Taxation of Irrevocable Trusts

Income and Transfer Tax Ramifications of Commutations and Reformations of Irrevocable Trusts that Substantially Change the Parties' Beneficial Interests

Southern Arizona Estate Planning Council

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Agenda

- Why Beneficiaries want to Terminate Irrevocable Trusts
- Ease of NJSAs/TEDRA/UTC Reformations and Terminations
- Potential Gift/Estate/GST Tax Effects
- Potential Asset Protection, Debtor/Creditor Law Effects
- **Potential Income Tax Effects**
  - Recent PLRs 2019-32001-10 Should Scare You!
  - IRC §1001 and the Legacy of *Cottage Savings case*
  - IRC §1001(e) Zero Basis Rule and 1001(e)(3) Exception
- IRS Chief Counsel Memo 2021-18008 re QTIP commutation
- When Reformations May Implicate IRC §1001 as Well
- Why Decanting may be the Same as any other Reformation (at least for *income* tax purposes); IRS comments re decanting
- Solutions to Avoiding IRC §1001 and the Zero Basis Apocalypse
- Situations Where Early Termination May Actually Save Tax
- Summary/Final Thoughts

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Explanation of Attached Material and Further Reference

- This CLE will primarily go over material in the article, *Potential Income Tax Disasters for Early Trust Terminations*, LISI Estate Planning Newsletter #2753
- Other material referenced is the "*Optimal Basis Increase Trust (OBIT)*" and *IRC 678 and the Beneficiary Deemed Owner Trust (BDOT),* both of these white papers may be downloaded for free from www.ssrn.com – just search under my name.
- For further discussion also see "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications", material available by emailing Steve Gorin at sgorin@thompsoncoburn.com – I highly recommend being added to his quarterly updates!

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New Paradigm

- Even if the $13.61 million ($27.22 million couples) applicable exclusion amount for 2024, adjusted for inflation, does revert to about $7 million ($5 million plus inflation adjustments), in 2026 or sooner, over 99% of the population would still be unworried about estate, gift or GST tax.
- Anyone with enough money to have a trust, however, is worried about *income* tax, and very few irrevocable trusts are designed to be *income tax* efficient.
- Irrevocable non-grantor trusts have three main *income* tax drawbacks: 1) lack of a basis adjustment in most trusts at the beneficiaries' death; 2) compressed tax brackets and 3) worse income tax treatment for special assets. See white papers on those issues.

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Why Terminate Irrevocable Trusts Early?

- Not needed for estate/GST tax savings
- No one worried about creditors/divorce/bankruptcy
- Hampers lifetime distributions/planning
- Hampers testamentary distributions/planning
- Income tax drawbacks from prior page
- Potential *state* income tax disadvantage
- Costs (trustee, attorney and accounting fees)
- Disputes with trustee(s)
- Disputes between current beneficiaries
- Disputes between current and remainder beneficiaries
- Pledging of assets is difficult, if not impossible
- ***Show me the money***!!! Beneficiaries want to spend!

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Ease of UTC Reformations and Terminations

(www.uniformlaws.org for cites to 35 UTC state plus D.C statutes)

- UTC § 111 – nonjudicial settlement agreements
- UTC § 411 – modification/termination by consent
- UTC § 412 – unanticipated circumstances
- UTC § 414 – uneconomic trust
- UTC § 415 – correct mistakes
- UTC § 416 – settlor's tax objectives
- UTC § 417 – combination, merger, division

- Non-UTC states often have similar provisions (TEDRA)

This does not even include decanting or common law remedies, still available unless inconsistent w/UTC:

UTC § 106 (for AZ's, see AZ Rev. Stat.§ 14-10101 et seq)

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Ease of UTC Reformations and Terminations

- UTC §410 Modification or termination of trust; proceedings for approval or disapproval.

  ***(b) A proceeding to approve or disapprove a proposed modification or termination under Sections 411 through 416, or trust combination or division under Section 417, may be commenced by a trustee or beneficiary, [and a proceeding to approve or disapprove a proposed modification or termination under Section 411 may be commenced by the settlor]. The settlor of a charitable trust may maintain a proceeding to modify the trust under Section 413.

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Ease of UTC Reformations and Terminations

- UTC §411: "Modification or termination of noncharitable irrevocable trust by consent.

  [(a) [A noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries, *even if the modification or termination is inconsistent with a material purpose* of the trust.] Alternate version:
  [If, upon petition, the court finds that the settlor and all beneficiaries consent to the modification or termination of a noncharitable irrevocable trust, the court shall approve the modification or termination *even if the modification or termination is inconsistent with a material purpose* of the trust.]

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Ease of UTC Reformations and Terminations

- UTC §411: "Modification or termination of noncharitable irrevocable trust by consent.

  (b) A noncharitable irrevocable trust may be terminated upon consent of all of the beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust. A noncharitable irrevocable trust may be modified upon consent of all of the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust.

  [(c) A spendthrift provision in the terms of the trust is not presumed to constitute a material purpose of the trust.]

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Ease of UTC NJSAs and TEDRA

- Nonjudicial Settlement Agreements are often preferred:
- UTC §111: "Nonjudicial Settlement Agreements.
- Trusts and Dispute Resolution Act (TEDRA)
  Idaho Code §15-8-101 et seq.
  Sections 301-305 focus on nonjudicial resolutions
  Section 103 has broad definitions including "c) The determination of any question arising in the administration of an estate or trust,"
  Section 205 has virtual representation

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Ease of Reformations: Problematic?

