Estate & Trust Planning

IRS Reverses the Rules on Trusts and Taxes

Patrick D. Crowley JD*, CLU

*Not practicing on behalf of MML Investors or Strategic Financial Partners.
Securities and investment advisory services offered through qualified registered representatives of MML Investors Services, LLC. Member SIPC. 949 South Shady Grove Road, Suite 300; Memphis, TN 38120. 901.767.5951. The information provided is not written or intended as specific tax or legal advice. Neither Strategic Financial Partners nor its employees and representatives are authorized to give tax or legal advice. Individuals are encouraged to seek advice from their own tax or legal counsel.
CRN202701-5826213

IRS Surprises Grantors and Their Trusts

Many families use trusts to accomplish a variety of family goals.

From an income tax perspective, trusts are divided into those that are *grantor and non-grantor*. With a non-grantor trust, the trust pays its own income taxes, and those rates are steep. The top marginal tax rate of 37% applies to trust taxable income over *$15,200* earned in tax year 2024. (By comparison, a single taxpayer reaches the 37% tax rate on income over *$609,350*.)

With grantor trusts, the person who set up the trust pays any income taxes, generated by the trust, at his or her own personal rate.[1] For example, families using a Revocable Living Trust (RLT), as their primary estate planning document, are familiar with this as the RLT uses the individual's Social Security number for tax reporting purposes.

Other grantor trusts are irrevocable. They are designed, typically, to minimize estate tax exposure. Here, the grantor is, typically, responsible for income tax payments.

Some grantors find they are facing larger tax rates than they expected or prepared for. One taxpayer, in a 2016 Private Letter Ruling (PLR)[2], asked the IRS's opinion about *modifying the trust* document to permit the trustee in assisting him with these payments. The IRS considered the request and okayed it for the taxpayer making the request. In sum, the trustee could use trust resources to assist in the payment of taxes, if the beneficiaries were good with it. While PLRs can only be relied upon by the IRS and the requesting taxpayer, other grantors saw this PLR as an opportunity to consider doing the same thing with their trusts.

At the end of 2023, the IRS published a Chief Counsel Advice (CCA)[3], saying in effect, "we *made a mistake in that PLR"*. Now, the IRS takes the position that ***modification*** of an existing grantor irrevocable trust, when the beneficiaries' consent to adding a *discretionary income tax reimbursement provision*, ***results in a taxable gift by the beneficiaries***. The rationale was that the beneficiaries were relinquishing a portion of their interest in the trust by doing so. (Oddly, the CCA does not say how to value the gift, stating that "…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." [4])

Since this was unexpected by many estate planners and because grantor trusts and tax reimbursement clauses are so common in estate planning, this is worth a deeper look.

The planners' surprise was based on the PLR and the IRS' *Revenue Ruling (RR) 2004 – 64*, which approved a similar arrangement. However, in the RR, the IRS *dealt with a document that included a tax reimbursement provision which could be exercised upon the discretion of the trustee.* (If it were mandatory, the IRS said the trust assets would be

---

[1] *The Grantor Trust Rules: An Exploited Mismatch,* The Tax Advisor, November 1, 2021.

[2] PLR 201647001

[3] CCA 202352018

[4] Ibid

*Not practicing on behalf of MML Investors or Strategic Financial Partners.
Securities and investment advisory services offered through qualified registered representatives of MML Investors Services, LLC. Member SIPC. 949 South Shady Grove Road, Suite 300; Memphis, TN 38120. 901.767.5951. The information provided is not written or intended as specific tax or legal advice. Neither Strategic Financial Partners nor its employees and representatives are authorized to give tax or legal advice. Individuals are encouraged to seek advice from their own tax or legal counsel.
CRN202701-5826213

included in the donor's estate at death.) In the RR, the IRS wrote that the use of the trustee's discretion to make the payments isn't something that the can donor can just expect. Per the IRS' RR, the existence of an implied understanding may be found if the tax reimbursement was used excessively.[5]

In the CCA, when distinguishing the facts of the PLR from the RR, the IRS found a significant difference between a trust with an existing reimbursement provision and one where a modification is sought to be include*.*

The IRS' CCA may raise two questions for you. First, *Why do grantors want to pay the tax for an irrevocable trust?* And *"If I have an irrevocable grantor trust, where I'm paying the taxes, what should I do next?* "In respect to the first question, having the grantor pay the income taxes avoids depleting the assets in the trust, thereby passing even more down to family beneficiaries.

F**or those with irrevocable grantor trusts in place, consider some of these planning steps:**

1. Contact your *Strategic Financial Partners* advisor to discuss this rule change as well as the coming income & estate tax law changes in 2026 with the expiration of the *Tax Cuts & Jobs Act* (TCJA).
2. Review irrevocable grantor trust document(s) for existing tax reimbursement language.
3. A possible correction for existing trusts is to have the trustee decant, or move assets to a new trust, with tax reimbursement language. It's unknown how the IRS will view that approach, so make sure to include your attorney in the discussion.
4. Instead of tax reimbursement, consider having the trustee make payments to the non-grantor spouse if he/she is a beneficiary or, if permitted, make loans from the trusts to the grantor, among other options.
5. For any new trusts, discuss with your attorney the pros and cons around including tax reimbursement language.
6. If you do have this language in your grantor trust now, remember the IRS' admonition from *Rev. Ruling 2004 – 64*, the tax reimbursement should not be used excessively or as part a plan between the trustee and grantor.

---

[5] *Revenue Ruling (RR) 2004 – 64*

*Not practicing on behalf of MML Investors or Strategic Financial Partners.
Securities and investment advisory services offered through qualified registered representatives of MML Investors Services, LLC. Member SIPC. 949 South Shady Grove Road, Suite 300; Memphis, TN 38120. 901.767.5951. The information provided is not written or intended as specific tax or legal advice. Neither Strategic Financial Partners nor its employees and representatives are authorized to give tax or legal advice. Individuals are encouraged to seek advice from their own tax or legal counsel.
CRN202701-5826213