Irrevocable Trust Modifications and Early Terminations

Unintended Tax Consequences and How To Avoid Them in Both Drafting and Administration Stages

Southern Federal Tax Institute
60th Annual Wealth Transfer Planning Conference
October 31, 2025

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  - Tax
  - Trust and Estate Planning
  - Business Succession
  - Asset Protection

Agenda

- Why Terminate Irrevocable Trusts Early?
- Basics of trust amendment, termination, commutation and/or decantation
- Potential Gift/Estate/GST Tax Effects of Reformations: Retroactive v. Prospective Effect
- Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment. (Incl. Important 2024 Case on QTIP Early Termination: *McDougall v. Comm*., 163 T.C. No. 5)
- Asset Protection Effect of Beneficiary Procurement or Acquiescence to Amendment
- Amendments or Modifications Affecting GST Tax Exemption
- CCA 202352018 – gift tax effect of adding reimbursement power – new IRS thinking?
- Potential ***Income*** Tax Effects of Commutations (Early Terminations): PLRs 201932001-10 (and now PLR 202509010 with a substantially similar holding) - They Should Scare You!
- IRC § 1001(e) Zero Basis *Apocalypse* and its § 1001(e)(3) Exception – *Is the Regulation valid*?
- When *Reformations* May Implicate IRC § 1001; Changing between grantor/non-grantor trust
- In the *planning stage*, how to avoid problems like *Diller*, *McDougall* and above PLRs through use of independent trustees, trust protectors and lifetime limited powers of appointment
- Final Thoughts on Techniques to Avoid Adverse Income and Transfer Tax Disasters

Introduction

- "I don't worry about gift tax ramifications of terminating this old trust because none of the family is likely to have a taxable estate". But anyone with enough money to have a trust is ***worried about income tax.*** I will therefore spend more time on the income tax ramifications than the transfer tax ramifications of early trust terminations.
- We will discuss the ***potential tax consequences of substantial modifications, early terminations and commutations of irrevocable trusts (whether from court action, nonjudicial settlement agreement or decanting)***, and several key court decisions as well as public and private guidance by the IRS and Treasury.
- By "early terminations" I do ***NOT*** mean termination clearly ***pursuant to the terms of the trust***, which is simply a distribution that carries out final year DNI/income on Form K-1. I mean when parties agree to terminate early ***despite*** the terms of the trust or completely contrary to it.

Why Terminate Irrevocable Trusts Early?

Times change. Spouses, kids and grandkids don't want to be locked into what dad wanted, etc.. Here's a ***baker's dozen*** of possible reasons why beneficiaries terminate irrevocable trusts:

1) Not needed for estate/GST tax savings.

2) No one worried about "asset protection" creditors/divorce/bankruptcy/Medicaid.

3) Hampers lifetime distributions/planning (a big one for QTIPs as we will see), or choices for investments (e.g. private equity, 529 plan, ability to fund Roth IRA etc).

4) Hampers testamentary distributions/planning.

5) Federal income tax drawbacks once grantor trust status is turned off, notably the highly compressed tax brackets and worse tax treatment for certain assets and distributions and no tax-free swaps/transactions w grantor, i.e., no BDOT provisions.

6) Potential state income tax disadvantage (e.g., trust pays tax in IL, CA, etc.)

Why Terminate Irrevocable Trusts Early? (cont.)

What follows is a ***baker's dozen*** of possible reasons why people terminate trusts (cont.):

7) Costs (trustee, attorney and accounting fees) – it's uneconomical.

8) Disputes with trustee(s) or other trust advisors.

9) Disputes between current beneficiaries.

10) Disputes between current and remainder beneficiaries.

11) Makes pledging of either trust assets or interests difficult, if not impossible.

12) Lack of a basis adjustments (step up) in trust assets at the beneficiaries' deaths unless a testamentary GPOA is included or added.

13) ***Show me the money!!! Beneficiaries want to spend!***

Basics of trust creation, amendment, termination, commutation and/or decantation

- Most relevant provisions in the Uniform Trust Code ("UTC") relating to creation, amendment, termination, commutation, and decantation of trusts:

UTC §111 - nonjudicial settlement agreements. Aka "private settlement agreements"

UTC §411 - modification/termination by consent

UTC §412 - termination due to unanticipated circumstances

UTC §414 - termination of uneconomic trusts

UTC §415 - modification to correct mistakes

UTC §416 - modifications to satisfy the settlor's tax objectives

UTC §417 - combination, merger, and division of trusts

Plus, common law remedies are still available (per UTC §106), and the majority of states have now passed decanting statutes (18+DC have passed the UTDA).

Non-UTC states often have similar procedures or follow the Restatement, e.g., *In re Frei Irrevocable Trust,* 133 Nev. Adv. Op. 8 (Mar. 2, 2017).

Differentiating When IRS Honors the Change v. The Change Being a Taxable Event in Itself

- The next few slides go over when the IRS has to honor the tax effects of a change to the trust terms pursuant to state law, e.g., moving forward only or retroactively

- Following these slides and discussion, we'll discuss whether *the change itself* could be a taxable event, which is harder to understand, more overlooked, more dangerous and more uncertain.

- These are two different questions which are easy to confuse.

Potential Gift/Estate/GST Tax Effects of Reformations: Retroactive v. Prospective

- Must a reformation pursuant to state law or the instrument be respected for federal tax purposes?
- The IRS and the courts have been very clear about the importance of the effective date of a decanting or other trust termination or modification. With respect to attempts to ***retroactively*** modify a trust, the courts usually haven't permitted it to have retroactive effect for tax purposes. See the following cases:
- *"[N]ot even judicial reformation can operate to change the federal tax consequences of a* ***completed transaction****." American Nurseryman Pub. v. Comr.*, 75 T.C. 271 (1980), citing a string of cases holding similarly from various circuits.
- In *Harvey C. Hubbell Trust v. Comr.*, T.C. Summ. Op. 2016-67, the Tax Court denied the income tax effect of a Hamilton County, Ohio probate court-ordered *retroactive* reformation that added a power to distribute gross income to charity. **The tax court denied the IRC Sec. 642(c) deduction even though the trustee made the gifts from gross income and the court had *retroactively* modified the trust so that the gifts were arguably made *pursuant to the governing instrument*.**

Potential Gift/Estate/GST Tax Effects of Will/Trust Reformations: True Scrivner's Errors/*Bona Fide* Dispute Settlements

