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The Uniform Basis Rules and Terminating Interests in Trusts Early

F. Ladson Boyle
University of South Carolina - Columbia, lad@boyleslaw.net

Howard M. Zaritsky
howard@howardzaritsky.com

D. Ryan Wallace
Sojourner, Caughman & Thomas, LLC

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THE UNIFORM BASIS RULES AND TERMINATING INTERESTS IN TRUSTS EARLY©

F. Ladson Boyle,* Howard M. Zaritsky** & D. Ryan Wallace***

Authors' Synopsis: The resolution of income tax issues that may arise for trust beneficiaries who dispose of temporal interests in trusts remains relatively obscure. Additional issues exist for subsequent interest holders; the methods that the Code and Regulations prescribe for establishing, maintaining, and potentially recovering basis for successor owners of interests in a trust are not well developed.

In some instances, the trust instrument creating a temporal interest will supply a suitable path for early termination and distribution of assets. In those cases, Subchapter J of the Code typically governs the transaction and provides that terminating the trust and distributing its assets be treated as nonrecognition events. However, one must look beyond the confines of Subchapter J when trust beneficiaries participate in the disposition without a settlor-provided power to do so. The Internal Revenue Service has consistently applied in letter rulings a different tax regime other than the income tax rules provided in Subchapter J of the Code; gain may be realized and recognized under section 1001, which often brings into play the uniform basis rules.

The uniform basis rules reflect the concept that property acquired by gift or from a decedent has a single or uniform basis, whether multiple persons receive an interest in the property and whether directly or through a trust, and the individual interests have a basis that it is a proportional part of the uniform basis. The uniform basis rules of section 1001(e)(1) often deny the seller of a life or term interest in a trust any recovery of basis unless all interests in the trust are transferred to a third party for consideration. On the other the hand, the uniform basis rules permit a remainder beneficiary to recover basis in a sale, whether or not the life or term interest is also transferred. Besides these two basic rules, there are many nuances to the tax consequences of uniform basis rules

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* F. Ladson Boyle is the Charles E. Simons, Jr. Distinguished Professor Emeritus of Federal Law at the University of South Carolina School of Law.

** Howard M. Zaritsky is a retired estate planning attorney. He can be reached through www.howardzaritsky.com.

*** D. Ryan Wallace, JD, LLM, CPA, is an associate with Sojourner, Caughman, and Thomas, LLC, Columbia, SC.

The authors thank Jonathan G. Blattmachr, Austin W. Bramwell and Steven B. Gorin for their input, although all mistakes and errors are solely the authors'. In addition, the authors thank the student editorial board of the Real Property, Trust and Estate Law Journal at the University of South Carolina School of Law for their hard work to make this a good article, and in particular Tony Doxey, Ross Scarborough and Lauren Egan.

and some interesting issues to evaluate when considering the sale of an interest in a trust, or the commutation or early termination of a trust, and how holders of transferred interests are treated for income tax purposes.

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I. INTRODUCTION 3
 A. BasicAssumptions 6
II. INCOME TAX CONSIDERATIONS OF WHETHER TO CREATE A TRUST 7
III. UNIFORM BASIS 8
 A. Basic Principles 8
 B. Property Received from a Decedent 10
 C. Changes in Total Uniform Basis 11
IV. SALE OR TRANSFER OF A TEMPORAL INTEREST IN A TRUST 17
 A. Sale of an Income Interest 17
 B. Sale of Remainder 18
 C. Sale or Disposition of Entire Interest 19
 D. Sale of Interest in a Charitable Remainder Trust 21
V. COMMUTING OR TERMINATING EARLY TRUSTS BY AGREEMENT OR COURT ORDER 24
 A. The Service's Ruling Position Applied 25
 B. Is Commutation or Early Termination as a Taxable Event the Correct Result? 27
  1. Case Law Support 27
  2. State Law Changes and Trust Decanting 28
  3. Cottage Savings 30
  4. Additional Case Law 33
  5. Additional Issues 35
  6. Revenue Ruling 69-486 36
  7. Does Subchapter J Preempt Section 1001? 36
  8. Is an Early Termination a Severance? 37
VI. AMORTIZATION OF A LIFE INTEREST 39
 A. History 39
 B. Section 273 40
 C. Section 167(e) 42

