COMMITTEE REPORT:
FIDUCIARY PROFESSIONS

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General Trust Administration Issues For Fiduciaries

How to reduce risk in light of CCA 202352018

In Chief Counsel Advice (CCA) 202352018 (Dec. 29, 2023) (the CCA), the Internal Revenue Service concluded that the beneficiaries of an intentionally defective grantor trust (IDGT) made a taxable gift for federal gift tax purposes when they consented to a trust modification authorizing the trustee to reimburse the grantor for income taxes payable by the grantor on the trust's income.

Although limited in scope, the CCA is a good starting point for discussing general trust administration issues as they pertain to fiduciaries. To provide context, we first outline legal and trust administration information that any trustee or prospective trustee of an IDGT should understand, including the recent CCA. We then discuss measures a trustee, or prospective trustee, can implement to mitigate fiduciary risk applicable to IDGTs in light of the CCA.

Planning Objectives of IDGTs

Put simply, an IDGT is an irrevocable trust that will be excluded from the grantor's gross estate for federal estate tax purposes at the grantor's death, but the trust income of which is taxable to the grantor during the grantor's lifetime. Grantor trust status arises because the grantor retains one or more powers that cause the grantor to be deemed the owner of the trust's assets for income tax purposes under the grantor trust rules, codified in Internal Revenue Code Sections 671 through 679.

IDGTs shift wealth from the grantor to the trust's beneficiaries by removing future appreciation on transferred assets from the grantor's taxable estate while allowing the grantor to continue paying the trust's income tax liabilities during the grantor's lifetime. By paying the trust's income taxes, the grantor makes additional gift tax-free transfers benefitting the trust's beneficiaries. In short, an IDGT supercharges wealth transfers by allowing the grantor to pay income taxes, including capital gain taxes, on assets transferred to the trust at no additional transfer tax cost to the grantor while simultaneously reducing the grantor's estate for estate tax purposes.

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Changing Circumstances

A grantor's circumstances may change between the time the IDGT is created and the grantor's death. For example, the assets of the IDGT may perform so well that, in the grantor's mind, sufficient assets have been set aside for the beneficiaries; the grantor may have a falling out with the beneficiaries; or the grantor may become concerned about the sufficiency of their remaining assets and be reluctant to make additional tax payments for income attributable to the trust. Often, the grantor can address these issues by "turning off" grantor trust status by releasing the power or powers that created grantor trust status in the first place.[1]

However, turning off grantor trust status completely may have a more severe result than the circumstances warrant. A more flexible alternative is to authorize the trustee of the IDGT to reimburse

the grantor for income taxes paid by the grantor and attributable to the trust. Understanding reimbursement alternatives requires understanding Revenue Ruling 2004-64, the primary source of guidance on this issue.

Rev. Rul.2004-64

Rev. Rul. 2004-64 addresses the gift and estate tax consequences of three potential situations in which the trustee would reimburse the grantor of an IDGT for income taxes payable by the grantor on the IDGT's income.

Situation 1: Neither the IDGT's original trust agreement nor state law required or authorized the trustee to reimburse the grantor for the grantor's payment of the IDGT's income taxes. Here, the IRS held that because the grantor hadn't retained the right to have the IDGT's property distributed to him, the trust's assets weren't includible in the grantor's estate for federal estate tax purposes.

Situation 2: The IDGT's original trust agreement required the trustee to reimburse the grantor for income taxes paid by the grantor on the IDGT's income. Here, the IRS held that the full value of the trust's assets was includible in the grantor's gross estate for federal estate tax purposes under IRC Section 2036(a)(1) because the grantor retained the right to have the IDGT's property distributed to him in satisfaction of his legal obligation.

Situation 3: The IDGT's original trust agreement authorized, but didn't require, the trustee to reimburse the grantor for income taxes paid by the grantor on the IDGT's income. Here, the IRS held that the grant of that discretion, by itself, didn't make the IDGT's assets includible in the grantor's estate for federal estate tax purposes.