- In some states, trustees don't even have standing to object and court involvement is not even needed (not solely a UTC development, see the Restatement of Trusts, 3d, §65). Does this ease cause tax issues to settlor/beneficiaries?
- IRC §2514/2041 prevent powers held in conjunction with donor from being a general power of appointment.
- Treas. Reg. §20.2038-1(a)(2) prevents §2038 application.
- More concerning (or providing more opportunity, depending on your perspective, if the estate is non-taxable) is whether settlor's power "either alone or in conjunction with another person" triggers IRC §2036(a)(2) (e.g. *Powell*, *Cahill*), which has no safe harbor for state law powers similar to § 2038.
- Conclusion: Congress did not intend §2036 to be so broadly interpreted, since this could conceivable trigger inclusion for every intervivos irrevocable trust, LLC. It's "too big to fail" and courts will have to rein in this interpretation.

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Ease of Reformations: Problematic?

- What about Debtor/Creditor law, regardless of transfer tax law?
- Under UTC/common law, a power of withdrawal is attachable, but not if such power is only exercisable with consent of someone adverse to such an exercise. A beneficiary's interest would always be adverse to a settlor's exercise, but the converse is *not always* necessarily true, since the settlor typically has no property interest.
- Example: Parent establishes irrev. trust for child for life, payable to child's estate at death. Parent and child acting together have the power to withdraw the entire trust (§411). Parent has no *power of withdraw* because the child's interest is *adverse* to such an exercise. Child, however, does have a power to withdraw, because the only other person whose consent is necessary to withdraw the assets of the trust, Parent, has no interest adverse to such an exercise. Creditors of Child should be able to attach the trust interest, if they are clever enough to figure this out.
- Contrast: If trust stated at Child's death remainder *to niece* outright (not child's estate), Child's power of withdrawal is only exercisable with Parent **and** niece, who is *adverse*. Therefore ***not*** attachable.

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The Rise of State Decanting Statutes

- Arguably decanting was available at common law in some states if there was sufficiently broad discretion granted to the trustee to distribute assets to the beneficiary, such power included the ability to distribution to a trust for the benefit of the beneficiary.
- A majority of states now have decanting statutes (see Ariz. Rev. Stat. § 14-10819 et seq), with attorneys in some states bragging that their statute allows removing mandatory interests and ascertainable standards and accelerating remainder interests into current interests, actions which go beyond administrative changes and materially change the legal entitlements of the beneficiaries.
- Uniform Trust Decanting Act is a well-done consolidation of some of the best thinking, introduced in 2015 and has already passed in CO, NM, VA, WA, NC, CA, AL, IL, WV, NE, KS, MD, ME and MT.
- Generally requires trustee to have broad discretion over *principal*, see, e.g., *In re Estate of Sibley*, 442 P.3d 805 (Ariz. Ct. App. 2018).
- Just because a trustee CAN decant under state law and reduce or even eliminate an interest does not mean it cannot be a breach: see, e.g., *Hodges v. Johnson*, 177 A.3d 86 (N.H. 2017).

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Ease of Reformations: Problematic?

- Nutshell: It's easier than ever to reform and/or terminate trusts. Some of this trend is quite positive. Others would argue that it has gone too far in the other direction.
- Case in point: *Miller v. Maples* (TN App. 2018) – mom dies, 3 daughters as co-trustees of their mom's trust. Trust is discretionary inc/principal *limited to HEMS but also pays out* ***over ten years***. All agree to **terminate the trust early without** receiving consent of remaindermen. But, before it's wrapped up and terminated, one daughter dies in a car accident. Daughter's executor seeks to enforce but now the two surviving daughters oppose, presumably because the step-child that decedent daughter never liked was going to receive her estate's 1/3 share, *not* the daughter's issue. Amazingly, the trial court and appellate court upheld the agreement – an agreement that never received consent of the remaindermen (at least several of whom were adults), because ***delaying the trust was not a "material purpose" of the settlor***. The court completely ignored the HEMS limitation.

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Ease of Reformations: Problematic?

- The ease of reformations and terminations, for most trust changes, probably do not cause estate/gift/GST or asset protection issues, but the more substantial it is *economically*, the more it is problematic.
- It does, however, raise serious questions for settlors who have various reasons for establishing trusts and would not want them thwarted by an agent acting for them under a power of attorney or guardianship/conservatorship during their lifetime or by the beneficiaries after their death.
- *If the trust is later reformed or even terminated early (a "commutation"), what are the federal tax consequences?* ***Note that when I speak of "early terminations" or "commutations" being a potentially taxable event in this webinar, I am NOT referring to trusts that simply terminate by their original terms or through trustee discretionary distributions within the terms of the agreement – those simply carry out DNI under ordinary rules. I am referring to cases when such distributions would be beyond the trustee's authority.***

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Must the IRS Honor Amendments?

