TAX

IRS flip-flops on gift tax question involving grantor trusts

By Tobias Salinger January 12, 2024, 3:52 p.m. EST 3 Min Read

The IRS flipped a stance the agency took seven years earlier on the question of whether certain trust distributions amount to a taxable gift.

Its Dec. 29 guidance, called "chief counsel advice," may affect the many financial advisors and tax professionals providing estate planning services to their clients. In it, the IRS stated that its 2016 conclusions that some payments out of a grantor trust are not gifts "no longer reflect the position of this office." The new position will primarily change a planning strategy for intentionally defective grantor trusts in which the person who contributed assets into the entity for the benefit of their children alters the terms to provide for reimbursement distributions of their income taxes.

"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," IRS Associate Chief Counsel for Passthroughs and Special Industries Holly Porter wrote in the guidance document last month.

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for the original owner of the money, securities, business stake or other holdings rather than the recipient. Those tax payments amount to a penalty-free gift to the beneficiary. Under the previous guidance, altering the terms to allow for reimbursement payments back to the grantor previously wouldn't have carried any gift tax penalties.

"This strategy is fraught with risks beyond just the gift tax issues," Valerie Escobar, a senior wealth advisor with the Overland Park, Kansas-based office of Mariner Wealth Advisors, said in an email. "Using this strategy so that the grantor can access the IDGT funds without turning off the defective feature could potentially disqualify the trust. We've seen attorneys refuse to even include this feature in the trust. The fact that the IRS has reversed their stance will likely prevent heartache. Other strategies, such as taking loans from the IDGT to cover tax payments, are cleaner and not shady."

Two footnotes included in the new guidance read as especially significant to certified public accountant Ed Zollars, the author of Kaplan Financial Education's "Current Federal Tax Developments" blog. In the first, the IRS said that the previous guidance that deemed the "discretionary trustee power to reimburse the grantor for the income tax paid attributable to the trust income" to be "administrative in nature" is not in place anymore.

In the second, the agency reminded advisors and tax professionals that, even if "the determination of the values of the gifts requires complex calculations," the trust beneficiaries "cannot escape gift tax on the basis that the value of the gift is difficult to calculate."

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These kinds of trusts come in handy when advisors, tax pros and their clients are seeking "helpful tools for reducing a taxable estate's liability in the future," according to Escobar. For example, business owners can put shares of their companies into the trust in order to "keep the potentially exponential growth out of the grantor's estate," she noted. Complexity may ensue, though, in trying to ensure that the grantors keep enough assets for their own budgets and long-term financial plans.

said. "As human nature creeps in, maybe the grantor decides they've grown tired of paying taxes for their heirs or need to keep the cash for their own expenses. Flexibility is written into the trust to allow for either eventuality."

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