Ideally, all IDGTs that can give the trustee discretion to reimburse the grantor for income taxes paid by the grantor on the IDGT's income without causing immediate and irreparable estate tax issues would do so.[2] In theory, this would discourage the grantor from turning off grantor trust status entirely if challenging, but temporary, cash flow issues arise, thereby allowing the trustee to maximize the wealth transfer planning opportunities of the IDGT. However, Rev. Rul. 2004-64 warned that estate tax inclusion could result from creating or administering the trust with a discretionary tax reimbursement clause. For example, if an explicit or implied agreement is evidenced by the trustee's frequent exercise of the power that the grantor would be reimbursed, estate tax inclusion could result. Some practitioners advise against including the discretionary authority for a trustee to reimburse the grantor out of concern that this authority, as exercised, may compromise the effectiveness of the trust for wealth transfer purposes. Others are concerned about the fiduciary issues involved in exercising that power. Therefore, those practitioners draft IDGTs that are silent on the issue of reimbursement. The CCA involved a modification of such a trust.

> The CCA raises complicated valuation and gift value allocation issues.

The CCA

In the CCA, the grantor created an IDGT for the benefit of the grantor's child and the child's descendants. The terms of the operative trust agreement authorized the trustee to distribute income or principal to the grantor's child in the trustee's discretion, and on the child's death, the remainder of the trust was distributable to the child's issue, per stirpes. As originally drafted, the trust contained no tax reimbursement clause, and state law neither required nor provided authority to the trustee to reimburse the grantor for the grantor's payment of the trust's income taxes.

Sometime after the trust was executed, the trustee petitioned the state court to modify the trust to give the trustee the discretionary power to reimburse the grantor for the grantor's payment of the trust's income taxes. Under the state's statute regarding the modification of trusts, all living beneficiaries of the trust, namely the grantor's child and the child's children, consented to the trust modification, and the court issued an order modifying the trust to allow income tax reimbursements to the grantor in the trustee's discretion.

In the CCA, the IRS analyzed the gift tax implications of the trust modification. The IRS cited the Treasury regulations under IRC Section 2511 to support its determination that the trust modification, effected with the beneficiaries' consent, constituted a taxable gift from the beneficiaries to the grantor because the addition of a discretionary power to distribute income and principal to the grantor is a relinquishment, by the consenting beneficiaries, of a portion of their interest in the trust. Further, the CCA states that:

> [t]he 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 CCA's conclusion that a trust modification that involves a beneficiary relinquishing a portion of the beneficiary's interest in the trust is a taxable gift when the trust modification requires the consent (or non-objection) of the trust's beneficiaries is contrary to the IRS' conclusion in Private Letter Ruling 201647001 (Aug. 8, 2016). However, it's consistent with other IRS rulings holding that a taxable gift arises when a beneficiary's affirmative action impacts the beneficiary's interest in a trust. For example, the Tax Court and IRS have held in numerous rulings that a taxable gift occurs when a trust beneficiary who holds a limited lifetime power of appointment over the trust exercises the power in a manner that divests the beneficiary of a portion of their interest in the trust.[3] The CCA fails to consider that the beneficiaries' consent (or non-objection) to a tax reimbursement clause may increase the value of their interests in the trust by discouraging the grantor from completely relinquishing grantor trust powers.

Further, the CCA raises complicated valuation and gift value allocation issues. It concedes that the valuation process will require complex calculations that must be made in accordance with the general rule for valuing interests in property for gift tax purposes under IRC Section 2512 and relevant principles. Prior rulings make clear that distributions being wholly within the trustee's discretion doesn't guarantee that the gifted interest will have no or nominal value.[4]

The more challenging issue arising from the CCA is how to proportionally allocate the gift's aggregate value among the various beneficiaries. Under the facts in the CCA, all of the living beneficiaries of the trust, namely the grantor's child and child's children, consented to the trust modification. It's not explicitly discussed in the CCA, but presumably, the child's unborn grandchildren and more remote descendants, if any, were parties to the agreement by representation. If these potential or future beneficiaries are deemed to have an interest in the trust, they could likewise be deemed to have made a gift to the grantor through the trust modification. In this regard, the CCA raises novel questions that are beyond the scope of this article.

> The trustee's counsel should review the trust agreement thoroughly to ensure it grants the trustee the necessary powers, discretions and protections to administer the trust properly.