- "[N]ot even judicial reformation can operate to change the federal tax consequences of a *completed transaction*." *American Nurseryman Pub. v. Comm.*, 75 T.C. 271 (1980), citing a string of cases holding similarly from various circuits.
- *Harvey C. Hubbell Trust v. Comm., T.C. Summ. Op. 2016-67*, denied the income tax effect of a Hamilton County probate court-ordered *retroactive* reformation that added a power to distribute gross income to charity. §642(c) deduction denied!

Prospectively, however, the story is (or should be) different:

- In Rev. Rul. 73-142, a grantor/decedent established a trust for his wife and children, not subject to ascertainable standards, and mistakenly retained the power to remove and become the trustee. Years ***prior*** to his death, he went to court to successfully construe the trust to mean that he could not be appointed trustee. The IRS ruled that this court order had the tax effect to negate the IRC §2036/2038 issue.

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Estate/Gift Tax Effect of Reformations and Terminations

- Treas. Reg. §25.2511-1:

  "(c)(1) The gift tax also applies to gifts indirectly made. Thus, **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**."

- Treas. Reg. § 25.2512-8 "Transfers for insufficient consideration.

  Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and *other dispositions* of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor."

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Estate/Gift Tax Effect of Reformations and Terminations

- A failure to preserve or defend one's rights by inaction may be considered a transfer, see Rev. Rul. 81-264, also GCM 38584, Rev. Rul. 84-105, Rev. Rul. 86-39 (e.g., could the beneficiary's complicity to the decanting in *Kaestner* be considered a taxable gift? *Yes*, though it is more obvious with express consent/reformations.)
- So, could the beneficiary or beneficiaries have blocked or undone the decanting, reformation or termination??? How hard would a beneficiary have to try?
- If there is a gift, how is it valued? Easy to value if a trust is a simple "all net income", but the IRS considers giving up even a discretionary interest (e.g., income and/or principal at trustee's sole discretion) to also have value, see PLR 2011-22007, also similar PLR 8535020

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Estate/Gift Tax Effect of Reformations and Terminations

- Rev. Proc. 2020-3, § 5. The IRS has placed decanting that changes beneficial interests in its list of "AREAS UNDER STUDY IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED UNTIL THE SERVICE RESOLVES THE ISSUE THROUGH PUBLICATION OF A REVENUE RULING, A REVENUE PROCEDURE, REGULATIONS, OR OTHERWISE"

  "(13) Section 2501.—Imposition of Tax.—Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a **change in beneficial interests** is a gift under § 2501.

  (14) Sections 2601 and 2663.—Tax Imposed; Regulations.—Whether the distribution of property by a trustee from an irrevocable generation-skipping transfer tax (GST) exempt trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a **change in beneficial interests** is the loss of GST exempt status or constitutes a taxable termination or taxable distribution under § 2612.

  Translation: "we suspect we may not like something about radical decanting, but we really don't know how to attack it"

  Don't hold your breath for answers, it's been on the list 12 years!

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Estate and Gift Tax Effect of Reformations and Early Terminations

- *Sexton v. U.S.*, 300 F.2d 490 (7th Cir. 1962): trust was due to terminate twenty years after the father's death, but could be amended by a majority of the trustees with consent of 2/3 of the beneficiaries. The beneficiaries consented to extend the trust past the original termination date. One beneficiary died after the original termination date but before the amended termination date. The district court held, and 7th Circuit affirmed, that the amendment was effective pursuant to the trust and state law, but that *her **complicity** in this amendment made her a de facto transferor for §2036 purposes*.

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Grandfathered GST Trust Tax Effect of Reformations and Terminations

- Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph § 26.2601-1(b)(4)(i)(A), (B), or (C) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13 [GST tax], ***if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust***.

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Asset/Creditor Protection Effect of Reformations

- A frequent topic at tax/asset protection conferences is removing a right to receive corpus at age X (e.g., *Ferri v. Powell-Ferri* case, *Kaestner* Supreme Court case, where such powers were removed for divorce and state income tax reasons respectively). Will this *wash* for creditor protection? Is the trust thereafter "self-settled"? Could the beneficiary have stopped the decanting?
- *Hawley v. Simpson (In re Hawley)*, 2004 Bankr. LEXIS 173, 2004 WL 330098 (Bankr. C.D. Ill. Feb. 20, 2004)– finding that an agreed-upon extension of an irrevocable trust by beneficiaries created a self-settled trust, negating 11 USC §541(c)(2)'s ordinary protection/exclusion of third party spendthrift trusts, making the irrevocable trust accessible to the beneficiary's bankruptcy estate!
- Creditor access = inclusion in beneficiary's estate

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Income Tax Effect of Commutations

- A commutation is simply a termination of a trust that involves the trustee giving each beneficiary the current actuarial value of their share. E.g. a trust that pays all net income to X, remainder outright to Y is commuted. X is age 60 and not terminally ill and the Section 7520 rate is 2%: X's interest is worth 33.46% and Y's interest is worth 66.54% (Number Cruncher calculation)
- *As interest rates fall, the value of the life interest falls. As they increase, the value of the life interest increases.*
- *As the life/term beneficiary grows older, the value of the life interest obviously decreases and the value of the remainder interest increases.*
- *Deviation too far from these calculations without cause may be deemed a gift. E.g., if above corpus were $1 million, and X got only $200,000 not $334,600, this is likely a $134,600 gift by X to Y.*

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Basic Facts of the Recent Commutation PLRs

- Ten related PLRs, 2019-32001 to 2019-32010:
  Before September 25, 1985, a settlor ("G1") established an irrevocable trust for his son ("G2") and his son's descendants and no contributions were made after that date.
- The trust paid the son all net income, with no discretion for additional principal, remainder to his issue per stirpes outright. The parties agreed to terminate the trust early according to the actuarial value of the interests of the son ("G2"), his four children ("G3", "Current Remaindermen") and eight grandchildren ("G4", "Successor Remaindermen") and went to court to approve the settlement agreement and terminate the trust accordingly (a "commutation"). This was permitted under state law provided no material purpose of the trust was frustrated. The court approved the settlement, contingent on the IRS granting a private letter ruling.