- Neither the IRS nor the courts will respect *retroactive* tax effect of a settlement based on "friendly" litigation where no bona fide dispute is present. For example, in *Grossman v. Campbell*, 368 F.2d 206, 18 AFTR2d 6251 (5th Cir. 1966), the court held that a settlement agreement had been reached in a situation where no real dispute existed, and thus the settlement would be ignored for estate tax purposes.
- The Ninth Circuit reached a similar result in *Commissioner v. Vease*, 314 F.2d 79, 11 AFTR2d 1800 (9th Cir. 1963), rev'g. 35 T.C. 1184 (1961). In that case, the court concluded that a settlement agreement had not resulted from a *bona fide* will contest but instead had resulted from "nothing more than a voluntary rearrangement of property interests acquired under an admittedly valid will."
- Similar, *Wolfsen v. Smyth*, 223 F.2d 111 (9th Cir. 1955); *Bath v. Comm.*, T.C. Memo 1975-102. Other examples of settlements that were disregarded for tax purposes include *Aronson v. Comm.*, T.C. Memo 2003-189; *Brandon v. Comm*., 86 T.C. 327 (1986), rev'd on other grounds, 828 F.2d 493 (8th Cir. 1987), on remand 91 T.C. 829 (1988); *Simpson v. Comm*., T.C. Memo 1994-259
- This can be rebutted - *Redstone v. Comm*., 145 T.C. 259 (2015) involved a settlement with some wealth moving downstream but taxpayers overcame the presumption and the court ruled no gift.
- Some taxpayers surely get away with it without the IRS ever catching on – see, e.g., *Matter of Sukenik*, 162 AD3d 564 [1° Dept, NY 2018]

Potential Gift/Estate/GST Tax Effects of Reformations: True Scrivner's Errors/*Bona Fide* Dispute Settlements

- The IRS will be more lenient for *scrivener's errors* as well as *bona fide* dispute settlement.

For example, in PLR 201002013, the attorney had drafted a family/bypass trust provision that was to pay surviving spouse's debts, taxes and expenses, potentially causing inclusion of some or all of the bypass trust in the surviving spouse's estate. A local court fixed the attorney error and the IRS held that would not cause any adverse tax results under IRC Sections 2514/2041 at the time of fix nor upon the surviving spouse's death.

In PLR 202009012, the IRS honored a judicial reformation that clarified/corrected a few scrivner's errors in a joint trust, primarily that it was intended to be irrevocable and decedent's portion split between Family and Marital Trusts at first spouse's death but the scrivener (*who admitted a mistake*) failed to include language that it was irrevocable by surviving spouse. The local court allowed the reformation and IRS in the PLR agreed to honor it for tax purposes.

Potential Gift/Estate/GST Tax Effects of Reformations: Mistakes of Law/Fact that are Not Scrivner's Errors

- Another example of a court honoring a retroactive court reformation is *Breakiron v. Gudonis*, D. Mass 2010, involving a mistake of law, ***not*** merely a "scrivener error":
- Plaintiff Breakiron sought to rescind two irrevocable disclaimers he had made of interests in a QPRT he received at the end of the term. He thought they were timely enough to avoid a taxable gift but had misunderstood (relying on bad tax advice). It was too late under IRC 2518 because the 9 months is measured from contribution, not the end of a QPRT. Therefore, he wanted to "undo" the disclaimer but more importantly "undo" the large taxable gift he had thereby made. He filed in state court originally, but the US (unique- IRS named as a party) removed to federal court.
- Under Massachusetts law, a written instrument may be reformed or rescinded in equity on the grounds of mistake when there is "full, clear, and decisive proof" of the mistake or if it was executed based on a mistake which frustrated the purpose for which it was executed.
- Although they recognized an apparent split in authority, because there was "decisive evidence of the [disclaimant's] intent to minimize transfer tax consequences", the federal district court followed precedent that correcting mistakes in equity retroactively could not only undo the disclaimer under MA law but more importantly held that the order bound the IRS and thus "undid" the taxable gift
- The IRS may not always allow itself to be named a party in such an action: *Van Vliet v. Van Vliet (E.D. Va 2015)* tried to follow the *Breakiron* fact pattern but were shut down and the IRS was dismissed from the case.

Potential Gift/Estate/GST Tax Effects of Reformations: Retroactive v. Prospective

- ***Prospectively***, however, the story is (or should be) different, and more certain than retroactive fixes:
- 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 the trustee and become the sole trustee (a 2038 taint). 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 Secs. 2036/2038 issue before death.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- ***Beneficiary procurement or even acquiescence to trust amendments or terminations may have detrimental tax and asset protection effects*.** This is arguably one of the most under-discussed areas of estate and asset protection planning in light of the tsunami of non-judicial settlement agreements, amendments and court reformations increasingly being used by practitioners pursuant to the UTC, UTDA, or non-UTDA decanting or other law, not to mention options available under common law before anyway, or in non-UTC states.
- Let's start with a quick reminder of the broad definition of a gift for gift tax purposes (or transfer with retained interest in the estate tax context) and then explore a few cases and rulings to eke out the meaning in the context of trust amendments. Treas. Reg. Sec. 25.2511-1(c)(1):

  *"**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**."* [emphasis added]