D. Technical Advice Memorandum 83-29-005 44
E. Sections 62 or 63 45
VII. NATURE OF GAIN - CAPITAL GAIN OR ORDINARY INCOME 47
A. Section 1239 50
B. Section 1041 50
C. Depreciation Recapture 50
VIII. THE REMAINDER 51
A. Transfer of a Vested Remainder Interest at Remainder Owner's Death 51
B. Transfer of a Contingent (Non-Vested) Remainder 55
IX. PURCHASE OF TERM INTEREST BY THE REMAINDER BENEFICIARY WITHOUT TERMINATING THE TRUST 58
X. COMMUTATION OR TERMINATION OF A TRUST 61
XI. OTHER CONSIDERATIONS AND CHOICES 64
A. Disadvantages 64
B. Advantages 65
XII. CONCLUSION 66

I. INTRODUCTION

Grantors create trusts for many reasons: often there is a desire to make an *inter vivos* or testamentary gift but to limit a beneficiary's access to the given assets; at other times, tax-savings is the motivation. The structure of non-tax motivated trusts may vary widely as the grantor has wide latitude when specifying the terms. Sometimes, however, the life beneficiary does not like the restrictions and limitations of a trust and wants to escape them either by terminating the trust early through commutation of the various interests or disposing of interest in the trust. Also, trust beneficiaries may wish to commute or terminate a trust because the trust's non-tax purposes may no longer exist.

Irrevocable trust documents may contain mechanisms for early termination of the trust. For example, a trustee might have a discretionary power to terminate a trust by distributing the trust's assets to one or more beneficiaries. Alternatively, someone other than the trustee, such as a trust protector, may have a power to accomplish the same result.[1] It is also

[1] *See* Alexander A. Bove, Jr., *Trust Protectors in the United States. A Step Behind the Rest of the World*, 22 TRUSTS & TRUSTEES 7 (2016); William S. Echols, *Action in the Chasm: Defining Duties of the Trustee's Delegates*, 6 EST. PLAN. & COMMUNITY PROP. L.J.

possible that the exercise of a power of appointment may be used to terminate a trust.[2] When a trust terminates by any of these methods, the income tax consequences are typically predictable: the rules in Subchapter J of the Internal Revenue Code (Code)[3] apply, and the beneficiaries generally receive the assets from the trust without recognition of gain, taking over the trust's basis in assets distributed.[4]

When a trust is not terminated by its own terms, but rather is terminated early or commuted, by court order, by agreement of the beneficiaries, or by both processes,[5] the Internal Revenue Service (Service) has consistently stated in letter rulings that a different tax regime applies other than the income tax rules provided in Subchapter J of the

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397 (2014); Lawrence A. Frolik, *Trust Protectors: Why They Have Become "The Next Big Thing,"* 50 REAL PROP. TR. & EST. L.J. 267 (2015); John D. Morley & Robert H. Sitkoff, *Making Directed Trusts Work: The Uniform Directed Trust Act*, 44 ACTEC L.J. 3 (2019); Charles A. Redd, *Directed Trusts—Who's Responsible?*, TR. & EST. MAGAZINE Sept. 2015; Jessica L. Showers, *Trust Protectors: A Practical Solution to Many Trust Problems*, 46 EST. PLAN. 03 (Nov. 2019). Because the termination by a trust protector is authorized by the trust instrument, it should produce the same "no tax result" as a termination by a trustee; a trust termination authorized by the trust instrument is not a taxable exchange. *See* Lloyd Leva Plaine, Cottage Savings *is a Loss to Trust Beneficiaries*, SJ073 ALI-ABA 477, 487–92 (2004).

[2] The exercise of a power of appointment should not be considered an exchange of the powerholder-beneficiary's interest resulting in an income taxable disposition of interest. *See* Priv. Ltr. Rul. 2001-12-038 (Mar. 23, 2001).

[3] All references to the Internal Revenue Code or simply "the Code" mean the Internal Revenue Code of 1986, as amended, unless expressly provided otherwise.

[4] The beneficiaries will receive the trust assets with the same basis the trust has in the assets without realizing any gain. *See* I.R.C. § 643(e).

