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TRUST MODIFICATIONS AND TRUST TERMINATIONS: UNINTENDED TAX CONSEQUENCES AND HOW TO AVOID THEM

By

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I. Why Terminate Irrevocable Trusts Early?

Change is constant. Trusts created even a short time ago can become unnecessary or burdensome as to suggest termination. Here is a baker's dozen of possible reasons why people terminate trusts:

1) Not needed for estate/GST tax savings.
2) No one worried about creditors/divorce/bankruptcy.
3) Hampers lifetime distributions/planning.
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.
6) Potential state income tax disadvantage.
7) Costs (trustee, attorney and accounting fees).
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 usually.
13) ***Show me the money!!! Beneficiaries want to spend!***

II. Basics of How Trusts Can Be Created, Amended, Terminated and/or Decanted – Some Through Multiple Steps, State Law Variations, Including Uniform Acts

Unlike English common law that generally permits beneficiaries to amend a trust, the United States has long followed the so-called *Claflin* Doctrine, which does not allow the termination or modification of an irrevocable trust if it would be contrary to a material purpose of the settlor.[1] If it is not

[1] *Claflin v. Claflin,* 149 Mass. 19, 20 N.E. 454 (1889).

contrary, then a court may permit.[2] Settlor intent is paramount, and the courts in most states will still look to enforce and honor the settlor's intent.[3] There are growing statutory exceptions to this, however.

What follows are some of the relevant sections of the Uniform Trust Code ("UTC") and the Uniform Probate Code ("UPC") relating to creation, amendment, or termination of irrevocable trusts:

1) UTC § 401 provides the methods of trust creation.
2) UTC § 102 recognizes that trusts can also be created by special statute or court order.
3) UPC § 2-212 provides for elective share of incapacitated surviving spouse to be held in trust on terms specified in statute.
4) UPC § 5-411(a)(4) permits conservator to create trust with court approval.
5) UTC § 111 provides for nonjudicial settlement agreements.
6) UTC § 411 provides for modification/termination by consent.
7) UTC § 412 provides for termination due to unanticipated circumstances.
8) UTC § 414 provides for termination of uneconomic trusts.
9) UTC § 415 provides for modification to correct mistakes.
10) UTC § 416 provides for modifications needed to satisfy the settlor's tax objectives.
11) UTC § 417 provides for combination, merger, and division of trusts.

Non-UTC states often have similar provisions or case law. For example, for those non-UTC states, the *Restatement (Third) of Property* provides that: "A donative document may be modified, in a manner that does not violate the donor's probable intention, to achieve the donor's tax objectives."[4] As another example, consider this quote from the Nevada Supreme Court (a non-UTC jurisdiction) adopting the Restatement Second of Trusts:

> We adopt Restatement (Second) of Trusts § 338 (Am. Law Inst. 1959) and hold that an irrevocable trust, spendthrift or not, may be modified with the consent of the surviving settlor(s) and any beneficiaries whose interests will be directly prejudiced.[5]

State statutory powers like those granted in the UTC or other state trust code are not exclusive. Even in a state that has passed the Uniform Trust Code, there may also still be common law remedies still available. The Uniform Trust Code, for example, provides that common law remedies are still available unless they are inconsistent with the UTC.[6] Many states have passed decanting statutes as well.

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[2] Restatement (Third) of Trusts § 65. This would include potential beneficiaries, even if they lack capacity. See comments b and c for further discussion.

[3] For example, see this recent Iowa case where beneficiaries unsuccessfully sought to terminate a trust holding mostly IRA money early on the grounds that it would save income tax, but the probate court denied the petition and appellate court affirmed: *In re Revocable Living Trust of Jeanne M. Winn,* 6 N.W.3d 20 (2024).

[4] Restatement (Third) of Property: Wills and Other Donative Transfers § 12.2.

[5] *Brock v. Premier Trust, Inc. (In re Frei Irrevocable Trust Dated Oct. 29, 1996)*, 390 P.3d 646 (Nev. 2017).

[6] Uniform Trust Code § 106.

A. Decanting – Why Do It and How it Differs From Above Methods of Change

Decanting simply is a form of trust ***modification*** that the trustee or someone else, usually acting in a fiduciary capacity, initiates. Neither the Internal Revenue Code, the Treasury Regulations, nor any state statute define the term "decanting," although Sec. 2(10) of the Uniform Trust Decanting Act (UTDA) defines "the decanting power" as "the power of an authorized fiduciary under this [act] to distribute property of a first trust to one or more second trusts or to modify the terms of the first trust."

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.[7] New York passed the first state decanting statute in 1992.

A majority of states now have decanting statutes, with attorneys in some states bragging that their statute allows removing mandatory interests and ascertainable standards and accelerating remainder interests into current interests, actions that go beyond administrative changes and would materially change the legal entitlements of the beneficiaries. Just because a trustee *can* decant under state law and add, reduce or even eliminate an interest does not mean it cannot be a breach of fiduciary duty.[8] And that breach may lead to $3.225 million judgments against the trustee or attorney if the decanting is a breach causing proven damages.[9]

Originally promulgated in 2015, as of summer 2025, 18 states plus the District of Columbia have enacted the UTDA, plus Indiana has substantially enacted it, and it's presently introduced in Massachusetts and Kentucky.[10] Many more states have passed statutes not based on the UDTA.[11] The first paragraph of the Prefatory Note to the UTDA states in pertinent part:

> The Uniform Trust Decanting Act … represent one of several recent innovations in trust law that seek to make trusts more flexible so that the settlor's material purposes can best be carried out under current circumstances. … While some trusts expressly grant the trustee or another person a power to modify or decant the trust, **a statutory provision can better describe the power granted, impose limits on the power to protect the beneficiaries and the settlor's intent, protect against inadvertent tax consequences, provide procedural rules for exercising the power and provide for appropriate remedies.** [emphasis added]

The following situations are a non-exclusive list of situations where decanting may be helpful.

1) Generally protect or improve tax treatment – including state income tax.