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- ***If the act of transfer is involuntary, then arguably no taxable gift occurs*.** However, the lines are blurred considerably in the event a putative donor could have ***prevented*** a transfer – a ***failure to preserve or defend one's rights*** by inaction ***may be considered a transfer***. See, e.g., Rev. Rul. 81-264 (failure to enforce note payable), also GCM 38584 and Rev. Rul. 84-105 (surviving spouse's failure to object to underfunding of a general power of appointment marital deduction trust).
- To take an extreme example - if my child steals my assets, without my knowledge or consent, yet I fail to attempt to retrieve or bring suit, I have made a gift – the original intent is irrelevant (although donative intent may be relevant in other contexts such as whether a charitable income tax deduction is permitted). In one ruling, a surviving spouse failed to object to a probate accounting where her lack of objection and acquiescence to getting less than what she was clearly entitled to was deemed to be a taxable gift to those who benefitted, despite there being no clear transfer or active action by the "donor." See, e.g., Rev. Rul. 84-105. Failing to contest a decanting or other reformation could be in the same category, if it would be so extreme as to be a breach of fiduciary duty and potentially reversible.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- A later ruling is similar: in Rev. Rul. 86-39, a beneficiary of a trust acquiesced in a recapitalization and funding of a trust split that essentially had the effect of shifting more value to the trust over which the beneficiary did not have a testamentary general power of appointment and away from the trust over which he did have a testamentary general power of appointment. The IRS ruled that this would be a taxable gift. *"**S**, as the beneficiary of Trust A,* ***could have asserted the right of a trust beneficiary under local law to prevent the trustee from permitting a loss*** *in value of the trust assets. The* ***execution of the release*** *in which S agreed not to raise an objection to the trustee's conduct with respect to the recapitalization* ***constitutes a release of a general testamentary power of appointment*** *by S over stock worth 70x dollars. For purposes of the gift tax, the release by S is treated as a transfer of property to C, the owner of the remainder interest in Trust B, for which S did not receive adequate and full consideration. See Rev. Rul. 84-105."* [emphasis added]
- In the above two deemed gift scenarios, the conclusion is easy because the donor could clearly prevent the transfer. Other cases are not so easy, especially when it's unclear whether someone can prevent an amendment (transfer). This is equally true for decanting as well as court ordered amendments.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- *Sexton v. U.S.*, 300 F.2d 490 (7th Cir. 1962), *cert denied* 371 U.S. 820 (1962) involved an irrevocable trust that a father had established for his seven children, is instructive. That 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, Bertha, died ***after*** the original termination date but ***before*** the ***amended termination date***. The IRS argued that the amendment was ***ineffective***, ***but if not ineffective***, still constituted a transfer subject to IRC Sec***. 2036.***
- The district court held, and Seventh 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 IRC Sec. 2036 purposes.*** Since she had a right to funds at the original termination date, ***her acquiescence was a relinquishment*** of that right, which may be ***considered a transfer of property*** for estate/gift tax purposes.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- Importantly, the court noted that, had the beneficiary ***not consented***, their argument that the amendment was not a relinquishment/transfer that had no tax effect ***"might be persuasive***" [emphasis added]– but the ***beneficiary's active consent killed her estate's case***, even though the amendment could have been accomplished ***without her consent***.
- Be that as it may, irrespective of whether or not she'd consented, she actually did, which mooted the argument. Bertha ***effectively turned her back on her own rights***, further justifying the court's conclusion.
- Another way to look at this case (not discussed in the opinion) is to see each beneficiary as exercising a joint GPOA (although other parties' consent was required, they may have been non-adverse parties).
- Of course, the family in *Sexton* was trying to ***avoid inclusion*** – there may be cases where transfers causing ***inclusion is desired.*** Not all transfers with retained interest are evil and sometimes causing estate inclusion is very valuable and you may be arguing ***for*** it.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- Two PLRs, 201122007 and 8535020 (the paper contains additional cites to other PLRs), highlight the ***gift tax issue***: a mother was the current beneficiary (and co-trustee) of a trust and entitled to income and principal only at the trustee's discretion for HEMS. She did not need nor want any discretionary distributions, had never taken any, and never expected to. Her children were remaindermen. Mother, children and trustees petitioned the local court for an **early distribution to the children**, which would be allowed with consent, as long as it did not frustrate the settlor's material purpose.
- Held in PLR 20112207: No taxable exchange under IRC §1001, but there was a taxable gift even though mom's interest was discretionary. The IRS did not rule on how to value the gift.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- While much of the concern for taxable events involve earlier termination of spousal interests in trust that do not usually terminate until after death, you will still encounter many trusts for children or grandchildren that terminate at ages 30, 40, 50 etc.
- It is common to hear attorneys at CLEs recommending such trusts be decanted or otherwise amended to ***remove*** the termination date so that the beneficiary's interest can remain protected from creditors or spouses (as in the *Powell-Ferri* case) and free from estate tax (if GST exempt), or save state income tax (as happened in *Kaestner*).
- I believe the IRS will likely view (if they ever look to find it) ***any beneficiary acquiescence*** to extending the trust **as a gift taxable transfer**, though depending on what powers are retained (e.g., power of appointment), the gift may often be incomplete. IRS TAM 9419007, citing *Jewett v. Comr.*, 455 U.S. 305 (U.S. 1982).
- Even removing a HEMS (ascertainable standard) power may be a gift. PLR 9451049, citing Rev. Rul. 75-550.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- The lesson: procurement or even active acquiescence to creating a GPOA or even LPOA (or removing a GPOA or vested right) that could divest a beneficiary of a property right could be a transfer and taxable gift, but the value of such gift in many cases would be minimal, since it is based on the "value conferred upon another" at the time. Treas. Reg. Sec. 25.2511-1(c)(1).
- Outright terminations are obvious: if mom were lifetime beneficiary of a bypass trust and mom, kids, grandkids agree to terminate the trust and distribute assets to mom, the remaindermen have very likely made a taxable gift (not of the entire trust, but of the value of their vested contingent remainder, and if they by virtual representation caused their children to be deprived, perhaps a smaller gift from them as well). See PLR 200536018 (pages 5-6 discuss gift tax aspects), in which the IRS determined that a court-ordered modification of remainder interests whereby children and grandchildren gave up some interest in the trust in favor of their children/grandchildren was a taxable gift. If mom has a testamentary power to divest children, I'd argue the gift has a very low value (see discussion of *McDougall*).
- Even if the parties are unconcerned about gift tax (now common), it is unclear whether IRC Sec. 1014(e) may deny the step up (but permit the step down) in basis if mom (or other donee) dies within one year, since it is likely the assets would come back to the children (less obvious, however, is *how much* step up would be denied).