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The Two Gift & GST Rulings in the Recent PLRs

- Since each group received the actuarial value of their interest in the commutation, the IRS ruled that there was no gift between the parties – no surprise there.
- The IRS also ruled that there were no GST ramifications. This is *not quite as obvious* as you would think. Recall the GST regulation previously quoted: "if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation". Remember, G4 would very likely not get a dime in most instances under the status quo ante – G2 would die, G3 would inherit outright and G4 would receive nothing (unless their parent, G3, died before them). Thus the commutation afforded G4, the great-grandchildren of G1, the right to get a significant sum they may have never received (a bird in the hand!), even if it was only the actuarial value of their share. A favorable ruling.

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Income Tax Effect of Commutations: Recent PLRs

Ten new related PLRs, 2019-32001 to 2019-32010:
IRS ruled no GST or gift tax ramifications, but for income tax this was deemed to be a *sale*!

> "Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Son [G2], the Current Remaindermen [G3], and the Successor Remaindermen [G4], ***in substance it is a sale*** of Son's [G2's] and the Successor Remaindermen's [G4's] interests to the Current Remaindermen [G3]."

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Income Tax Effect of Commutations: Recent PLRs

- There are no dollar amounts in the PLRs, but let's imagine the trust corpus in these PLRs is $20 million, with $5 million basis and the actuarial value of G2's interest is $8 million, G3's interest is $11 million and G4's interest is $1 million.
- The $5 million of basis (1/4 of FMV) would be divided under the uniform basis rules as $2 million, $2.75 million and $250,000 respectively (1/4 of the value of their interests).
- G2 pays long term capital gains tax (20% + 3.8% + potentially state) on $8 million (G2 cannot use his share basis)!
- G4 pays long term capital gains tax on $1 million, but is permitted to use their $250,000 share of uniform basis to offset gain, incurring $750,000 of long-term capital gain.
- G3 does not pay tax on receiving their share, but the transaction does trigger tax to G3 on the $9 million of assets going to G2 and G4 to "buy out" their share, minus the $2.25 million of basis attributed to those assets ($9 million - $2.25 million = $6.75 million gain).

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Income Tax Effect of Commutations: Recent PLRs

Summing up the tax bill with our hypothetical low basis $20 million trust:

- G2: $8 million gain
- G3: $6.75 million gain
- G4: $0.75 million gain
- Total gain: $15.5 million

At 30% combined LTCG/NIIT/State tax rate: **$4.65 million**

A very heavy price to pay to terminate a trust! Even if we took a zero off the trust values, $2 million, not $20 million, it's still $465,000 in taxes due!

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Income Tax Effect of Commutations: Recent PLRs

Why isn't the son [G2] allowed to reduce his gain by his share of uniform basis like the others?

IRC §1001(e)(1):

> "In general
> *In determining gain* or loss *from the sale or other disposition* of *a term interest* in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded." [i.e. the basis is deemed to be $0]

Term interest is later defined to include a life interest, even if it is discretionary.

Son's gain would be the same if the entire trust were invested in cash, or even if basis were *higher* than FMV.

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Income Tax Effect of Commutations: Recent PLRs

Is the IRS ***correct*** in its rulings*?*

Arguably, a commutation is just an order distributing assets to beneficiaries, so why isn't it treated like any other trust termination, carrying out DNI, carryover basis, no tax?

There is no clear authority. The IRS cites a Rev. Rul. that is not apt. The best authority on IRC §1001 and when there is a disposition for income tax purposes is the U.S. Supreme Court case of *Cottage Savings*, which dealt with a bank exchanging groups of loans. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is material to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent.

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Income Tax Effect of Commutations: Recent PLRs

Is the IRS ***correct*** in its rulings*?*

- *Many* prior PLRs cited find that a *commutation is a disposition* of assets under IRC §1001, so this is **not** new.
- PLR 2007-23014, however, found a commutation *NOT* to be a disposition: "If, under local law, the trustee is authorized to terminate Marital Trust B and distribute its assets to the remainder and life beneficiaries, the proposed termination and distribution will be by operation of law and *will not be a sale or other disposition with respect to Marital Trust B*."

There are very few citable *cases* in this area:

- *Evans*: trust beneficiary who changed his interest from income to fixed annuity deemed disposed for §1001
- *Silverstein*: trust beneficiary who kept the exact same terms, but where trust *terminated* and the remainder beneficiary paid annuity instead of trustee deemed *not* to trigger §1001.