[5] *See* UNIF. TRUST CODE § 411 (UNIF. LAW COMM'N 2004) (allowing modification or termination of non-charitable irrevocable trust upon consent of the grantor and all beneficiaries, regardless of if consistent with material purpose of the trust); UNIF. TRUST CODE § 412 (modification or termination because of unanticipated circumstances); UNIF. TRUST CODE § 413 (Cy Pres for charitable trusts); UNIF. TRUST CODE § 414 (modification or termination of uneconomic trust); UNIF. TRUST CODE § 415 (reformation to correct mistakes); UNIF. TRUST CODE § 416 (modification to achieve settlor's tax objectives); UNIF. TRUST CODE § 417 (combination and division of trusts). For a discussion of modifying trusts before the recent statutory rules, see Richard Barnes, *Repairing Broken Trusts and other Fallen Estate Plans*, 41 EST. PLAN. 3, 8 (2014); F. Ladson Boyle, *When It's Broke, Fix It: Reforming Irrevocable Trusts to Change Tax Consequences*, 53 TAX LAW. 821 (2000); Diana S.C. Zeydel, *Developing Law on Changing Irrevocable Trusts: Staying Out of the Danger Zone*, 47 REAL PROP. TR. & EST. L.J. 24 (2012); *see also* an excellent discussion in Diana S.C. Zeydel, *What's Happened to Settlor Intent?* 158 TR. & EST. 14 (Dec. 2019).

Code. Gain may be realized and recognized under section[6] 1001, and that often brings into play the uniform basis rules.

The uniform basis rules reflect the concept that property acquired by gift or from a decedent has a single or uniform basis, whether multiple persons receive an interest in the property directly or through a trust;[7] the individual interests have a basis that it is a proportional part of the uniform basis. In addition, as explained in Parts IX and X below, the beneficiaries of a trust may have a basis in their trust interests that is different from just a share of uniform basis because the interest is inherited or purchased.

The uniform basis rules of section 1001(e)(1) often deny the seller of a life or term interest in a trust any recovery of basis unless all interests in the trust are being transferred to a third party for consideration.[8] On the other the hand, the uniform basis rules permit a remainder beneficiary to recover basis in a sale, whether or not the life or term interest is also transferred.[9] Besides these two basic rules, there are many nuances to the tax consequences of uniform basis rules and some interesting issues to evaluate when considering the sale of an interest in a trust, or the commutation or early termination of a trust.

Part II of this Article reviews the basic income tax differences between outright gifts of property and gifts of property to a trust. Part III introduces the basics of the uniform basis rules. Part IV examines sales of temporal interests in a trust, including the unique rules applicable to non-charitable interests in a section 664 charitable remainder trust.[10] Part V provides a detailed analysis of the Service's position when a trust is terminated early or commuted. Part VI explores the amortization deduction that is available to the purchaser of a life or term interest in a trust. Part VII considers the character of the gain realized from a sale of a life or term interest in a trust. Part VIII examines the rule applicable to a change in the ownership of the remainder interest in a trust. Part IX analyzes the tax effect of a remainder beneficiary acquiring the life or term interest, but the trust is not

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[6] All references to "section" are references to the Internal Revenue Code of 1986, as amended, unless expressly provided otherwise.

[7] *See* Treas. Reg. § 1.1014-4(a)(1).

[8] *See infra* Part IV.

[9] *See infra* notes 50–52 and accompanying text.

[10] *See* MATT BROWN & JEROME M. HESCH, EARLY TERMINATION OF PRIVATE TRUSTS AND CHARITABLE TRUSTS: VALUATION OF THE INTERESTS AND THE ALLOCATION OF INCOME TAX BASIS 19-1 (37 Notre Dame Tax & Est. Plan. Inst., 2012) (discussing some of the issues considered in this Article); *see also* I.R.C. § 1001(e)(2) (applying the same rules whether it is a legal life estate or a term certain in property and a remainder owner).

terminated. Finally, Part X resolves the basic tax question when the life interest in a trust is acquired by the remainder beneficiary as the Service asserts happens when a trust prematurely terminates and the governing instrument does not provide a mechanism to achieve that result.

It should be noted that, to the extent a beneficiary consents to a trust's commutation or early termination results in the surrender of, or reduction in, the beneficiary's property rights, the consent or acquiescence may be deemed a transfer of property on which the gift tax might be imposed.[11] This Article will not, however, evaluate transfer tax issues.