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- Adding testamentary general powers of appointment is less clear, but probably does *not* have the same implication as a termination. E.g., mom is lifetime beneficiary of bypass trust, remainder to son. Mom and son agree and, pursuant to state law, procure a reformation to grant mom a testamentary GPOA. As stated in discussions of authority cited above, the IRS should have to honor this change in property rights at mom's death if pursuant to state law or the trust. IRS has honored this in PLR 202206008.
- However, could the son be said to have made a gift by converting his ***vested*** remainder interest into a vested remainder interest ***now subject to divestment***? Could this trigger IRC Sec.1014(e) if done within one year of mom's death? Perhaps to a *very small* extent. Unlike our previous trust termination example, no value clearly transferred to mom – any increase in the value of her property interest is extremely minimal.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- The closer you get to being able to ***quantify*** how much a reformation/amendment ***decreases*** the value of one or more beneficiaries' interests ***and*** (to a lesser extent) ***increases*** other beneficiaries' interests, the more likely that gift (and GST and income) tax issues may be implicated.
- In one GST tax regulation example, a beneficiary ***consented to a court-ordered trust modification*** that increased one beneficiary's share of trust income and the IRS ***considered it a gift*** by other current beneficiaries to the current income beneficiary whose interest was increased. Treas. Reg. Sec. 26.2601-1(b)(4)(i)(E), Example 7. The fact that it is "court-ordered" rather than through an NJSA (nonjudicial settlement agreement) is ***irrelevant***.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- Here's the nutshell – it is ***safer*** to avoid this morass of gift tax issues by ***avoiding beneficiary involvement*** in any amending actions that *substantially* change beneficial interests. Do so through an independent trustee, independent holder of a collateral lifetime limited power of appointment, trust protector or possibly a party with standing who could not be said to be making a gift by initiating the action.
- Some court-ordered UTC and other state reformations do *not* require beneficiary consent to accomplish (e.g., Ohio RC 5804.12, .15, .16, UTC Sections 412, 415, 416). If there is no action/consent by the beneficiary, there is arguably no "act of making the transfer" under the gift tax regulation cited above. While there is no clear example in the statute or regulations excluding such changes from being a taxable gift if done by others, the IRS has ruled that changes effected by state law that removed a general power held by trustee/beneficiaries were ***not*** taxable gifts. Rev. Proc. 94-44.
- If a decanting *substantially reduces* someone's beneficial interests, the harmed beneficiary may have an action for breach against the trustee. Similar if a harmed beneficiary does not take action to thwart a court petition to amend the trust. By not taking action to void the decanting or order, a beneficiary *may* be making a gift.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- The Tax Court recently issued a reviewed opinion in *McDougall v. Comr.*, 163 T.C. No. 5 (September 17, 2024).
- *McDougall* involved three separate redeterminations of IRS notices of deficiency, one for a dad, and one for each child.
- First, the IRS asserted a disposition by dad under IRC Sec. 2519 around the termination of a QTIP trust (originally funded with a $54 million-dollar QTIP marital deduction) where the two children surrendered their QTIP remainder interests, leaving dad as sole owner of the property in the terminated QTIP (which had doubled to over $100 million dollars in less than five years).
- Second, the IRS alleged that each child made a gift to dad by surrendering the remainder interest each held in the QTIP trust.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- The Tax Court unanimously decided the IRC Sec. 2519 issue identically to its recent reviewed decision in *Anenberg Est.*, 162 T.C. No. 9 (May 20, 2024), with the result that the surviving spouse parent won, like in *Anenberg Est.* (indirectly repudiating portions of the *Kite v. Comr.* case - see Steve Akers' *LISI Estate Planning Newsletter* #2185 (January 21, 2014)). No gift by spouse.
- However, but without deciding the valuation issues, the Tax Court unanimously decided that ***each child had made a taxable gift to dad*** upon surrender of that child's remainder interest. For a $100 million trust, this could be devastating!
- Note that each child was ***involved and consented to the termination***.

Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

- Case will proceed to trial on ***valuation***. What's the value?
- If it were a simple all net income or unitrust, the determination of value would be straightforward (and result in a nasty gift tax).
- While the Tax Court probably got the issue of whether there is a gift right, I think the taxpayer has the upper hand on the valuation (hypothetical willing buyer!)
- Crucial fact: Wife had given her husband a testamentary limited power of appointment to appoint among their descendants. Husband can completely divest either or both of them and **make the remainder interest completely worthless**.
- *What would you as a "willing buyer" pay for a remainder interest in trust, even if the trust is worth $100 million, if it could be, and is 99.99% likely to be, divested by the father by exercising his power of appointment?* I may pay $20 or so on the hope that I can find a loophole to invalidate dad's exercise of his LPOA or it gets lost, but that's a long shot. Like a MegaMillion ticket.

Why "One Way" Terminations are Not Problematic for Income Tax Purposes

- In typical cases where parties are terminating a trust and the family is getting along, like *McDougall*, you have either kids giving up their interests to grandchildren, or spouse giving up their interest in favor of children, or vice versa.
- Where benefits are only going in one direction (donor to donee), Treas. Reg. 1001-1(e) and IRC 102 should apply: taxable gifts are ***not*** taxable exchanges for income tax purposes and are ***not*** taxable to the donee. But be careful of step transactions and side-agreements (mom gives interest to children, terminating trust, and children then give portion back to mom, etc.)

Why Decanting Done by a Non-Beneficiary Trustee Can Still Involve a Taxable Gift/Transfer

- A ***failure to preserve or defend*** one's rights by inaction ***may be considered a transfer***. See Rev. Rul. 81-264, see also GCM 38584, Rev. Rul. 84-105, Rev. Rul. 86-39. See, generally, Treas. Reg. Secs. 25.2511-1 and 25.2512-8.
- This is not without some justification when it is likely that the beneficiary could have gone to court and ***blocked*** an extreme amendment/decanting. For example, could the beneficiary's complicity to the decanting in *Kaestner* or *Ferri v. Powell-Ferri* (which eliminated significant beneficiary rights to property) be considered a taxable gift by the primary beneficiary whose vested termination was delayed by the trustee's actions? Potentially.
- 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?
- This is easy to value if a trust is a simple trust that distributes all net income or a unitrust amount, but the IRS has opined that giving up even a discretionary interest (e.g., income and/or principal at trustee's sole discretion) to also have value. See PLR 201122007, see also similar PLR 8535020. We don't have good data or rulings with any actual numbers though.

Why Decanting Done by a Non-Beneficiary Trustee Can Still Involve a Taxable Gift/Transfer

- 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":*

  "(7) Sections 661 and 662. — Deduction for Estates and Trusts Accumulating Income or Distributing Corpus; Inclusion of Amounts in Gross Income of Beneficiaries of Estates and Trusts Accumulating Income or Distributing Corpus. — 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 distribution for which a deduction is allowable under §661 or which requires an amount to be included in the gross income of any person under §662.

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  (16) 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.

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  (19) 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."

Why Decanting Done by a Non-Beneficiary Trustee Can Still Involve a Taxable Gift/Transfer

- Translation: ***"we suspect we may not like something about decanting and fear it may be abusive in some cases, but we really don't know how to attack it yet."*** Don't hold your breath for answers, these points have been on that list for a decade.
- Can a decanting done by a trustee who is not a beneficiary without express consent ever cause a gift/transfer? It may depend on how "egregious" the decanting is, whether it would be a breach of fiduciary duty and reversible by the beneficiary if they contested it. That said, the IRS recently in CCA 202352018 (to be discussed in a subsequent section) has indicated that a decanting or other action that changes beneficial interests ***can cause a gift when the beneficiary has notice and does not object and the decanting substantially reduces the value of their interest***.
- Absent from the CCA's analysis is whether such an objection would actually make a difference or to what extent that pointless Potemkin posing should be required.