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[7] *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940), *Morse v. Kraft*, 466 Mass. 92 (2013), *Ferri v. Powell-Ferri*, 326 Conn. 457 (2017) and 326 Conn. 438 (2017). *Restatement (Second) of Property: Donative Transfers (Second Restatement)* and the *Restatement (Third) of Property: Wills and Other Donative Transfers (Third Restatement)*.

[8] See, e.g., *Hodges v. Johnson*, 177 A.3d 86 (N.H. 2017).

[9] See, https://www.probatetrial.com/wright-v-mcdonald-january-24-2025-nh-trust-docket-order/

[10] www.uniformlaws.org

[11] https://www.afslaw.com/sites/default/files/2022-06/State-by-State-Summaries-of-the-Uniform-Trust-Decanting-Act-JUN22.pdf

2) Correct a drafting error or mistake.
3) Clarify any potential or actual ambiguities in the trust instrument.
4) Correct trust provisions, due to mistake of law or fact, to conform to the grantor's intent.
5) Update trust provisions to include changes in the law, including new trustee powers.
6) Change situs of trust administration for administrative provisions or tax savings.
7) Combine trusts for efficiency and reduce administrative expenses.
8) Add or modify powers of appointment.
9) Allow for appointment or removal of trustee without court approval.
10) Allow for appointment of special trustee for limited time or purpose.
11) Change trustee powers, such as investment options/restrictions, diversification, etc.
12) To create a trust eligible to hold S corporation stock (e.g., an ESBT or QSST).
13) Transfer assets to a special needs trust.
14) Address a beneficiary's changed circumstances, e.g., creditor or marital issues, addiction/mental illness/dementia, including modifying distribution provisions to postpone or delay distribution of trust assets.
15) Modify or add a spendthrift provision.
16) Divide a trust into separate share trusts.
17) Extend the term of a trust.
18) Appoint fiduciaries and trust protectors for the decanting event.
19) Partition of trust for marital deduction or GST tax planning.
20) Convert a grantor trust into a non-grantor trust, and vice-versa.
21) Change beneficiaries (e.g., to stretch out IRA distributions by removing older remote contingent beneficiaries).
22) Reduce a beneficiary's distribution rights to permit a beneficiary to qualify for Medicaid or other government benefits.
23) Expand the trustee's decision-making authority over principal and income.
24) Eliminate or segregate beneficiaries.

A state's decanting law must be construed in the context of the state's other trust laws as well as other provisions of a state's laws or constitution. The various states' decanting laws differ widely on many aspects, including:

1) Extent of permissible changes in beneficiaries or beneficial rights (for example, many will not permit eliminating a beneficiary's withdrawal or distribution right, but some will).
2) Tax savings/restrictions – many have them, but will such blatant self-serving language ("no trustee may decant if it causes a negative tax effect") ultimately be honored by the IRS and federal courts?
3) Other state law restrictions, e.g., state constitution, Rule Against Perpetuities, etc.

4) Notice, consent and approval, etc., particularly as to advance notice/consent, notice to state attorney general if charity is a beneficiary.

5) Fiduciary duty considerations/limitations.

6) Extent of state decanting statutes – must state law apply, or only administration in state, etc.

7) Whether and when a court may or must approve.

Gift tax generally requires some affirmative action or inaction by a donor, *but dispositions do not*. As we analyze the various cases on the tax effects of substantial modifications and early terminations (commutations) discussed in the next sections, it is logical to conclude that decanting should *usually* be safer from a tax perspective than actions involving the beneficiaries' explicit consent, such as certain court proceedings or a non-judicial settlement agreement. If the trustee obtains the beneficiaries' consent prior to the decanting, however, (understandably, to protect the trustee from allegations of breach), the IRS may see this as exactly the same from a tax perspective as an agreed upon non-judicial settlement.

Absent those concerns, 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 alleged donor could not have easily prevented it*, but this would not necessarily save the action from being a *disposition* under IRC Sec. 1001/*Cottage Savings* (discussed later herein) 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 and their inability to affect the merger or sale does not absolve them from their income tax liability. Note that the ***tests for transfer tax and income tax purposes overlap, but are completely different.***

What's the IRS position on 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 those are the ones placed on the "no-ruling" list.[12] These are uncertain and waiting for the IRS to choose an appropriate case with enough low-hanging fruit to spend its resources battling.

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

Must a reformation pursuant to state law or the instrument be given effect 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 generally haven't permitted it to have retroactive effect for tax purposes. As the Tax Court stated in one oft-cited case:

> [N]ot even judicial reformation can operate to change the federal tax consequences of a completed transaction.[13]

[12] Rev. Proc. 2025-3, 2025-1 I.R.B. 142, Section 5.01, paragraphs (5), (14), (17).

[13] *American Nurseryman Pub. v. Comm'r*, 75 T.C. 271 (1980), citing a string of cases holding similarly from various circuits. Another oft-cited case for this proposition is *Van Den Wymelenberg v. United States*, 397 F. 2d 443, 446 (7th Cir. 1968). Rev. Rul. 93-70 was similar in refusing to honor a retroactive fix to trust for QSST qualification.

Similarly, in *Harvey C. Hubbell Trust v. Comm'r*, 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 IRC Sec. 642(c) deduction was denied, even though the gifts were made and the court had *retroactively* modified the trust so that it was arguably pursuant to the governing instrument.**[14]

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 Secs. 2036/2038 issue, as it was done prior to the taxable event occurring.[15]

A. Exceptions for Scrivener's Errors and Bona Fide Dispute Settlements

A taxpayer may have more success arguing that it is a settlement of a *bona fide* dispute of a debatable interpretation or even better, a simple scrivener's error.

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*, the Fifth Circuit 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.[16] The Ninth Circuit reached a similar result in *Commissioner v. Vease*, in which it 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."[17]

This can be rebutted. In *Redstone v. Comm'r*, a dispute settlement caused some wealth to move downstream, but taxpayers overcame the presumption and the Tax Court ruled that the settlement involved no taxable gift.[18]

The IRS will be more lenient for *scrivener's errors* as well as *bona fide* dispute settlements. Here are a few PLR examples:

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

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[14] *Harvey C. Hubbell Trust v. Comm'r*, T.C. Summ. Op. 2016-67.

[15] Rev. Rul. 73-142.