A. Basic Assumptions

In this Article, the terms "commutation" and "early termination" of a trust are used interchangeably. The use of these terms is limited to trusts that are terminated by court order, by agreement of the beneficiaries, or by both processes, rather than pursuant to its own terms, including powers granted by the trust settlor to the trustee, a trust protector, or person with a power of appointment.

All trusts in the various examples below are assumed to be irrevocable, nongrantor trusts: some are *inter vivos* and some are testamentary, although the difference is minor for uniform basis purposes, as explained below. When beneficial ownership of property is divided into present interests, such as life estates, and future interests, such as remainders, these interests are sometimes referred to as temporal interests to reflect their time element. Section 1001(e)(2) provides that a legal life estate, a term certain, and a remainder interest not held in trust are treated the same for income tax purposes as a life, term certain, and remainder interest in a trust.[12] The Service construes the term "life interest" as including more than a pure life estate or lifetime income interest; it also includes, for example, a unitrust interest in a net income charitable remainder trust.[13] Logically, this same analysis would extend the section 1001(e) definition to a lifetime annuity interest, a lifetime unitrust interest, or a lifetime right to discretionary distributions of income, principal, or both. In the

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[11] *See* Rev. Rul. 84-105, 1984-2 C.B. 197; Rev. Rul. 86-39, 1986-1 C.B. 301; Priv. Ltr. Rul. 93-08-032 (Feb. 26, 1993).

[12] *See* I.R.C. § 1001(e)(2) ("For purposes of paragraph (1), the term "term interest in property" means—(A) a life interest in property, (B) an interest in property for a term of years, or (C) an income interest in a trust.").

[13] *See* Priv. Ltr. Rul. 2008-33-012 (Aug. 15, 2008); Priv. Ltr. Rul. 2008-27-009 (July 4, 2008); Priv. Ltr. Rul. 2007-33-014 (Aug. 17, 2007) (discussing net income charitable remainder unitrusts).

examples, the fair market values assigned to various interests in a trust are assumed to be based on the current actuarial values provided for under section 7520.[14]

II. INCOME TAX CONSIDERATIONS OF WHETHER TO CREATE A TRUST

For a donor considering an *inter vivos* or testamentary gift, the choice of structure for a gift, including whether it is made outright or in trust, may have income tax implications for the donee. For example, a donor who wishes to give $1 million equally to *A* and *B* may choose to give $500,000 to *A* and to give $500,000 to *B*. Such a gift is income tax free, apart from the tax consequences of future income that may be produced by the given assets.[15] In the alternative, the donor might choose to give $1 million to a trust and to provide *A* with income from the trust for life and to provide *B* the remainder when *A* dies.[16] If at the time the trust is created *A* is fifty-five and the prevailing interest rate is three percent, the actuarial value of *A*'s income interest is approximately $500,000 and *B*'s remainder is also $500,000.[17] While the structure of the two gift alternatives have almost the same present gift tax value,[18] they are very different from both a property law perspective and an income tax perspective. The property law difference is obvious: with a trust, *A* receives the income earned by the $1 million for life but has no access to principal; *B* has no current benefit from the trust but will receive the trust assets when *A* dies, potentially many years later. For income tax purposes, *A*'s gift of a trust income interest may produce taxable income and section 102(b) provides that the income from a gift of property is not tax exempt.[19] Whether it is a conscious decision or

[14] *See* Treas. Reg. § 25.7520-1; *see also* Treas. Reg. §§ 1.1001-1(f)(3), 1.1014-5(a)(3), 1.1015-1(b). When a beneficiary is the possible recipient of trust principal by way of a trustee's power of invasion, that valuation of the beneficiary interest is problematic.

[15] *See* I.R.C. § 102(a) (this section can be traced back to the Revenue Act of 1916 § 4, 39 Stat. 756 (Sept. 8, 1916)).

[16] For purposes of this Article, unless specifically stated otherwise, the description of a present interest in a trust includes a present interest for a term of years.

[17] This valuation assumes a current Applicable Federal Rate (AFR) of 3%. If the applicable interest rate changes, the relative value of the income and remainder interests will change.

[18] Ignoring any possible annual exclusion under section 2502(b).