Asset Protection Effect of Beneficiary Procurement or Acquiescence to Amendment

- It is only a matter of time before such arguments are used by creditors and bankruptcy trustees to attack any trusts amended in conjunction with beneficiaries as *de facto* self-settled trusts.
- There are cases that bust such amended trusts when there is no clear amendment power in the trust or state law, but I would caution that such cases might be extended even to cases in which a debtor/beneficiary takes other actions to extend a trust pursuant to state law. *Hawley v. Simpson (In re Hawley)*, 2004 Bankr. LEXIS 173 – finding that an extension of trust by beneficiaries created a self-settled trust, negating 11 USC §541(c)(2)'s ordinary protection/exclusion of third-party spendthrift trusts, making it accessible to the beneficiary's bankruptcy estate.
- If the court order is retroactive *nunc pro tunc*, as a trust construction might be, there is a good argument that the debtor should be absolved from any fraudulent transfer claims similar to the relation back doctrine governing such rules for disclaimers in most states. However, it is wisest to avoid the argument altogether through an action initiated by a trustee (or a trust protector) other than the beneficiary, whether through court reformation or decanting. Similar to the gift tax aspects and the *Sexton* case issues mentioned above, this would ideally be done without any required consent on the beneficiary's part. Alternatively, create an affidavit of solvency and qualify as an Ohio Legacy Trust or other DAPT.

Modifications Affecting GST Tax Exemption

- Could any amendments/modifications affect GST tax exemption? Not usually, but this is yet one more issue to examine when modifying irrevocable trusts.
- Treas. Reg. Sec. 26.2601-1(b)(4)(i)(D) provides that:

  OTHER CHANGES.

  (1) A ***modification*** *of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) 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****,* ***if*** *the modification* ***does not shift a beneficial interest*** *in the trust to any beneficiary who occupies a lower generation (as defined in section 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.* [emphasis added]

- Thus, practitioners should take care not to cause any GST tax-exempt trust to be modified or terminated in such a way to shift a beneficial interest (value) to a lower generation.

CCA 202352018 – A Shot Across the Bow

- Two years ago the Office of Chief Counsel at the IRS 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 IRC Secs. 25.2511-1(e) and 25.2511-2(b)."*
- The IRS National Office further concluded:
- "As a result of the Year 2 modification of Trust, A [the settlor] ***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."*** [emphasis added]

CCA 202352018 - A Shot Across the Bow?

- What is the value of the gift, if any? The CCA concluded: ***"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."*** [emphasis added]
- 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 the case, perhaps their interest becomes ***more*** valuable now by keeping that benefit intact.
- 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? That seems extreme and unlikely. But consider:
- ***Possible solution:*** if beneficiary consents were needed for later reimbursement, this would make the gift incomplete (at least initially, until they approved).
- ***Possible solution:*** some amendments/decantings can be done without any beneficiary consent (but must a beneficiary fake a fight?).

Potential **Income Tax** Effects of Commutations Generally

- A ***commutation*** is simply an early 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 IRC Sec. 7520 rate is 2%: X's interest is worth 33.46% and Y's interest is worth 66.54% (NumberCruncher 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. For example, 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.

PLRs 201932001-10 Regarding Commutations Should Scare You!

- Ten related PLRs, 201932001 to 201932010 throw even more gas on the fire and raise the level of our concern:
- Before September 25, 1985 (so, a ***GST tax-grandfathered trust***), 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.

PLRs 201932001-10 Regarding Commutations Should Scare You!

- The IRS ruled favorably on GST or gift tax ramifications (none), but for income tax purposes, the IRS ruled that this was deemed to be a ***sale***, concluding:
- *"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]."* [emphasis added]
- 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).

PLRs 201932001-10 Should Scare You!

- 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 G4 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).
- Summing up the tax bill with our hypothetical low basis $20 million trust:
- 1) G2: $8 million gain.
- 2) G3: $6.75 million gain.
- 3) G4: $0.75 million gain.
- Total gain: $15.5 million.
- If 30% combined LTCG (20%)/NIIT (3.8%)/State tax rate: ***$4.65 million!!!***

PLRs 201932001-10 Should Scare You!

- This is ***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! Why isn't the son [G2] allowed to reduce his gain by his share of uniform basis like the others?
- IRC Sec. 1001(e)(1) provides:
- "*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.

PLRs 201932001-10 Should Scare You!

- 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 Rev. Rul. 69-486, which deals with non-pro rata distributions, which is not truly applicable or helpful. The best authority on IRC Sec. 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 IRC Sec. 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.

Not a "One-Off" Ruling: New PLR 202509010

- Unfortunately, those 2019 PLRs are ***not*** just a one-time only rogue ruling. Just recently the IRS issued PLR 202509010, with extremely similar facts and rulings.
- Settlor established trust before 1985 for grandson and grandson's decedents. They went to court to terminate the trust and sought and obtained a ruling that if each party gets their actuarial share, no gift, estate, GST tax effects. More troublesome, however, was that the PLR decided the exact same way as the 2019 PLRs on the income tax effect – e.g., 100% is taxable to grandchild:

  "Grandchild's holding period in the life interest in Trust exceeds one year. Accordingly, based on the facts submitted and the representations made, the entire amount realized by Grandchild as a result of the early termination of Trust will be long-term capital gain under § 1222(3)."

PLRs 201932001-10 and 202509010 – Scary Outliers?

- However, in PLR 200723014, the IRS found a commutation to ***not*** be a disposition, concluding:

  “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.”* [emphasis added]

- There are very few **citable** court cases that are **authority** in this area, including:
- *Evans*: trust beneficiary who changed his interest from income to fixed annuity deemed disposed for purposes of IRC Sec. 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 IRC Sec. 1001.

PLRs 201932001-10 and 202509010: Correct?

- Perhaps the strongest authority for the government is an older (pre-IRC Sec.1001(e)) case: *McAllister v. Comr.*, 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 characterizatio***n (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."*** [emphasis added] However structured, the beneficiary's ***receipt*** was a ***dispositive*** transaction.
- 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 the 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 and receiving fee simple equivalents in return.***

PLRs 201932001-10 and 202509010: Correct?