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Income Tax Effect of Commutations: Recent PLRs

Is the IRS ***correct*** in its rulings*?*

- Perhaps the strongest authority for the government is an older (pre-§1001(e)) case: *McAllister v. Comm., 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947),* in which the income beneficiary was paid $55,000 to release her interest in the trust, and the trust was terminated by court order with beneficiary consent. She attempted to declare a *capital loss,* alleging the $55,000 was less than her basis. The court found her interest in the trust to be a ***capital asset*** (not all courts have followed) and remanded to determine basis/gain/loss. The court dismissed any tax distinction based on terminology or characterization (e.g., termination, cancel, surrender, transfer, etc.), summarizing that "at the conclusion of the transaction the remainderman had the entire estate and the life tenants had a substantial sum of money." The beneficiary's receipt was a ***dispositive transaction,*** however structured.

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Income Tax Effect of Commutations: Recent PLRs

Is the IRS *correct* in rulings that commutation=disposition?

Uncertain. The IRS does have a good argument based on *Cottage Savings* that the parties are all receiving materially different legal entitlements (this part seems obvious), but the other authority cited in PLRs is *dubious*, and the conclusion that only two groups out of three are selling to the other is extremely suspect (recall, the IRS claims a commutation is in substance a sale by G2 and G4 to G3]. It is more logical to conclude that all three groups of beneficiaries (G2, G3 and G4) are disposing of their trust interests.

A commutation is clearly a *disposition* involving parties receiving different interests, but aren't all trust terminations? If distributions are pursuant to trust/state law, traditional trust tax law concerning terminations *should* trump §1001.

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Income Tax Effect of Commutations: Recent PLRs

But what does the IRS say for "close calls"?
Treas. Reg. § 1.1002-1 Sales or exchanges.
"(b) **Strict construction of exceptions from general rule**. The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception."

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Income Tax Effect of Commutations: Recent PLRs

Is the IRS correct in its rulings regarding zero basis rule?

Arguably when a trust terminates, Congress permitted all parties to use their share of uniform basis (no zero basis):

> IRC §1001(e)(3): "Exception
> Paragraph (1) shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to ***any person or persons***."

Treasury Regulations require sale to a third party, however:

> Treas. Reg. §1.1001-1(f)(3) "Exception. Paragraph (1) of section 1001(e) and subparagraph (1) of this paragraph shall not apply to a sale or other disposition of a term interest in property *as a part of a single transaction in which the entire interest in the property is transferred to a* ***third*** *person* or to two or more other persons [maybe the regs overreach here?]

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Income Tax Effect of Commutations: Recent PLRs

Is the IRS correct in its rulings regarding zero basis rule?

Congress probably did not mean to be punitive when a trust is being completely terminated (it does not prevent tax avoidance, but the opposite, creates an unwarranted IRS windfall), but you have a negative Treasury regulation and many PLRs that are not favorable, so it is best to structure any early termination in such a way to avoid this potential result.

If the zero basis rule is avoided, the impact of taxing a termination may be tolerable to the family, depending on the nature of the assets and basis.

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Income Tax Effect of Commutations: Recent PLRs

Despite the devastating income tax result in these recent PLRs, *it could have been much WORSE:*

- What if the trust was in existence less than a year?
- What if the trust owned qualified plans/IRAs?
- What if there were assets implicating related party rules?
- What if the trust had illiquid assets such that the beneficiaries did not have to funds to pay the tax?
- What if parties terminated a trust and never reported it as a potentially taxable event and it's caught later? Does the statute of limitations run three or six years after filing the Form 1040 (or never, if deemed false/willful, though that would be unlikely – see IRC §6501)?
- Plenty of potential for penalties, interest, lawsuits galore! Do you want to guarantee the result for a client?

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Income Tax Effect of Commutations: Recent PLRs

What if the PLRs had involved an irrevocable ***grantor*** trust?

- We think of all irrevocable grantor trusts as being ignored under Rev. Rul. 85-13, but that is only if the transaction is with the grantor (or spouse).
- If G2 and G4 are deemed to sell to G3, and the trust is still a *grantor* trust as to G1, who *owns* G2, G3 and G4's interests? Is the transaction ignored for income tax purposes? Remember, the IRS in all of these PLRs, not just the recent ones, *ignores the trust as a taxpayer* and looks to the *beneficial owners* of the interest as selling, so it's very possible that the result is ***exactly the same***.
- What if the trust were a beneficiary deemed owner trust, granting G2 a power to withdraw all taxable income from the trust such that G2 is deemed the owner under §678? Would this matter? Perhaps, but only for G2.

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Income Tax Effect of Commutations: Recent PLRs

What if the PLRs had involved a **charity** as a beneficiary?

- Trusts are generally eligible for a charitable income tax deduction for distributions to charity from gross income if "pursuant to the governing instrument", but…
- The IRS has taken the position that trust reformations and commutations are not "pursuant to the governing instrument", hence even if gross income is traceable and paid to charity on an early termination, any attempted IRC §642(c) deduction for trust payments pursuant to the final termination will likely be denied to the trust. I think they are wrong in interpreting that phrase, but you can't cite my opinion as authority to the IRS!
- See PLR 2008-48020.
- Commuting a *CLAT*? If charity is a PF, then zero basis, 1.39% tax could apply on receipt. Amount realized over share of uniform basis is gain to remaindermen.