[16] *Grossman v. Campbell*, 368 F.2d 206, 18 A.F.T.R.2d 6251 (5th Cir. 1966).

[17] Similar, *Wolfsen v. Smyth*, 223 F.2d 111 (9th Cir. 1955); *Bath v. Comm'r*, T.C. Memo. 1975-102. Other examples of settlements that were disregarded for tax purposes include *Aronson v. Comm'r*, T.C. Memo. 2003-189; *Brandon v. Comm'r*, 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'r*, T.C. Memo. 1994-259.

[18] *Redstone v. Comm'r*, 145 T.C. 259 (2015).

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 Secs. 2514/2041 at the time of fix nor upon the surviving spouse's death.[19]

In PLR 202009012, the IRS honored a judicial reformation that clarified/corrected a few scrivener'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.[20]

Further back, in PLR 200144018, the IRS approved the retroactive beneficial tax effect of a reformation of a scrivener's error in a trust to prevent the decedent from otherwise holding or releasing a general power of appointment. The Service cited the Bogart & Bogart on Trusts treatise that "if, due to a mistake in drafting, the instrument does not contain the terms of the trust that the settlor and the trustee intended, the settlor or other interested party may maintain a suit in equity to have the instrument reformed so that it will contain the terms that were actually agreed upon."[21]

Despite the favorable rulings above, relying on a scrivener's error may not always work to fix trust mistakes. Consider *Estate of Kraus v. Commissioner*, in which the Seventh Circuit upheld the Tax Court's decision not to respect a state court's reformation of an irrevocable life insurance trust (ILIT) for retroactive estate tax effect. The initial chancery court had based its initial reformation on a scrivener's error. The Seventh Circuit determined that the Tax Court had given proper regard to the ruling of the state court even though it reached a contrary result.[22]

B. Mistake of Law or Fact

Another example of a court honoring a retroactive court reformation is *Breakiron v. Gudonis*, involving a mistake of law, not merely a "scrivener error".[23]

The 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 the law (relying on bad tax advice). It was too late under IRC §2518 because the 9-month time period to make a qualified disclaimer is measured from gift/contribution, not the end of a GRAT/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 government (uniquely, the IRS was named as a party) removed to federal court.

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[19] PLR 201002013.

[20] PLR 202009012.

[21] PLR 200144018.

[22] *Estate of Kraus v. Comm'r*, 875 F. 2d 597 (7th Cir. 1989).

[23] *Breakiron v. Gudonis*, 452 Mass. 1008, 893 N.E.2d 351 (D. Mass 2010).

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 (although the court's conclusion in the decision that the gift was incomplete until it could not be undone is problematic and suspect).

Note that the IRS may not always allow itself to be named a party in a reformation action. The case of *Van Vliet v. Van Vliet* (E.D. Va 2015) tried to follow the Breakiron fact pattern by including the IRS as a party to the local court case, but that attempt wasshut down and the IRS was dismissed from the case.

Conclusion: Don't overpromise clients the same results as in the *Breakiron* case, but with some favorable or sympathetic "good facts," you can build a strong case that mistake of law, correcting scrivener's errors or a bona fide dispute settlements should have retroactive tax effect.

IV. Gift/Estate Tax Effect of Beneficiary Acquiescence to Amendment/Termination

***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.

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)** 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**."
>
> ***
>
> **(g) (1)** Donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. However, there are certain types of transfers to which the tax is not applicable. It is applicable only to a transfer of a beneficial interest in property. It is not applicable to a transfer of bare legal title to a trustee. A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee (but such a transfer may constitute a gift by the creator of the trust, if until the transfer he had the power to change the beneficiaries by amending or revoking the trust).

The gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions, described in 25.2512-8.

(2) If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. [emphasis added]

Further, Treas. Reg. Sec.25.2511-2(a) provides that:

The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is **measured by the value of the property passing from the donor**, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable. [emphasis added]

***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**.[24] To take an extreme example: If my son steals my assets, without my knowledge or consent, yet I fail to attempt to correct or bring suit, I have clearly 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".[25] 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 non-judicial settlement agreements or court ordered amendments.

The *Sexton* case is instructive here. [26] *Sexton* involved an irrevocable trust established by a father for his seven children. The 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

[24] Rev. Rul. 81-264 (failure to enforce note payable); see also GCM 38584; Rev. Rul. 84-105 (surviving spouse's failure to object to underfunding of a general power of appointment marital deduction trust).

[25] Rev. Rul. 84-105. 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.

[26] *Sexton v. U.S.*, 300 F.2d 490 (7th Cir. 1962), *cert denied*, 371 U.S. 820 (1962).

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. Importantly, the court noted that, *had the beneficiary not consented, their argument that the amendment was not a relinquishment/transfer and therefore had no tax effect "might be persuasive"* – but the beneficiary's active consent killed her estate's case, even though the amendment could have been accomplished without her consent. Another way to look at this case (not discussed in the opinion) is to see each beneficiary as exercising a 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 – what if, as posited herein, inclusion is the goal? Not all transfers with retained interest are evil.

There was a district court case that held to the contrary on similar facts (though the issue was whether the extending amendment created a grantor trust rather than an estate/gift tax case). [27] The *Brooks* court found that exercising such powers (analogizing to limited powers of appointment) granted by the trust were **not** transfers of property. This district court case reasoning was rejected by the Seventh Circuit in *Sexton*, but it also lays out the contrary argument that might be cited in "clean up mode," and it may be a useful citation when amending trusts to gain better ongoing income tax results.

Another recent PLR highlights 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 of the trust. The IRS held favorably on GST and income tax results, but held that, although the gift may be "nominal", there is still a taxable gift by the mother for giving up her rights, however speculative in value.[28] The IRS offered no guidance as to how to value such a discretionary interest, but it has consistently held that even discretionary interests have some value.[29]

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 and spouses and free from estate tax (or save state income tax, as happened in *Kaestner*). What differentiates this situation from spousal trust situations is that the beneficiary holds a vested contingent remainder interest – ***the IRS will likely see any beneficiary***

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[27] *Brooks v. Welch*, 29 F. Supp. 819 (D. Mass. 1938).

[28] PLR 2011-22007; see also PLR 8535020 (similar).