[19] *See* I.R.C. § 102(a). This dichotomy in income tax result may occur when the split gift is not made using a trust structure; it applies if the gift is a life estate in property for *A* and a remainder to *B*. For purposes of this Article, references to life estate or term interests in trust will include legal life estate or term interests.

not by the donor, the outright $500,000 gift to *A* is income tax free at the time of the gift, while the gift of income from a $1 million trust for life is not income tax free. What *B* receives now or when *A* dies will be income tax exempt when received.[20]

III. UNIFORM BASIS

A donor's decision to create a trust for donees brings into play many issues, including the question of basis for the donees. Section 1014 (for testamentary gifts) and section 1015 (for *inter vivos* gifts) provide the basic basis rules. For *inter vivos* gifts, the donee generally has a carryover of the donor's basis. For testamentary gifts, the donee's basis is generally the fair market value at the time of the decedent's death. But when the gift is in trust, the basis issue is more complex because the uniform basis rules apply.

A. Basic Principles

Property acquired by gift or from a decedent has a single or uniform basis, regardless if multiple persons receive an interest in the property, or if the interests are held directly or indirectly through a trust.[21] The uniform basis of the property is fixed, subject to the potential for adjustments under sections 1016 and 1017 (for capital additions and subtractions).[22] The uniform basis rules make clear that the basis of the property is unaffected by the identity of the owners: whether the life or term interest owner is old or young has no effect on the property's basis. When an interest in a trust (lifetime, term, or remainder) is commuted, sold, or otherwise disposed of for value, the uniform basis rules determine gain or loss on the interest being transferred because the disposition of a trust interest is a realization event.[23] Gifts of such interests are received without income tax consequences under section 102.

The regulations direct the use of the actuarial factors contained in Treasury Regulation section 20.2031-7(d)(7) to determine the basis of a life interest, a term certain interest, or a remainder interest in property on the date such interest is sold, exchanged, or otherwise disposed of for

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[20] *See id.*

[21] *See* Treas. Reg. § 1.1014-4(a)(1).

[22] *See* Treas. Reg. §§ 1.1014-1(b), 1.1015-1(b).

[23] Note, however, that a gift of an interest in a trust to a third party should not be an income tax event for the donor. *See* Charles D. Rubin, *Tax Results of Settling Trust Litigation Involving QTIP Trusts*, 36 EST. PLAN. 23, 26 (2009).

consideration.[24] Presumably, with respect to current sales, the correct actuarial tables are those contained in the regulations under section 7520.[25]

The uniform basis is the total basis of all interests in the property. The sum of the parts equals the basis of the underlying assets, but the allocation of uniform basis among the interests varies as the relative values of the interests change with the passage of time.[26] For example, the portion of the uniform basis attributable to a life or term interest tends to shrink as time passes.[27] Conversely, the portion of the basis attributable to a remainder interest increases as the life tenant ages or as a term-for-years becomes shorter.[28] Both adjustments may be offset by changes in the prevailing interest rates because higher interest rates under section 7520 generally increase the value of the life or term interest, while lower interest rates tend to increase the value of the remainder interest. The value of a life estate may also be changed when the actuarial tables are updated periodically to reflect changes in life expectancy. The uniform basis in the property itself, however, remains constant. But, as explained below, the uniform basis in the property may also change for other reasons.

Example 1: One million dollars of securities, with a $500,000 adjusted basis, are given to an *inter vivos* trust for the lifetime benefit of Spouse, remainder to Child. Spouse is sixty years of age when the gift is made. The section 7520 rate on the date of the gift is three percent.

> Under the then-applicable actuarial tables, Spouse's life estate is worth 44.7950% of the value of the securities, or $447,950.
>
> Child's remainder interest is worth 55.205% of the value of the securities, or $552,050.
>
> Spouse's share of the uniform basis on the date of the gift is $223,975.[29]

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[24] *See* Treas. Reg. § 1.1014-5(a)(3).

[25] *See id.*; Treas. Reg. §§ 25. 7520-1, 1.001-1(f) (3), 1.1015-1(b).

[26] *See* Treas. Reg. §§ 1.1001-1(f)(2), 1.1014-4(b), 1.1015-1(b).

[27] *See* Treas. Reg. § 20.2031-7(d); *see also*, JOHN A. BOGDANSKI, FEDERAL TAX VALUATION (West 2019).

[28] *See* Treas. Reg. § 20.2031-7(d).

[29] 44.7950% x $500,000.