- ***A commutation is clearly a disposition*** involving parties receiving different interests, but aren't all trust terminations? If distributions pursuant to state law, traditional trust tax law and statutes concerning terminations should arguably trump IRC Sec. 1001.
- But what does the IRS say for ***"close calls"*** when it's hard to determine whether there is a ***disposition***? Unfortunately, Treas. Reg. Sec. 1.1002-1 Sales or exchanges, provides in pertinent part:

  "(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."*** [emphasis added]

IRC Sec. 1001(e) Zero Basis Apocalypse-the IRC Sec. 1001(e)(3) Exception

- Arguably when a trust ***terminates***, Congress permitted all parties to use their share of uniform basis (no zero basis):
- IRC Sec. 1001(e)(3) provides:

  "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." [this implies that a transfer to a beneficiary is permitted as long as the trust is terminated as a result, but see below]

- The Treasury Regulations require sale to a third party, however. Treas. Reg. Sec. 1.1001-1(f)(3) provides:

  "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****."*
- After *Loper-Bright*, is the regulation a *convincing* interpretation of the statute? That "any persons" *excludes* beneficiaries? I personally think there is a good argument that any complete termination (commutation) comes under the statute, even if the regulation requires a sale to a third party, but even after Loper-Bright, it's not exactly a slam dunk and who wants to be the test case?

Solutions to the IRC §1001(e) Zero Basis Apocalypse

- Removing a spendthrift provision so that the beneficiaries can sell to any third party (there is no related party rule in IRC Sec. 1001(e)(3) or regulations) should ***not*** be a "disposition" (e.g., PLRs 201026024 and 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 beneficiary?
- Parties might contribute their interest to an LLC taxed as a partnership that is generally a non-recognition event per IRC Sec. 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?
- What about **gifting** in lieu of sale (or part-gift, part-sale)? One-way gifts should avoid 1001. E.g., if kids gift their remainder to mom, and mom later gifts/bequeaths to kids, I'd argue this avoids it.
- 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 IRC Sec. 1001(e) applies.
- The U.S. Supreme Court has held that a current beneficiary donating their life income interest in a trust to their children (e.g., by non-qualified disclaimer) does ***not*** implicate the assignment of income doctrine: *Blair v. Comr.*, 300 U.S. 5 (1937).

Solutions to the IRC §1001(e) Zero 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 both current and remainder beneficiaries – perhaps with a limitation that amounts be in the same % to parties that a commutation would cause?
- Essentially, it is giving the trustee the discretion to partially or fully commute via distributions (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 (they simply carry out DNI). If done close in time, would this be a "step transaction"? Unclear.
- What if the trust protector had that power to start with? I believe that should make a difference, but there is no clear answer. It's a harder argument for the IRS to make.

Solutions to the IRC §1001(e) Zero Basis Apocalypse

- ***"Severances"*** are specifically excepted from IRC Sec. 1001 disposition, per Treas. Reg. Sec. 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**."* [emphasis added]

- 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.* [emphasis added – wouldn't early termination adversely affect this?]

Solutions to the IRC 1001(e) Zero Basis Apocalypse

- 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. Sec. 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 tax purposes), it is still a "severance." This is weak authority (none, really) for ***income tax*** purposes though. We have nothing in the Treas. Reg. Sec. 1.1001 regulations confirming this- there is no good definition of the term.
- ***Severances:*** Many PLRs have concluded that severances are not an income taxable disposition under Treas. Reg. Sec. 1.1001-1(h), but most of these have been 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 National Office determined that 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. But a ***horizontal*** division between income and remainder beneficiaries would create completely different economic interests.

Solutions to the IRC 1001(e) Zero Basis Apocalypse

- The general rule of IRC Sec. 1001 and *Cottage Savings* will *probably* control over Treas. Reg. Sec. 1.1001-1(h) for any severance that ***materially*** changes the interests of the parties, as a horizontal severance would. But there's a good argument at least, and a regulation that seems to be on point and give cover.
- Even if the IRC Sec. 1001(e) zero basis rule is avoided by using techniques elsewhere herein, ***there may still be significant issues***, even if basis is relatively high, with special assets (IRC Sec. 1245 gain, "hot assets", 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% to 15% LTCG 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? Perhaps – 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.

When Reformations May Implicate IRC 1001

- Settlements and amendments of irrevocable trusts can cause an income taxable exchange pursuant to IRC Sec. 1001 if the parties' beneficial interests are changed enough.
- This might be the most overlooked and underappreciated risk to irrevocable trust amendments, especially with fewer taxpayers concerned about the gift and estate tax.
- The seminal oft-cited case for this proposition is the Supreme Court case of *Cottage Savings Assn v. Comr.*, 499 U.S. 554 (1991).
- In that case, the taxpayer, a savings and loan, had exchanged one group of mortgages for another set of mortgages. The exchanged mortgages were substantially identical in many respects.
- Nevertheless, the court determined that the exchanged mortgages were of legally distinct entitlements because of the material difference in the obligors and security and the legal entitlements pertaining thereto.
- Therefore, the taxpayer was determined to have disposed of its interests in the exchanged mortgages and could recognize the loss, for income tax purposes.

When Reformations May Implicate IRC 1001

- Prior to *Cottage Savings*, in *Evans v. Comr.*, 30 T.C. 798 (1958), the taxpayer gave her income interest in a trust to her husband, who agreed to pay her a fixed lifetime annuity. The Tax Court concluded that this was also a taxable realization event (this was prior to enactment of IRC Sec. 1042 that now generally disregards sales between spouses).
- In other prior rulings, tenant-in-common owners rearranged affairs so that parcels were distributed in kind and it was ruled an exchange (but parties were eligible for IRC Sec. 1031 like kind exchange treatment). See, e.g., Rev. Ruls. 73-476 and 79-44. However, if it’s only one parcel being divided pursuant to state law partition, see Rev. Rul. 56-437 and another more recent ruling holding that no exchange occurs, PLR 200411022.
- By contrast, where a taxpayer exchanged her interest in a trust for a right to similar specified annual payments from the remainderman of the trust, in *Silverstein v. U.S.*, 419 F.2d 999 (7th Cir. 1969), the Seventh Circuit held that the taxpayer did not “dispose” of her trust interest, since the taxpayer was to receive the exact same annual payments from the remainderman as she had been receiving from the trust, which the Seventh Circuit found to be a distinguishing factor from *Evans*. The fact that the trust and fiduciary relationship was removed altogether was not “meaningful” – there was no “change in economic position” necessary for a sale or disposition.

When Reformations May Implicate IRC 1001

- The IRS applied the *Evans* and *Cottage Savings* rationale against a proposed trust settlement and modification in PLR 200231011, with potentially disastrous results.
- In this PLR, the trustee and the beneficiaries (one of whom was the taxpayer in the PLR) had agreed that the taxpayer would, in exchange for the income interest he held in the trust, receive (i) a 7% annual unitrust payment from the trust, (ii) principal from the trust in the discretion of the trustee and (iii) a testamentary general power of appointment over the remaining trust property.
- Charitable remaindermen would receive an immediate payment based on the value of their remainder interest and be thereafter removed.
- The IRS ruled that ***such a substantial modification of the trust*** (even though it was not terminated) ***was in effect a sale or disposition under IRC Sec. 1001(a).***
- Unlike a commutation, this was phantom income since the taxpayer did not receive anything from the trust to pay for that tax.