[29] In addition to PLRs above, Rev. Rul. 67-370; Rev. Rul. 75-550; PLR 8824025; PLR 8905035; PLR 9451049 (support); PLR 9714030; PLR 9802031; PLR 9811044; PLR 1999-08060; PLR 2002-43026; PLR 2003-39021; PLR 2007-45015; PLR 2007-45016; PLR 2001-22007; PLR 2013-42001 (list copied from fn 38 of "The Dueling Transferors Problem in Generation Skipping Transfer Taxation," *ACTEC Law Journal* Volume 41 Number 1 Spring 2015, by Austin Bramwell and Sean R. Weissbart). More recently, CCA 202352018 found a reformation to cause a gift by granting a discretionary power in the trustee to reimburse a settlor for income tax on a grantor trust – there was no discussion as to the likely value.

acquiescence to extending the trust as a taxable transfer, though depending on what powers are retained, the gift may be incomplete.[30] Even removing a HEMS (ascertainable standard) power may be gift.[31]

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.[32] 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 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). [33] Even if the parties couldn't care less about gift tax, 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 the gift would be).

Adding testamentary general powers of appointment is much 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. 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. This probably makes more than a few readers' heads spin.

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) tax issues may be implicated. In one GST tax regulation example, a beneficiary consented to a court-ordered trust modifications that increased one beneficiary's share of trust income and this was considered a gift by other current beneficiaries to the current income beneficiary whose interest was increased.[34]

Here's the nutshell – it is safer to avoid this morass of gift tax issues by avoiding beneficiary involvement in any amending actions. Do so through an independent trustee, independent holder of a collateral lifetime limited power of appointment, trust protector or possibly an interested party who could

[30] IRS TAM 9419007 (citing *Jewett v. Comm'r*, 455 U.S. 305 (U.S. 1982)). The TAM discussing the exercise of a limited power of appointment that essentially eliminated a power holder's vested contingent remainder interest, and the *Jewett* case discussing a non-qualified disclaimer's elimination of the same.

[31] PLR 9451049 (citing Rev. Rul. 75-550 for how to value such interests). Just because a discretionary HEMS interest is not in one's estate for federal tax purposes per IRC Sec. 2041, nor subject to creditors under most state laws, does not mean that it has no value as a property right! Not only is this true in the gift context, but also for tax liens on trust interests, see separate outline by Ed Morrow.

[32] Treas. Reg. § 25.2511-1(c)(1), quoted in full above.

[33] 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 favor of their children/grandchildren was a taxable gift.

[34] Treas. Reg. § 26.2601-1(b)(4)(i)(E) Example 7. The fact that it is court-ordered is irrelevant.

not be said to be making a gift by initiating the action.[35] Some court-ordered UTC and other state reformations do not require beneficiary consent to accomplish.[36] If there is no action by the beneficiary, there is arguably no "act of making the transfer" under the gift tax regulation cited above.[37] 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.[38]

Finally, note that post-mortem amendments of trusts that qualified for the marital or charitable estate/gift tax deduction, or even administration contrary to trust terms, can retroactively disqualify the trust from the marital or charitable deduction that would have previously been allowed.[39] This is logical, of course. Otherwise, billionaires could leave their estates to a marital GPOA trust, and some court could remove the GPOA, and voila, tax on billions of dollars avoided. You can bet that if the statute of limitations had already passed on the decedent's Form 706 estate tax return filing that the IRS would find some way to either reopen the estate or seek an equitable recoupment of some sort.

A. Tax Court Decision (and Pending Trial on Valuation) in *McDougall*[40]

The Tax Court has recently issued a full court opinion in *McDougall* that illustrates the above points.[41] Clotilde McDougall died in December 2011. At that time, Clotilde's gross estate was valued at $59.76 million. Her surviving spouse, Bruce, served as personal representative of Clotilde's estate. Clotilde left the residue of her estate to Bruce in trust and as trustee of a QTIP-able residuary trust, and their two children were remainder beneficiaries.

As income beneficiary, Bruce, was entitled to the trust's fiduciary accounting income at least annually. The trustee also was authorized to make HEMS distributions of trust principal to Bruce, in "his accustomed manner of living." She also gave Bruce a testamentary special power to appoint the principal of the trust "to or among [Clotilde's] descendants, equally or unequally, outright or in trust, on such terms and in such amounts as he shall determine." If Bruce did not exercise his special power of appointment, the trust remainder was to be divided "into equal shares, one share for each of [Clotilde's] children who is then living and one share for each of [her] children who is then deceased with descendants then living." It did not have to be pro rata.

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[35] See *Gifts by Fiduciaries by Tax Options and Elections,* November/December 2004 issue Probate and Property, by Jonathan Blattmachr, Stephanie Heilborn and Mitchell Gans, for a good discussion of gift tax effects of interested fiduciary decisions regarding Clayton QTIPs, investment choices, alternate valuation date, choice of where to deduct expenses and other dilemmas, concluding that independent fiduciaries are generally safer, but that investment choices by a beneficiary/trustee should not lead to GPOA inclusion. Also, recall the beneficiary/spouse/trustee in PLR 9805025 and PLR 2011-32017 discussed herein initiated the reformations to no ill effect.

[36] E.g., UTC §§ 412 and 416.

[37] See *DiMarco v. Comm'r*, 87 T.C. 653 (1986) (holding that no gift occurred merely due to acts of a decedent's employer beyond his control pertaining to involuntarily granted survivor benefits later payable to his spouse).

[38] Rev. Proc. 94-44.

[39] *Estate of Victoria E. Dieringer v. Comm'r*, 146 T.C. No. 8 (2016); *Atkinson v. Comm'r*, 309 F.3d 129 (11th Cir. 2002); CCA 2006-28026. This may extend to QSSTs too.

[40] Portions of this section copied from *Ed Morrow & Paul Hood on McDougall v. Commissioner: Commutation of QTIP Trust Results in Potential $64 Million Gift,* LISI Estate Planning Newsletter #3146 (September 23, 2024).

[41] *McDougall v. Comm'r*, 163 T.C. 112 (2024).

As personal representative of Clotilde's estate, Bruce made a QTIP election over the trust property. As a result, Clotilde's estate claimed a marital deduction of about $54 million.

