stat. § 736.08145(5).
[5] Fla. Stat. § 736.0505(1)(c).

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