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Income Tax Effect of Commutations: Prior PLRs

There is a long history of the IRS applying these rules to the commutations, especially of CRTs, so these 2019 PLRs are not a crazy outlier you should just ignore:

- PLRs 201136012-201136016 (noncharitable trust where remaindermen sold their interest – zero basis rule did not apply since they were not current beneficiaries, but taxable event);
- PLRs 201026024-201026027 (noncharitable trust, probably same taxpayers as the above PLRs – purchasers of remainder interest receive cost basis);
- PLR 200833012 (CRT commutation does not retroactively disqualify CRT, nor is it self-dealing, but zero basis rule applies to life income beneficiaries on disposition)
- PLR 200827009 (CRT commutation – similar conclusion to above)

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Income Tax Effect of Commutations: Prior PLRs

There is a long history of the IRS applying these rules to the commutations, especially of CRTs, so these 2019 PLRs are not a crazy outlier you should just ignore:

- PLR 200733014 (CRUT commutation, zero basis rule of §1001(e) applies to income beneficiaries "selling" interest),
- PLRs 200648016-200648017 (noncharitable trust commutation was "in substance..a sale", zero basis rule of §1001(e) applied to payment to income beneficiary, LTCG to contingent remainder beneficiaries on amount realized over their share of uniform basis, very similar to the 2019 PLRs);
- PLR 200443023 (noncharitable trust – removing spendthrift clause not taxable event – sale of interest taxable)
- PLR 200442020 (noncharitable trust, similar to above)
- PLR 200231011 (discussed later & in article – mere *modification* of income interest triggers zero basis phantom income disaster!)
- PLR 200210018 (noncharitable trust, surviving spouse gives up her interest to benefit decedent's children via *net gift* renunciation – still an income tax event w/zero basis!)

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The Latest: IRS Chief Counsel Memoranda

IRS CCM 2021-18008:

- Walks through the gift and estate tax ramifications of parties agreeing to terminate a QTIP Trust in favor of spouse (which the IRS saw as a *de facto commutation* with gift by remaindermen because the trustee did not have wide discretion to distribute beyond HEMS). Not one word about potential *income tax* aspects!
- However, on page 5 the IRS stated that the commutation was "***essentially a sale transaction***", which should set off alarm bells regarding income tax, but may easily be overlooked.
- IRS concluded that both the spouse (due to IRC §2519) and the remaindermen were deemed to have made a taxable gift of the same property (the remainder interest).
- Also of interest is that the testamentary limited power of appointment and HEMS rights were essentially ignored in valuing the remainder (which is debatable)
- Lesson: unless blended family, grant trustee wide discretion

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The Latest: IRS CCA 202352018

The Office of Chief Counsel at the IRS recently issued a memorandum (CCA 202352018) in which it expressly reversed its position taken in a prior PLR (PLR 201647001) regarding the later addition of a grantor income tax reimbursement clause to a pre-existing irrevocable grantor trust. To quote the IRS:

> "In substance, the modification constitutes a transfer by Child and Child's issue for the benefit of A [the grantor]. 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 [adding the reimbursement power], 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)."

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The Latest: IRS CCA 202352018

- What is the value of the gift, if any? *"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."* What are the beneficiaries giving up exactly? Does it matter whether the grantor could easily or did threaten to cut off grantor trust status entirely? If so, perhaps their interest becomes *more* valuable.
- Could the IRS try to apply Chapter 14 principles and ignore the value of the interest retained by the purported "donors" so that the entire value of their interest is a gift? A very harsh result!
- Solutions – if beneficiary consents were needed for later reimbursement, this would make the gift incomplete (initially)
- Solutions – some amendments/decantings can be done without any beneficiary consent (but must beneficiary fight?)
- Solutions – loans to settlor would often be better than reimbursement for various reasons, but must be reasonable bona fide loans

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The Latest: IRS CCA 202352018

- Are the risks of adding a discretionary power worth it?
- Another wrinkle even if trustee reimbursement clause is there at the outset that is often overlooked – who is trustee? An independent trustee has no beneficial property interest, so they are not making a gift by exercising discretion. But there might be *a gift if the trustee is also a beneficiary* and the distribution reduces their interest! Beneficiary exercises of lifetime powers of appointment can cause taxable gifts and beneficiary/trustee exercises of discretion can as well if not limited by ascertainable standards! See Treas. Reg. §25.2511-1(g)(2).

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Why Mere Reformations May Implicate IRC § 1001 as Well as *Terminations*

While the prior PLRs concerned complete *terminations* of the trust, there is no reason that substantial *reformations* of trusts cannot be deemed a disposition under §1001 as well, provided one or more of the parties is receiving a "*materially different legal entitlement*."

How do we know what's *materially* different?!

- PLR 2002-31011: reformation where charitable remainder beneficiary was bought out/removed and the individual income beneficiary received a much higher guaranteed payout was deemed to trigger §1001.
- *Evans v. Commissioner*, 30 T.C. 798 (1958), the taxpayer exchanged an income interest in trust for a more certain fixed annuity, and this was found to trigger §1001.