Fiduciary Risk and Mitigation

In general, a trustee's fundamental duty is to administer trust assets solely in the interests of the trust beneficiaries and to carry out the terms of the trust in accordance with the grantor's intent. Fulfilling this duty is complicated in the ordinary course of administration of a non-grantor trust. When performance of the trustee's duty to the beneficiaries requires the trustee to monitor, navigate and respond to changes in the grantor's personal financial life, as may be the case with an IDGT, traditional lines demarcating the objects of the trustee's duty can become blurred. To maintain the integrity of the office of trustee, the trustee of an IDGT should take affirmative steps to establish the trustee's independence from the grantor. Following are some suggestions that will help minimize risk in general and in the context of IDGTs.

The trustee, or prospective trustee, should consult an attorney regarding all matters related to the trustee's role as a fiduciary for the IDGT. Prior to accepting the office of trustee, the prospective trustee should understand the grantor's general planning objectives and how the IDGT fits into the grantor's wealth transfer framework. The trustee may want to request economic modeling of the IDGT before accepting the office of trustee and periodically thereafter. The grantor should provide the trustee with sufficient personal financial information for this purpose.

The trustee's counsel should review the trust agreement thoroughly to ensure it grants the trustee the necessary powers, discretions and protections to administer the trust properly. The trust agreement should indemnify the trustee for all actions the trustee takes or doesn't take in good faith in the administration of the IDGT. In particular, with respect to each discretionary distribution from the IDGT (including a distribution to the grantor to reimburse the grantor's payment of the trust's income taxes), the trust agreement should authorize the trustee to require a release from and to be indemnified by the distributee. In connection with annual accountings for the IDGT, the trust agreement should direct the trustee to seek general releases from all current and remainder beneficiaries. If possible, any revisions to the trust agreement should be made before the prospective trustee accepts office.

The trustee should establish policies and procedures for discretionary distribution requests by the trust's beneficiaries and other discretionary actions the trustee is authorized to take. The trustee should thoroughly document each determination made and the process by which the trustee arrived at such determination. As a matter of course, the trustee should seek releases and indemnifications as authorized by the trust agreement and take advantage of state law protections and statutes of limitation related to trust accountings.

If the IDGT authorizes the trustee to loan funds or make discretionary distributions to the grantor from the trust to reimburse the grantor for paying the trust's income taxes or provide the grantor with temporary liquidity, the trustee should establish a formal process for considering each such loan or distribution request. No loan or distribution should be made to the grantor unless a determination is made that it's in the beneficiaries' best interests. As part of this process, the trustee should assess the likelihood that the loan or distribution will result in the grantor's future ongoing payment of the trust's income taxes without reimbursement. This process should show thorough documentation of each decision. Prior to making any loan or distribution, the trustee should consult with counsel to assess any attendant risks.

If the trustee contemplates a modification of the trust agreement, trust decanting or other change, either pursuant to the trust agreement or local law, the trustee should consider procuring a tax opinion from the trustee's counsel or a PLR from the IRS assessing the tax impact of the proposed changes to the trust, the trust's beneficiaries and the grantor. In light of the gift tax complications described in the CCA, the trustee should focus on changes that may result in gifts from beneficiaries. If the change could result in a taxable gift, the beneficiaries should consider filing gift tax returns disclosing the change to start the statute of limitations.

Endnotes

1. This issue is complicated when the intentionally defective grantor trust creates a spousal lifetime access trust and the grantor and spouse divorce. Discussion of alternatives in that situation are beyond the scope of this article.
2. For example, Revenue Ruling 2004-64 states that the value of the trust would be included in the grantor's estate for federal tax purpose if applicable state law would subject the assets of the trust to claims of the grantor's creditors.
3. *See, e.g., Estate of Regester v. Comm'r*, 83 T.C. 1 (1984); Rev. Rul. 79-327; Private Letter Ruling 8535020 (May 30, 1985).
4. In PLR 8535020, *ibid.*, the taxpayer requested a ruling that the exercise of her limited lifetime power of appointment (POA) over the entire trust in favor of her sister wouldn't be a taxable gift because: (1) all distributions from the trust were in the discretion of the trustee; and (2) because of the taxpayer's other resources, the taxpayer was unlikely to receive distributions from the trust. The Internal Revenue Service ruled that the taxpayer's exercise of her POA would constitute a taxable gift by the taxpayer and that the trustee's discretion regarding distributions was merely a factor to be considered in valuing the taxpayer's interest in the trust.