By 2016, the value of the trust assets had more than doubled. Bruce and his children, Linda and Peter, agreed that those assets could be more effectively used if Bruce held them outright and free of trust. Therefore, in October 2016, Bruce, Linda, and Peter executed a nonjudicial settlement agreement concerning the trust assets (NJSA).

Section 2 of the NJSA provided:

> The parties hereby agree that the Trust shall be **commuted** and the **entire remaining balance of the Trust shall be distributed outright and free of trust to Bruce.** [emphasis added]

Section 3 of the NJSA provided:

> By signing this Agreement and by virtue of the QTIP election for the [Residuary] Trust, the **commutation** of the Trust results in a **deemed gift**, for federal gift tax purposes, of the remainder interest in the Trust assets from Bruce to Linda and Peter under Section 2519 of the Code. By virtue of the distribution of all of the Trust assets to Bruce, the **commutation** of the Trust **does not result in a deemed gift** of Bruce's income interest in the Trust under Section 2511 of the Code. Additionally, by signing this Agreement and by virtue of the distribution of all of the Trust asset [sic] to Bruce, the **commutation** of the Trust results in a **gift**, for federal gift tax purposes, of the remainder interest in the Trust from Linda and Peter to Bruce. **The deemed gift of the remainder interest from Bruce to Linda and Peter and the gift from Linda and Peter to Bruce results in a reciprocal gift transfer.**[emphasis added]

After auditing Bruce's Form 709, the IRS issued a notice of deficiency to Bruce, which stated the Commissioner's determination that the commutation of the Residuary Trust "resulted in a gift from the Taxpayer to the remainder beneficiaries under Internal Revenue Code sec. 2519." The IRS also issued notices of deficiency to Linda and Peter, which each stated the Commissioner's determination that the distribution to Bruce of all the property of the Residuary Trust "constitutes a transfer of the remainder interest in the . . . Trust and a gift by the remainder beneficiaries under Internal Revenue Code sec. 2511."

This paper will skip over the Section 2519 issues and the court's decision that Bruce did not make a taxable gift, and focus on the court's decision that the children did make a taxable gift to their father by effectively gifting their remainder interests to them. The value of that gift is to be determined in another trial on valuation that is, as of this writing, still ongoing and being briefed for a final decision.

What is the value of their gift? It may largely depend on whether the potential to be completely divested of the trust interest is taken fully into account in valuing the trust interest.

Valuation can only be done by including testimony from valuation and actuarial professionals, but the most important factor may be up to the court to determine. If the trust were a simple "all net income" or unitrust, the valuation question would be rather straightforward (and potentially devastating due to the size of the trust at over $100 million). Luckily for the children, however, their remainder interest could not only be reduced by additional distributions of principal, but were subject to complete divestment through the father's exercise of a testamentary power of appointment.

The value of the remainder interest in the trust may be worth tens of millions of dollars to the two children, but what it is worth to them is not the proper test under the gift tax law. The proper test goes back to our long-time friend that is so often cited in any case on valuation for transfer tax purposes – "fair market value." Revenue Ruling 59-60 defines this as "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts."

Imagine that the spendthrift provision were removed and one of the McDougall children offered to sell you their remainder interest in the trust. How much would you pay for it? At first blush, your eyes get wide at the prospect of someday coming into half of more than a $100 million at their father's death. Therefore you might look to the father's age, health, and Section 7520 rates, but these factors are worthless in valuing the interest as a practical matter, because the children's interest does not include any power whatsoever over the father's testamentary power of appointment. You would be a complete fool to pay more than a token amount for such a trust interest unless the father gives up this power, since he would simply exercise his testamentary power of appointment to divest your interest completely. Those who like to gamble might pay $50 or so on the speculative chance that the father might forget or the instrument exercising the power may get lost or declared defective somehow, but the odds of getting anything at all, ever, are not much better than a MegaMillions ticket. But this assumes that the father still has such a power. In the NJSA, the entire trust was terminated. But at the end of the day, the father is keeping his power to divest, since he owns the property outright. So, any argument that the NJSA removed this power falls somewhat flat. At least to me. The Tax Court may ultimately reach a different conclusion.

As of September 2025, the parties left in the case (the children and IRS, not the father) are briefing the valuation issues and there may be a court decision on the valuation later this year.

V. Why Decanting Can Still Cause a Taxable Gift or Disposition (and a Trust Protector Action is Less Likely to)

Treas. Reg. Sec. 25.2511-1 provides:

> (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. Sec. 25.2512-8 provides:

> 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.

A failure to preserve or defend one's rights by inaction may be considered a transfer.[42] This is not without some justification when it is likely that the beneficiary could have gone to court and blocked the 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 beneficiary whose vested termination was delayed (or eliminated) by the trustee's

[42] See Rev. Rul. 81-264; see also GCM 38584; Rev. Rul. 84-105; Rev. Rul. 86-39.

actions? Probably so, though the gift element is certainly more obvious with any reformations/settlement agreements that involve express consents.

The proper analysis for a court should probably be to ask, "could the beneficiary or beneficiaries have blocked or undone the decanting, reformation or termination?" How hard would a beneficiary have to try? In most decantings, a local court would recognize and approve the trustee's action absent an abuse of discretion, which is a fairly high bar. Perhaps there's a case where a new beneficiary is being added, or someone is completely eliminated, but other than such extremes, most decantings would be approved even if a beneficiary objected.[43]

That said, there is still a possibility of undoing a decanting whenever a trustee is held to a fiduciary standard – the more substantial and material the change in beneficial interests, the more likely that a decanting could be successfully contested. This is why an action through a Trust Protector (especially if the Trust Protector is not a Fiduciary) may in many cases actually be safer than a decanting from a tax perspective. Whether a Trust Protector is considered a Fiduciary or not may depend on both the document and state law. Ohio, for example, creates a presumption that such an advisor is a fiduciary, but permits the settlor to state in the trust instrument whether they are or not.[44] UTC provisions that permit amendments and modifications do not preempt or prevent a trust protector action under the power granted in the instrument.[45]

Holders of lifetime limited powers of appointment are typically not fiduciaries:[46]

> (13) "Power of appointment" means a power that enables a powerholder acting in a nonfiduciary capacity to designate a recipient of an ownership interest in or another power of appointment over the appointive property. The term does not include a power of attorney.[47]

Exercises of such powers are also much more likely to be safe from causing a taxable gift, because it's even less likely that a beneficiary has any power whatsoever to overturn an appointment to another trust. It's even less likely than voiding a trust protector action.

