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Internal Revenue Service
memorandum**

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subject: Gift tax consequences of modifying a grantor trust to add a tax reimbursement clause

Issue

What are the gift tax consequences to the beneficiaries when the trustee of an irrevocable trust, with respect to which the grantor is treated as the owner under subpart E, part I, subchapter J, chapter 1 (subpart E) of the Internal Revenue Code (Code), modifies the trust, with the beneficiaries' consent, to add a tax reimbursement clause that provides the trustee the discretionary power to make distributions of income or principal from the trust in an amount sufficient to reimburse the grantor for the income tax attributable to the inclusion of the trust's income in the grantor's taxable income?

Conclusion

The modification to add the tax reimbursement clause will constitute a taxable gift by the trust beneficiaries because the addition of a discretionary power to distribute income and principal to the grantor is a relinquishment of a portion of the beneficiaries' interest in the trust.

Facts

In Year 1, A establishes and funds Trust, an irrevocable inter vivos trust, for the benefit of A's Child and Child's descendants. Trustee is the current trustee of Trust and satisfies the governing instrument requirement that a trustee of Trust must be a person not related or subordinate to A within the meaning of § 672(c) of the Code. Under the governing instrument of Trust, a trustee of Trust may distribute income and principal to or for the benefit of Child in the trustee's absolute discretion. Upon Child's death, Trust's remainder is to be distributed to Child's issue, per stirpes.

Under the governing instrument of Trust, A retains a power that causes A to be the deemed owner of Trust under § 671 of the Code, and, accordingly, all items of income, deductions, and credits attributable to Trust are included in A's taxable income.

Neither State law nor the governing instrument of Trust requires or provides authority to a trustee of Trust to distribute to A amounts sufficient to satisfy A's income tax liability attributable to the inclusion of Trust's income in A's taxable income.

In Year 2, when Child has no living grandchildren or more remote descendants, Trustee petitions State Court to modify the terms of Trust. Pursuant to State Statute, Child and Child's issue consent to the modification. Later that year, State Court grants the petition and issues an Order modifying Trust to provide a trustee of Trust the discretionary power to reimburse A for any income taxes A pays as a result of the inclusion of Trust's income in A's taxable income.

Law

Under § 671 of the Code, if the grantor of a trust is treated as the owner of any portion of the trust under subpart E, those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust must be included in computing taxable income or credits of the grantor.

Section 2501(a)(1) imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual. Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(c)(1) of the Gift Tax Regulations provides that the gift tax applies to gifts indirectly made. Further, any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Section 25.2511-1(e) provides that if a donor transfers by gift less than their entire interest in property, the gift tax is applicable to the interest transferred. Further, if the donor's retained interest is not susceptible of measurement on the basis of generally

accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift.

Section 25.2511-1(g)(1) provides in relevant part that donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor.

Section 25.2511-2(a) provides that the gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer. Rather, it is a tax upon the donor's act of making the transfer. The measure of the gift is the value of the interest passing from the donor with respect to which they have relinquished their rights without full and adequate consideration in money or money's worth.

Section 25.2511-2(b) provides that as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for their own benefit or for the benefit of another, the gift is complete. If a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among the donor's descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or X's heirs, the entire transfer would be a completed gift.

Rev. Rul. 67-370, 1967-1 C.B. 324, concludes that a defeasible remainder interest in trust which is subject to termination at the will of another is an interest in property within the meaning of § 2033 of the Code. The ruling notes that the fair market value of the interest would be affected by its possible divestment under general transfer tax rules for the valuation of property, but the value of that interest would not necessarily be nominal.

In Rev. Rul. 2004-64, 2004-2 C.B. 7, a grantor created an irrevocable inter vivos trust for the benefit of the grantor's descendants and retained sufficient powers with respect to the trust so that the grantor is treated as the owner of the trust under subpart E of the Code. In relevant part, the ruling considers two situations in which the trustee reimburses the grantor for taxes paid by the grantor that are attributable to the inclusion of all or part of the trust's income in the grantor's income. In *Situation 2* of Rev. Rul. 2004-64, the distribution reimbursing the grantor is mandated under the terms of the governing instrument. In *Situation 3* of Rev. Rul. 2004-64, the governing instrument provides the trustee with the discretionary authority to make a reimbursing distribution. In both of these situations, when the trustee of the trust reimburses the grantor for the income tax paid by the grantor, the ruling concludes that the payment does not constitute a gift by the trust beneficiaries because the distribution was either mandated by the terms of the governing instrument or made pursuant to the exercise of the

trustee's discretionary authority granted under the terms of the governing instrument.

Analysis

Under the governing instrument of Trust, Child and Child's issue each have an interest in the trust property. As a result of the Year 2 modification of Trust, A acquires a beneficial interest in the trust property in that A becomes entitled to discretionary distributions of income or principal from Trust in an amount sufficient to reimburse A for any taxes A pays as a result of inclusion of Trust's income in A's gross taxable income. In substance, the modification constitutes a transfer by Child and Child's issue for the benefit of A. This is distinguishable from the situations in Rev. Rul. 2004-64 where the original governing instrument provided for a mandatory or discretionary right to reimbursement for the grantor's payment of the income tax. Thus, as a result of the Year 2 modification, Child and Child's issue each have made a gift of a portion of their respective interest in income and/or principal.¹ See § 25.2511-1(e) and § 25.2511-2(b). See also *Robinette v. Helvering*, 318 U.S. 184 (1943). The 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 gift from Child and Child's issue of a portion of their interests in trust should be valued in accordance with the general rule for valuing interests in property for gift tax purposes in accordance with the regulations under § 2512 and any other relevant valuation principles under subtitle B of the Code.²

Section 6110(k)(3) provides that this document may not be used or cited as precedent.

Please call Daniel J. Gespass at (202) 317-6859 if you have any further questions.

Sincerely,

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By: Karlene M. Lesho
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¹ PLR 201647001 concludes that the modification of a trust to add a discretionary trustee power to reimburse the grantor for the income tax paid attributable to the trust income is administrative in nature and does not result in a change of beneficial interests in the trust. These conclusions no longer reflect the position of this office.

² Although the determination of the values of the gifts requires complex calculations, Child and Child's issue cannot escape gift tax on the basis that the value of the gift is difficult to calculate. See *Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943) ("The language of the gift tax statute, 'property . . . real or personal, tangible or intangible,' is broad enough to include property, however conceptual or contingent.")

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