When Reformations May Implicate IRC 1001

- It’s worth reading the IRS reasoning in the 2002 PLR as to why this triggered gain to avoid the disastrous result for other settlements:
- “*Grandson currently is entitled to trust income, subject to a floor and a ceiling. Under the proposed order, he would become entitled to annual payments of seven percent of the fair market value of the trust property, with the trustee having some discretion to make additional payments under certain circumstances. Even assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required by the Performance Chart. He also would not be limited by the Performance Chart's maximum annual payment ceilings. Finally, payments would be determined without regard to trust income. In short, Grandson's interest in the modified trust would entail legal entitlements* ***different*** *from* ***those he currently possesses****. This conclusion is* ***reinforced by adding to the Taxpayer's current entitlement the general power of appointment over any trust corpus****, even though this was a necessary element in a favorable GST conclusion set forth in issue #3, below.”* [emphasis added]

When Reformations May Implicate IRC 1001

- In PLR 201042004, two trusts were merged, and after the modification, a withdrawal right became exercisable only during the month of January of each year, rather than at any time during the year.   This was a relatively minor change in the beneficiary's rights, so the IRS found that:

  "no beneficiaries are acquiring new or additional interests in surviving Trust E as a result of the merger of Trust B into Trust E. Moreover, there does not appear to be any reciprocal exchange of legal rights and entitlements involving Child 2 or any of the other beneficiaries under the trusts here. Therefore, no "exchange" has occurred under § 1001."
- There are really two key questions that emerge from these PLRs and *Cottage Savings* when amending irrevocable trusts – 1) ***when do you even have a "sale or exchange" pursuant to IRC Sec. 1001*** and 2) if so, when ***would the changes be "material" differences*** in legal entitlement? Not all changes are material, as in 201042004.
- Is there a "sale or exchange" in most reformations? Neither one-way transfers nor administrative changes are even exchanges.

When Reformations May Implicate IRC 1001

- Unlike in *Cottage Savings*, the taxpayer in PLR 200231011 was required to disregard his basis in the interests being exchanged because of their term nature, as provided in IRC Sec. 1001(e).
- Accordingly, the taxpayer was required to recognize capital gain on the entire amount received. ***Yikes***! ***If you knew only of this PLR, you may be wary of doing any substantial modifications to irrevocable trusts much less terminations!!!***
- Thankfully, this PLR is more a fluke than a trend, and unitrust conversions and powers to adjust were subsequently granted some safe harbor regulations under IRC Sec. 643.
- Let's differentiate this ruling from the others subsequent to it that are more taxpayer-friendly which held that various modifications, divisions, mergers, amendments and reformations did ***NOT*** trigger IRC Sec. 1001 or *Cottage Savings*.
- The next slides describe some rules gleaned from cases and rulings, with three more recent *taxpayer-friendly* ones to explain what does and does not bother the IRS.

When Reformations May Implicate IRC 1001

- Watch out for two or more parties receiving substantially different interests after the reformation/settlement. If only one party is giving up or granting rights, that there is probably no “exchange” for IRC Sec. 1001, but the IRS has viewed this more expansively in some rulings, so don’t take my interpretation of this as gospel.
- In PLR 200231011, there was a dispute and legal settlement by which the parties were *actively exchanging* substantial interests – the charities were giving up their trust expectancy for immediate payout and the grandson was getting a high unitrust and greater testamentary powers in lieu of an income payout. *Evans* involved an ***exchange*** of a ***trust income interest for an annuity outside of trust***. With ***any*** *quid pro quo*, there is ***arguably an exchange***. But with a decanting or certain court reformations that do not even need the consent of the beneficiary, the beneficiary would not be exchanging anything (or at least it’s much less obvious or very indirect), nor would the trustee – there is no *quid pro quo* as in the 2002 PLR. That said, there is not the need to find a voluntary component for sales and dispositions as there would be for a taxable gift.

When Reformations May Implicate IRC Sec. 1001

- In some amendments the beneficiaries' economic interest is keeping roughly the same, which squarely fits in with the Seventh Circuit's conclusion in *Silverstein* – if the beneficiary is keeping the same payment scheme as before, with no change in economic position, it's hard to argue there is a sale or exchange. By contrast, contested settlements, or reformation actions initiated or negotiated by beneficiaries, particularly if a termination is involved, may come closer to resembling a sale, as in PLR 200231011 or *Evans*.
- Moreover, even if there were a deemed exchange, most changes would not be nearly as material as in PLR 200231011. Still, this PLR serves as a ***warning*** to make changes as minimal as possible, to ***use a method that does not require active beneficiary procurement if possible***, and to avoid negotiations between beneficiaries to avoid any "sale or exchange" argument altogether.

When Reformations May Implicate IRC 1001

- In PLR 9352005, the beneficiary exercised a lifetime limited power of appointment to modify trust provisions concerning the naming of trustees, and remove his lifetime limited power of appointment in the new trust. ***The IRS ruled that IRC Sec. 1001 did not apply***, that the removal of a power of appointment did not affect beneficial ownership, and moreover, naturally questioned whether it could even be a sale/transfer in the first place:
- *"Taxpayer and Son will be entitled to the same benefits under the new trust as they were entitled to under the 1978 trust. Son will not possess a power of appointment over the assets in the new trust. However, the exercise of the limited power with respect to the 1978 trust and the lack of a power of appointment over the new trust in this case will not materially affect either Taxpayer or Son's beneficial interest in the property that comprises the trust principal. Here, the rights of Taxpayer and Son as to principal and income are exactly the same under both trusts. As in Silverstein, previously cited, the substance of the transaction is that the beneficial interests of the parties will not change; they will be as secure as they were before, neither will realize a realistically different value under the new trust than they had under the 1978 trust, and neither will give anything meaningful in the transaction.* ***The transfer, if it is a transfer at all, is a transfer of bare legal title to the trust assets not affecting the beneficial ownership of the property."*** [emphasis added]

When Reformations May Implicate IRC Sec. 1001

- In PLR 201320004, the IRS was quite lenient and ruled that such a trust modification that **removed the requirement to pay "all net income"** to the beneficiary was not a taxable gift, ***did not trigger gain under IRC 1001***, nor did it affect the GST tax zero inclusion ratio. It's likely that the giving up of net income was not considered a taxable gift in the PLR because any accumulated income, pursuant to the trust amendment, was payable to and would be included in the beneficiary's estate.