If there is a gift caused by decanting, 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.[48]

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

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[43] See New Hampshire trial court level decision of *Wright v. McDonald*, 317-2020-EQ-00202, assessing $3.225 million in damages against an attorney-trustee for trying to add a client-grantor's new spouse as beneficiary: https://www.probatetrial.com/wp-content/uploads/2025/02/Wright-v.-McDonald-Order-January-24-2025.pdf.

[44] Ohio R.C. Section 5808.08. See also Uniform Trust Code § 808 and the Uniform Directed Trust Act.

[45] *Minassian v. Rachins*, 152 So. 3d 719 (4th DCA 2014).

[46] See Restatement Third of Trusts § 50 Cat. a (2003).

[47] Uniform Power of Appointment Act § 102(13).

[48] See PLR 201122007; see also PLR 8535020 (similar).

THE SERVICE RESOLVES THE ISSUE THROUGH PUBLICATION OF A REVENUE RULING, A REVENUE PROCEDURE, REGULATIONS, OR OTHERWISE":[49]

> (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.
>
> ***
>
> (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.
>
> ***
>
> (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.

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, a few of these points have been on that list for almost a decade, although the number of decanting/modification no-rule issues has increased recently.

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 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 even when the beneficiary *has notice and does not object*. Absent from the CCA's analysis is whether such an objection would actually make a difference, or to what extent that pointless posing should be required.

VI. 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*.[50] Particularly those that are extending a trust past what would otherwise be a termination date (think of famous

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[49] Rev. Proc. 2024-3, Section 5.

[50] For discussion of fraudulent transfer issues using decanting see "Ferri v. Powell-Ferri: Asset Protection Issues, Perils and Opportunities with Decanting," Ed Morrow & Steve Oshins, *LISI Asset Protection Newsletter #240*. In *Ferri*, a divorcing wife tried to void a trustee's decanting that removed the husband/beneficiary's withdrawal right just prior to divorce as fraudulent but was denied relief. This case had a long, interesting history with multiple issues. The decanting was ultimately upheld.

decanting cases like the Supreme Court case of *Kaestner*, or the *Ferri v. Powell-Ferri* case). There are cases that bust such amended trusts when there is no clear amendment power in the trust or state law, but we 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.[51]

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.[52] However, it is wisest to avoid the argument altogether through an action initiated by a trustee (or a trust protector) other than the beneficiary seeking better protection, whether through court reformation or decanting. Similar to the gift tax aspects and the *Sexton* case issues mentioned in the section above, this would ideally be done without any required consent on the beneficiary's part.

VII. Amendments or Modifications Affecting GST Exemption

Could any amendments/modifications affect GST exemption? Not under most circumstances, 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.[53]

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

In PLRs 201932001-10, 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 tax ramifications. This is not quite as obvious as you would think. Recall the GST tax 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

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[51] *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).

[52] See discussion in the *Uniform Disclaimer of Property Interests Act*, §§ 6-7.

[53] Treas. Reg. § 26.2601-1(b)(4)(i)(D).

sum they may have never received (a bird in the hand!), even if it was only the actuarial value of their share. All in all, a favorable ruling.

VIII. CCA 202352018 – the IRS Looking Anew at the Tax Effect of Trust Modifications

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 IRC Secs. 25.2511-1(e) and 25.2511-2(b).

In CCA 202352018, the IRA 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]

Thus, the IRS views the settlor as having *acquired* a beneficial interest in the trust on modification or addition of a grantor income tax reimbursement power.

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 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? We don't think so. But consider:

Possible solution: If beneficiary consents were needed for later reimbursement to the grantor, this would make the gift incomplete (at least initially), and provide a much clearer path to valuing whatever that gift may be if such a reimbursement is ever consented to.

Possible solution: Some amendments/decantings can be done without ***any*** beneficiary consent (but must a beneficiary fake a fight?).

IX. Potential Income Tax Effects of Commutations: PLRs 201932001 and 202509010

A *commutation* is simply an early termination of a trust that involves the trustee giving each beneficiary the current actuarial value of their share and terminating the trust. 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% (Number Cruncher calculation)

As interest rates fall, the value of the life interest falls. As rates 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.

Recent PLRs 201932001-10 (and now 202509010) 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.

The IRS National Office ruled no GST or gift tax ramifications, ***but for income tax purposes, the IRS National Office 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].

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 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.

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

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.

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, that 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.

Many prior PLRs cited find that a commutation is a disposition of assets under IRC Sec. 1001, so this is not new.

However, in PLR 200723014, the IRS National Office 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* cases in this area, including:

Evans: Trust beneficiary who changed his interest from income to fixed annuity held to be disposed of or exchanged for IRC Sec. 1001, discussed later herein.[54]

Silverstein: Trust beneficiary who kept the exact same terms, but where trust terminated and the remainder beneficiary paid annuity instead of trustee held *not* to trigger IRC Sec. 1001.[55]

Perhaps the strongest authority for the government is an older (pre-IRC Sec. 1001(e)) case: *McAllister v. Comm'r*, 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." 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 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 pursuant to state law, traditional trust tax law and statutes concerning terminations should 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.

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[54] *Evans v. Commissioner*, 30 T.C. 798 (1958).

[55] *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969).

X. IRC Sec. 1001(e) Zero Basis Apocalypse and 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.

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.

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 looking like a commutation and this potential result, but with the understanding that the IRS may disagree.

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

1) What if the trust had been in existence less than a year?
2) What if the trust owned qualified plans/IRAs?
3) What if there were assets implicating related party rules (including the IRC Secs. 453/1239 double whammy)?
4) What if the trust had illiquid assets such that the beneficiaries did not have to funds to pay the tax?
5) 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 Sec. 6501)?
6) Plenty of potential for penalties, interest, lawsuits galore! Do you really want to opine as to the result for a client?
7) 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.