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Why Reformations May Implicate IRC § 1001 as Well as Terminations

- Mere administrative changes should not trigger this rule.
- State law unitrust conversions have a safe harbor (see Treas. Reg. §1.643(b)-1, PLR 2008-10019).
- Severances have a safe harbor, Treas. Reg. §1.1001-1(h)
- PLRs 2017-02005 and 2017-02006 involved converting pot trusts into separate trusts, held, no §1001 event
- PLR 2018-14005, the IRS ruled that a court reformation that converted a mandatory distribution to a discretionary distribution standard and replaced a beneficiary's rights to withdraw corpus at ages 25 and 30 with testamentary general powers of appointment ("GPOA") at that age did not trigger §1001
- There are very good reasons that so many reformation PLRs ask for the IRS to rule on the IRC §1001 issue!

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Why Reformations May Implicate IRC § 1001 as Well as Terminations

- Several Rulings approve **changing from grantor to non-grantor trust status and vice versa (**with exception for "negative basis", where debts exceed basis):
- CCA 2009-23024 – "The conversion of a nongrantor trust to a grantor trust is not a transfer for income tax purposes of the property held by the nongrantor trusts to the owner of the grantor trust that requires recognition of gain to the owner." Also, PLR 2017-30017. Can we convert to BDOT?
- Treas. Reg. §1.1001-2(c), Ex. 5 has example of a grantor trust owning partnership interest w/$1,200 basis, but $11,000 of debt attached. When trust converts to non-grantor trust, grantor realizes gain of $9,800 ($11,000 debt relieved/amt received - $1,200 basis). The negative implication is that, absent this, conversion not typically an income tax realization event. Also, see *Madorin v. Comm'r*, 84 T.C. 667 (1985). Toggling: Notice 2007-73

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Why Reformations May Implicate IRC § 1001 as Well as Terminations

- Where is the line? We have scant guidance, other than a few PLRs and rulings, as to when the IRS or court may find that parties are receiving *materially different legal entitlements. Each IRS agent (including appeals officers) may have their own smell test, as well as judges:*

Mere administrative change (not taxable)→Taxable Disposition
??????????????????????????????????
←--------|-----------|-------------|--------------|-------------|---------→

Change Trustee, Investment Advisor	Mandatory to Discretionary Interest [**adding** or subtracting testamentary GPOA/LPOAs] [removing 5x5 powers][**adding** 5x5 or BDOT powers]	Discretionary to Mandatory Interest	Beneficiary removed or **accelerated**	Commutation - trust is terminated early

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Why Decanting is Probably the Same as a Reformation (at least for income tax purposes)

- Gift tax generally requires some affirmative action or inaction by a donor, but *dispositions* do not. Thus, it is possible that a unilateral action by a trustee to reform a trust, or a decanting that reforms a trust that might shift beneficial interests enough to be a gift *may* not trigger gift tax if the donor could not have prevented it, but this would not necessarily save the action from being a disposition under IRC §1001/*Cottage Savings* if the resulting interests are *materially different*.
- What's the IRS think of decanting? Several PLRs seem to bless decanting in general, so minor administrative changes are fine, but it's the ones that effect a "*change in beneficial interests*" that the IRS has been "studying" for a decade now.

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Avoiding the § 1001(e) Basis *APOCALYPSE*

- Removing a spendthrift provision so that the beneficiaries can sell to any third party (there is no related party rule in IRC §1001(e)(3) or regulations) should not be a "disposition" (e.g., PLRs 201026024, 201136012), which would permit the income beneficiary to use their basis to offset gain if all sell to a third party. Or, what if the remaindermen sell to the income bene?
- Parties might contribute their interest to an LLC taxed as a partnership that is generally a non-recognition event per IRC §721. If the LLC is trustee and owns all the interests, the trust merges/collapses, but can an LLC be trustee under applicable state law?

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Avoiding the § 1001(e) Basis *APOCALYPSE*

- ***Gifting*** in lieu of sale (or part-gift, part-sale):
- Income beneficiary could *gift* their interest to charity or to remaindermen (note that this alone may not collapse the trust, since there could be contingent remaindermen)
- Again, even if the spendthrift clause prohibits this, decanting, reformation or NJSAs etc. can always remove or grant an exception to the spendthrift provision.
- Because there would be no consideration received, there can be no taxable income/gain to the donor even if the zero basis rule of §1001(e) applies.
- The Supreme Court has held that a current beneficiary donating their life income interest in a trust to their children does ***not*** implicate the assignment of income doctrine: *Blair v. Comm'r*, 300 U.S. 5 (1937).

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Avoiding the § 1001(e) Basis *APOCALYPSE*

- What if the court orders or parties agree via NJSA to amend the trust first to a discretionary spray trust that enables the trustee in his/her/its discretion to make payments to remaindermen currently – perhaps with a limitation that amounts be in the same % to parties that a commutation would effect? Essentially, it is giving the trustee the *discretion* to partially or fully commute (if to trusts, a *horizontal* rather than *vertical* severance)?
- With a spray trust, we have many decades of experience and authority under subchapter J as to how such discretionary distributions are taxed.
- If done close in time, would this implicate a "step transaction"? What if the trust protector had that power to start with? Should that make a difference? No clear answer, but it's a harder argument for the IRS.

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Avoiding the § 1001(e) Basis *APOCALYPSE*

- Other solutions may involve granting more discretion to trustees and/or splitting the trust first.
- **"Severances"** are specifically excepted from IRC §1001 disposition, per Treas. Reg. §1.1001-1(h), but we don't have a clear definition of what a "severance" is.