When Reformations May Implicate IRC 1001

- In PLR 201814005, 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 IRC Sec. 1001. The IRS seemed to be satisfied that this was not a ***material*** change even though the current beneficiary gave up significant economic rights.

When Reformations May Implicate IRC 1001

- There are ***no clear answers*** about when substantial reformations can trigger income tax, but the weight of the PLRs and more importantly the code, regulations and *Cottage Savings* and *Silverstein* cases, do not implicate relatively minor amendments that do not substantially affect what a beneficiary is currently receiving.
- Most common amendments should not be "sales or exchanges" - they are not negotiated between parties nor do they involve "consideration" in the contractual sense as in *Cottage Savings* and PLR 200231011. Even if it were a ***disposition***, it is certainly arguable, as the IRS found in PLR 9352005, that changes should not be ***material*** – especially if it's only adding a ***limited*** rather than ***general*** power of appointment, or simply adding language to ***allow capital gains to be part of DNI. Conversions of pot trusts to separate trusts should be OK as well.*** That said, practitioners should take care ***to avoid a negotiated quid pro quo*** between beneficiaries or a complete overhaul (or worse, a partial termination) of a trust, as in PLR 200231011.

When Reformations May Implicate IRC 1001 as Well

- An example of a potentially dangerous reformation arising out of a common occurrence would be splitting up a trust between children of prior marriage and a surviving spouse where both receive an outright distribution or separate trust with the other parties excluded and they part ways (a/k/a, a commutation). ***This could easily be found to be a "sale or exchange" of interests if it's not a one-way gift.***
- If the split involves IRD such as inherited IRAs or qualified plans, or assets with substantial appreciation, this may be a substantial. Or, if there happened to be a life insurance policy transferred to a non-insured party, this may be a "transfer for value" removing the usual tax-free status of the death benefit and leading to eventual taxation of the proceeds over the basis. Worse, if only the income interest is being terminated (e.g. the spouse is paid off and trust continues for children), then the zero-basis rule may come into play, and the income beneficiary could be taxed on the entire amount.
- While many of the prior PLRs concerned complete terminations of the trust, there is no reason that substantial reformations of trusts can't be deemed a disposition under IRC Sec.1001 as well, provided one or more of the parties is receiving a "materially different legal entitlement" as per *Cottage Savings*.

Unlikely Triggering of Gain When Changing From Grantor to Non-Grantor Trust Status (or Vice Versa)

- Several Rulings approve changing from grantor to non-grantor trust status for income tax purposes and vice versa (with exception for "negative basis," where debts exceed basis):
- ***CCA 20093024*** – "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." See also, PLR 201730017.
- Treas. Reg. Sec. 1.1001-2(c), Ex. 5 has an 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. Comr.*, 84 T.C. 667 (1985).

Why Decanting *May Be* the Same (but may not be) as a Modification (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 Sec. 1001/*Cottage Savings* if the resulting interests are materially different.
- After all, taxpayers are often taxed on corporate mergers when they took no action whatsoever to sell their stock.

The Tests For Transfer Tax and Income Tax Purposes Overlap, But Are Different

- What’s the IRS think of decanting?
- Several PLRs seem to bless decanting in general, so minor administrative changes are certainly fine, but it’s the ones that effect a “change in beneficial interests” that the IRS has been “studying” for over a decade now and put on their “no ruling” list.
- These are uncertain and waiting for the IRS to choose an appropriate abusive case with low-hanging fruit.

Negative Income Tax Consequences for Early Terminations under IRC §1001

- There is a long history of the IRS applying these rules to the commutations, especially of CRTs, so the 2019 PLRs and 202509010 are not just crazy outliers you should just ignore. For example:
- ***PLR 200733014*** (***CRUT commutation***, ***zero basis rule*** of IRC Sec. 1001(e) ***applies*** to income beneficiaries "selling" their interest).
- ***PLRs 200648016-200648017*** (***noncharitable trust commutation*** was "in substance...a sale", ***zero basis rule of IRC Sec. 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*** but sale of interest taxable).
- ***PLR 200442020*** (noncharitable trust, similar to above).
- ***PLR 200231011*** (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!)

Summary/Final Thoughts – *Solving in the Drafting Stage*

- Giving a trustee "sole and absolute discretion" to make distributions is better than HEMS limitation, but may not necessarily allow an independent trustee to safely terminate the trust because it could still be a breach of fiduciary duty (and a gift by remaindermen by not contesting) – see *Diller v. Richardson* (CA) case, or *Hodges v. Johnson (NH),* but language clearly favoring the current beneficiary and permitting the exhaustion/termination of the trust would probably prevent any such arguments (but then does that fail to protect remaindermen?).
- Trustees terminating a trust via super-large distribution to surviving spouse (or other current bene) under wide discretionary authority are likely going to want consents/hold harmless by remaindermen who might later be disinherited and sue, but won't this be just as much of a taxable gift under *McDougall,* and other cases and rulings cited herein?
- Trust protector in some instruments/states (e.g. OH) may be allowed to be non-fiduciary (effectively like a LLPOA) with similar power. If TP is a fiduciary, aren't they in the same spot as a trustee? Non-fiduciaries and LPOA holders are safer.

Summary/Final Thoughts – *Solving in the Drafting Stage*

- If settlor wants the trust to be able to terminate early in favor of current beneficiary, it would be much safer to grant someone a non-fiduciary lifetime limited power of appointment to appoint assets to them to allow early trust termination, but this is a very broad power that some clients may balk at (especially blended family or contentious families). Consider drafting the power to require another trusted party's consent.
- If a beneficiary has this power, it may cause a taxable gift as measured by how much the powerholder's interest is being depleted.
- Terminating a trust early pursuant to limited powers of appt would avoid the *McDougall* fiasco, the *Diller/Hodges* litigation and all the other negative PLRs mentioned.

Summary/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 the distribution went beyond applicable distribution standards*), with or without a court order, with absolutely no reporting of any income tax or gift by any party. It's not been on the IRS auditor watch-list.
- That said, "***We've done it before and lots of attorneys I know have done this without any audit or tax consequence" is not a great defense, nor citable authority. Especially with the most recent PLRs (income tax) and McDougall case (for gift tax).***
- The risk may be low, but with these recent 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!!!***

Thank you!!!

Questions or Criticisms Welcome

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