8) 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 IRC Sec. 678? Would this matter? Perhaps, but only for G2.

9) 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 Sec. 642(c) deduction for trust payments pursuant to the final termination will likely be denied to the trust. The IRS National Office may be wrong in interpreting that phrase, but that's their position.[56]

A. Solutions Around 1001(e): Sales by Remaindermen, Gifting of Trust Interests, Partnership Contributions, Multi-Step Process, Severances

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. So, what if the remaindermen sell their interest to the income beneficiary? They would not be subject to the zero-basis rule. This may work but sometimes may be problematic in dynastic trusts that don't vest outright, since younger or future generations may have vested interests.

All the parties might also contribute (after removing a spendthrift provision) their interest in a trust to an LLC taxed as a partnership. This is generally a non-recognition event.[57] If the LLC/partnership is trustee and owns all the interests, the trust merges/collapses, but can an LLC be trustee under applicable state law? Since termination rather than long-term asset protection is the goal, maybe a simple general partnership actually works better than an LLC here.

Gifting a Trust Interest to Terminate the Trust in Lieu of Sale (one-way transfer only)

An income beneficiary could gift (perhaps via non-qualified disclaimer) 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 should 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 does not implicate the assignment of income doctrine.[58]

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[56] See also PLR 200848020.

[57] IRC § 721.

[58] *Blair v. Comm'r*, 300 U.S. 5 (1937).

Multi-Step Variations

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 a reformation first adds a Trust Protector or more leeway for an Independent Trustee to decant or amend the trust? No clear answers for these and other variations of accomplishing the same thing in multiple, more elaborate steps, but it's a harder argument for the IRS than an outright commutation.

Severances:

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

> (h) Severances of trusts
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> (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 –
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> (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.

It may be possible to get to the same end result in a safer manner by severing a trust. Not only is this permitted under common law, but most states have a statute that covers it, e.g., 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.[59]

We usually think of a severance in the context of a pot trust for multiple beneficiaries being split into separate trusts for the current beneficiaries of it. Is any split of a trust a severance, even if it is close to or facilitates a commutation? What about splitting between current and remainder and contingent

[59] Uniform Trust Code § 417.

remainder beneficiaries? 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 that a horizontal splicing of a trust is equally avoidant of being a sale or exchange. There is no good definition of the term in the income tax code or regulations.

PLRs on 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.

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. Others may disagree with us – it is unclear, but it's a stretch to argue that ***horizontal*** severances are covered by statute/Treas. Reg. Sec. 1001-1(h).

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, 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.

Other older PLRs on the issues above. There is a long history of the IRS applying these rules to the ***commutations***, especially of CRTs, so these 2019 PLRs (and the similar newer one issued in 2025) are not a crazy outlier you should just ignore as a risk. 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!)

B. Is There an Argument That Section 1001(e) Merely *Shifts* Rather Than *Destroys* The Basis?

In other tax code sections that require a taxpayer to disregard basis, such as the denial of a loss under the wash sale rules or sales at a loss to related parties, the basis is often not completely destroyed – it is merely shifted to other assets or other parties.[60] Is there an argument that the IRC Sec. 1001(e)'s denial of the use of basis by the life beneficiary should similarly shift the basis to the other beneficiaries? While it may sound logical and fair, it does not have the same statutory and regulatory authority that basis shifting has in other areas, as there is nothing in that code section or regulations to indicate this result – they merely instruct that basis is "disregarded" or the current beneficiary cannot "take into account" their basis.

A taxpayer may have more success arguing that the practical effect of IRC Sec. 1001(e) is to create a tax on wealth instead of *income* and is therefore unconstitutional and beyond the Sixteenth Amendment.[61] While that may be plausible, it's still a long shot and probably best to avoid having to make Constitutional arguments in trust and estate planning!

XI. When Substantial Reformations May Implicate IRC Sec. 1001 as Well

Reformations and amendments of irrevocable trusts can cause an *income* taxable *exchange* pursuant to IRC Sec. 1001 if the parties' beneficial interests are *materially 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 *Cottage Savings Assn v. Comm'r.*[62] 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.

Prior to *Cottage Savings*, in *Evans v. Commissioner*, 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

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[60] See IRC § 1091 (wash sale); IRC § 267 (denial of loss on sales to related parties).

[61] U.S. Const. Art. 1, § 9. See most recent Supreme Court case rejecting such an argument in *Moore v. United States*, 602 U.S. __ (2024).

[62] *Cottage Savings Association v. Comm'r,* 499 U.S. 554 (1991).

also a taxable realization event (this was prior to enactment of IRC Sec. 1041 that now generally disregards sales between spouses).[63] 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).[64]

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, 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.[65]

The IRS applied the *Evans* and *Cottage Savings* rationale against a proposed trust settlement and modification in PLR 200231011.[66] 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).[67] It's worth reading the IRS reasoning 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.

Unlike in *Cottage Savings,* the taxpayer in the PLR 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

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[63] *Evans v. Comm'r*, 30 T.C. 798 (1958).

[64] Rev. Rul. 73-476; Rev. Rul. 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 2004-11022.

[65] *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969).

[66] PLR 2002-31011.

[67] IRC § 1001(a); Treas. Reg. § 1.1001-1(a).

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.

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.[68] Let's differentiate this ruling from the many 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*.[69]

There are dozens of these PLRs (many of which are simple divisions of trusts with no additional changes), but let's pick four recent ones to explain what does and does not bother the IRS.

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.[70] Despite this change, 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 PLR 200231011 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?

Is there a "sale or exchange" in most reformations? Neither one-way transfers nor administrative changes are even exchanges. As defined in the regulations:

> (d) Exchange. Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.[71]

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 there is probably no "exchange" for IRC Sec. 1001 (it's more of a gift), but the IRS has viewed this more expansively in some rulings, so don't take our 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.

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[68] State law unitrust conversions have a safe harbor. Ssee Treas. Reg. § 1.643(b)-1; PLR 200810019.