"(h) Severances of trusts -

(1) In general. The severance of a trust (including without limitation a severance that meets the requirements of § 26.2642-6 or of § 26.2654-1(b) of this chapter) is ***not*** an exchange of property for other property differing materially either in kind or in extent if -

- (i) An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and
- (ii) Any non-pro rata funding of the separate trusts resulting from the severance (including non-pro rata funding as described in § 26.2642-6(d)(4) or § 26.2654-1(b)(1)(ii)(C) of this chapter), whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument."

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Avoiding the § 1001(e) Basis *APOCALYPSE*

- **Severances**: Example of state statute – see UTC §417:
  - COMBINATION AND DIVISION OF TRUSTS. After notice to the qualified beneficiaries, a trustee may combine two or more trusts into a single trust **or divide a trust into two or more separate trusts**, if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust.
- Is any split of a trust a *severance*, even if it is close to or facilitates a commutation? Where is the line? Wouldn't a horizontal severance go against the purpose of the trust?
- Treas. Reg. § 26.2642-6(j), example 3 assumes that, while a division based on actuarial interests of each beneficiary's interest in a trust is not a "qualified severance" (a term of art subset of "severance" for GST purposes), it is still a "severance". This is weak authority (none, really) for ***income tax*** purposes though. We have nothing in the §1.1001 regulations confirming this- no good definition of the term.

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Avoiding the § 1001(e) Basis *APOCALYPSE*

- **Severances**: Many PLRs have concluded that severances are not an income taxable disposition under Treas. Reg. §1.1001-1(h), but these are garden variety splits of trusts, e.g., a spray trust for X, Y and Z split into a trust for X, a trust for Y and a trust for Z. The PLRs were all approving **vertical, not horizontal**, divisions/splits.
- E.g., PLR 200010037 (trustee had discretionary power to divide trust and IRS concluded trustee's division of trust was not an exchange and no gain realization).
- Similarly, in PLRs 200116016 and 200210056 the trustee's power in trust instrument to divide trusts and the subsequent division of trust was not an exchange and therefore no gain realization.
- In PLR 200128035, the IRS determined the beneficiaries' interests in proposed trusts resulting from a division of a trust were not materially different from their interests in the original trust, and, therefore, no gain realization.
- The general rule of IRC §1001 and *Cottage Savings* will **probably** control over 1.1001-1(h) for any severance that *materially changes* the interests of the parties, as a *horizontal* severance would. Others may disagree with me – it is unclear, but it's a stretch to argue that horizontal severances are covered by statute/1001-1(h).

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Problem Situations Even if § 1001(e) is Avoided

- Even if §1001(e) zero basis rule is avoided by using techniques from prior slides, there may still be significant issues, even if basis is relatively high, with special assets (§1245 gain, etc.)
- When deferred comp or traditional retirement plans/IRAs are paid to trusts, it is "income in respect of a decedent" taxable at ordinary income tax rates. Selling the trust interests is long-term capital gains per Rev. Rul. 72-243. Sounds great – convert 37% → 20% rate or 32% → 15% rate etc.! Let's just terminate all those see- through trusts! *But*, does this trigger income tax on the 401(k) and IRA *in addition* to the LTCG on the sale of the trust interest? Probably – see CCA 200644020. Even if the IRS did not find a commutation to trigger gain immediately, when distribution comes out – odds are someone has to pay ordinary income tax on distribution.

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When Commutation May Actually *Save* Taxes

- QTIP trusts (or marital GPOA trusts) are already in the surviving spouse's estate per IRC § 2044 (or § 2041), potentially subject to 40% estate tax. To the extent a spouse commutes the trust causing a net gift, if he/she survives 3 years, the spouse uses their exclusion early and the effective tax rate for anything above the lifetime exclusion is only 28.57%! Gifting can also remove growth from the estate and grow income tax free in IGT. If the zero-basis rule is avoided, any income tax incurred on gifting/commutation may pale next to the potential estate tax savings.
- Still easier and simpler, however, *if* the trustee has wide discretion, to distribute and have spouse gift directly

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Final Thoughts

- Is this a problem nationwide that is "too big to fail"? Thousands of irrevocable trusts have been commuted (or terminated early in favor of current income beneficiary, which is mostly the same if beyond applicable distribution standards) in the last decade, with or without a court order, with *absolutely no reporting of any income tax by any party*. It's certainly ***not*** on the IRS auditor watch-list.
- That said, "Lots of attorneys I know have done this without any audit" is *not* a great defense, *nor* citable authority.
- The risk may indeed be low, but with so many negative PLRs, and no clear authority, there is still a **very real substantial *income* tax *risk that clients should be informed of***, and different methods to achieve the same end goal may ensure your client is not the "*low hanging fruit*" for an IRS agent. This protects your client, and just as importantly, your practice!

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Questions?

- Updated material on basis and income tax planning will be periodically added to the Optimal Basis Increase Trust and Beneficiary Deemed Owner Trust (BDOT) white papers at http://ssrn.com – just search under my name.
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  - While effort is made to make this outline accurate, this material is not intended as specific tax advice – see your own counsel regarding specific tax issues.
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Please refer to disclosures in the appendix.

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