[69] PLR 200804015 (splitting into subtrusts); PLR 200736023; PLR 200728026; PLR 200725008; PLR 200717007; PLR 200645005; PLR 201042004; PLR 201033025; PLR 201021004; PLR 201023004; PLR 200742011; PLR 200736023; PLR 200728026; PLR 200647022; PLR 200637042; PLR 200633012; PLR 200629021; PLR 200627008; PLR 200619001; PLR 200618003 (all concerned various minor modifications and divisions of trusts, but nothing so drastic as 200231011). There are probably more than cited above.

[70] PLR 201042004.

[71] Treas. Reg. §. 1.1002-1(d).

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,[72] 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 and certainly nothing like the obvious exchange in *Cottage Savings*. That said, there is not the need to find a voluntary component for sales and dispositions as there would be for a taxable gift.

Treasury recognizes this for trustee severances of trusts:

> **(h) Severances of trusts**
>
> **(1) In general.** The severance of a trust (including without limitation a severance that meets the requirements of §26.2642-6or 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**.[73] [emphasis added]

There is no clear definition of "severance" above,[74] but decantings and unilateral constructions/reformations/divisions of trusts initiated by the trustee seem to fit a "severance" more than a "sale or disposition" – and these would of course be done pursuant to the trust and/or state law and any good trust would permit non-pro rata funding.[75]

In most instances, typical amendments are more reasonably described as a severance and/or more squarely fit 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*

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[72] E.g., UTC §§ 411-417.

[73] Treas. Reg. § 1.1001-1(h).

[74] Although there is no definition in IRC § 1001, Treas. Reg. § 26.2642-6(b) and (d) provide a definition in the GST context and set out seven requirements, summarized as 1) pursuant to instrument or state law, 2) effective under local law, 3) funding done within 90 days of selected valuation date, 4) fractional basis division, not pecuniary (formula and non-pro rata division permitted), without taking discounts into account, 5) terms of the resulting trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust, 6) where there is an inclusion ratio of either one or zero, each trust resulting from the severance will have an inclusion ratio equal to the inclusion ratio of the original trust; 7) where the trust has an inclusion ratio between 0 and 1, then one of two additional requirements must be satisfied, but the trust can be split into an exempt and non-exempt portion (0 and 1 inclusion ratio).

[75] If you are in a UTC state, see UTC § 816(22), which adds that power. The Comments expressly note why: "Paragraph (22) authorizes a trustee to make non-pro-rata distributions and allocate particular assets in proportionate or disproportionate shares. This power provides needed flexibility and *lessens the risk that a non-pro-rata distribution will be treated as a taxable sale*."

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 old PLR serves as a warning to make changes as minimal as possible, and to use a method that does not require active beneficiary procurement if possible, to avoid any "sale or exchange" argument altogether. Who knows what the IRS or Tax Court will find to be "material"? What should we make of the statement in PLR 200231011 that the adding of a general power of appointment to the trust "reinforced" the conclusion that there was an exchange? Would it have been enough by itself?

If the amendment merely granted a general testamentary power to appoint to creditors with consent of a non-adverse party would it be *materially* different? If the amendment merely granted a *limited* power of appointment that only permitted the appointment to the same remaindermen or to trust therefore, in order to trigger the Delaware Tax Trap, would such a minimal change in the current interest be "material"?

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 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.[76]

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***, nor did it affect the GST tax zero inclusion ratio.[77] We believe 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.

Similarly, in PLR 201647001, an independent trustee of an irrevocable grantor trust went to court and reformed the trust to add a power to reimburse the grantor for income taxes paid as a result of the trust's income. This was a drastic change – *it basically allowed the grantor to be added as a beneficiary of the trust*! Yet, the IRS ruled that even this was not a gift by the beneficiaries, nor did it cause any taxable sale or exchange, because the grantor remained responsible for the tax and the current beneficial

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[76] PLR 9352005.

[77] PLR 201320004 (modifications complying with GST grandfathering regs were OK for *allocated* GST exemption).

interests did not change by the reformation (even though the remainder beneficiaries could suffer significant dilution of their interests through future discretionary reimbursements to the grantor).[78] NOTE: this PLR has recently been questioned by the IRS in CCA 202352018 discussed elsewhere herein. Additionally, note that the CCA did not discuss whether they still concur with the conclusion in this 2016 PLR regarding "sale or exchange"!!!

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 either.

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. To analogize, there is no hint in the *Cottage Savings* case that a mere minor modification of one of the taxpayer's loans would have triggered tax – the case concerned swapping a book of loans with completely different obligors and properties as security interests!!!

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.[79] 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 the problematic and potentially devastating PLR 200231011.

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 so found, this does not mean that 100% of such proceeds would be taxable, just that any gains would be triggered – settlement proceeds would not be taxable income if they are merely a substitute in lieu of what would have probably been an income tax-free gift/bequest.[80]

However, 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.[81] Worse, if only the income interest is being terminated (e.g. the spouse is paid off and trust continues for children), then the

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[78] PLR 201647001.

[79] PLRs 201702005 and 201702006 involved converting pot trusts into separate trusts for beneficiaries and the IRS ruled that such changes would not trigger an IRC Sec. 1001 event.

[80] *Getty v. Comm'r*, 913 F.2d 1486, 1488 (9th Cir. 1990).

[81] IRC § 101(a)(2).

zero basis rule may come into play and the income beneficiary could be taxed on the entire amount.[82] 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*.

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 in a taxable exchange of property. Each IRS agent (including appeals officers) may have their own smell test, as well as tax court and other judges.

A. Changing From Grantor to Non-Grantor Trust Status and 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):

As the IRS Chief Counsel's Office stated: "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."[83]

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/amount 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).

XII. 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 only the current income beneficiary or remaindermen), in the last decade, with or without a court order, with absolutely no reporting of any income tax implications by any party (or gift tax, but most people are never subject to that so the gift tax ramifications are often irrelevant). It's certainly not on the IRS income tax 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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[82] IRC § 1001(e), with exception at IRC §. 1001(e)(3) when the trust is terminated (both income and remainder interest), but regulations require this be through sale to a third party, see Treas. Reg. § 1.1001-1(f), so this could occur even if the entire trust is terminated.

[83] CCA 20093024; see also PLR 201730017.