Child's share of the uniform basis on the date of the gift is $276,025.[30]

Example 2: Assume the same facts as in Example 1, except that ten years have passed since the gift was made. Spouse is now is seventy years of age. The section 7520 rate has increased to four percent, and the securities have increased in value to $2 million.[31] The actuarial tables have not been changed to reflect changes in life expectancies.

The value of Spouse's life estate is then $804,720.[32]

The value of Child's remainder interest is then $1,195,280.[33]

Spouse's share of the uniform basis on the 10th anniversary of the gift is 40.236%, or $201,180.

Child's share of the uniform basis on that date is 59.764%, or $298,820.

B. Property Received from a Decedent[34]

The actuarial division of the uniform basis in property received from a decedent is based on the value of the interests on the date of the decedent's death, rather than the date of distribution from the estate or when the particular interest vests or becomes possessory.[35]

Example 3: One million dollars of securities, with a date of death value of $1 million, are left to a testamentary trust for lifetime benefit of Spouse, remainder to Child. Spouse is sixty years of age when the decedent dies but is sixty-two years of age when the estate is settled and the trust is funded. The section 7520 rate is three percent on the date of the decedent's death.

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[30] 55.205% x $500,000.

[31] This example assumes that the same securities are still held in trust so that there has been no change in basis of the trust assets.

[32] 40.236% x $2,000,000.

[33] 59.764% x $2,000,000.

[34] The uniform basis rules do not apply when a trust or estate sells property to a beneficiary or transfers assets in satisfaction of a pecuniary amount due. The beneficiary's basis in such property is determined under the usual basis rules applicable to sales between unrelated parties. *See* Treas. Reg. § 1.1014-4(a)(3).

[35] *See* Treas. Reg. § 1.1014-4(a)(2).

> Under the actuarial tables, Spouse's life estate is worth 44.7950% of the value of the securities on the date of the decedent's death, or $447,950.
>
> Child's remainder interest is worth 55.205% of the value of the securities, or $552,050.
>
> Spouse's share of the uniform basis on the date of the decedent's death is $447,950.[36]
>
> Child's share of the uniform basis on the date of the decedent's death is $552,050.[37]

Example 4: Assume the same facts as in Example 3, except that the trust is funded two years later. Spouse's share of the uniform basis is potentially less because of the passage of time, but overall the uniform basis does not change, even if the fair market value of the trust assets may have changed. On funding, Spouse is now sixty-two years of age. Assuming the section 7520 rate has increased to 3.2% and the securities have increased in value to $1.2 million:[38]

> The fair market value of Spouse's life estate is then $531,804.[39]
>
> The value of Child's remainder interest is then $668,196.[40]
>
> Spouse's share of the uniform basis on that date is 44.317% of $1 million, or $443,170.
>
> Child's share of the uniform basis on that date is 55.683%, or $556,830.[41]

C. Changes in Total Uniform Basis

The initial basis of a temporal interest in a trust is a portion of the uniform basis of the property held in the trust. As discussed above, the basis of the various interests change as time passes or interest rates change;

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[36] 44.7950% x $1,000,000.

[37] 55.205% x $1,000,000.

[38] This example assumes that the same securities are still held in trust so that there has been no change in basis of the trust assets.

[39] 44.317% x $1,200,000.

[40] 55.683% x $1,200,000.

[41] $1,000,000 - $443,170.

as the life tenant ages, his or her interest is a smaller percentage of the uniform basis, and the remainder beneficiary's interest is a larger percentage.[42] A rise in the prevailing interest rates under section 7520 generally increases the value of the life or term interest, while lower interest rates generally increase the value of the remainder interest.[43]

Nevertheless, the regulations explain that the total uniform basis—the basis of the underlying assets—may change for a number of reasons, including adjustments for "capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable."[44]

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[42] *See* Treas. Reg. § 20.2031-7(d); *see also* BOGDANSKI, *supra* note 27.

[43] *See* Treas. Reg. § 20.2031-7(d); *see also* BOGDANSKI, *supra* note 27.

[44] Treas. Reg. § 1.1014-4(b); *see* Treas. Reg. § 1.1015-4(b). Under Treasury Regulation section 1.1014–6, adjustments are also possible for property acquired from a decedent prior to his or her death. Treasury Regulation section 1.1014-6(a)(3), Examples 1 and 2 state:

> Example 1. The taxpayer acquired income-producing property by gift on January 1, 1954. The property had a fair market value of $50,000 on the date of the donor's death, January 1, 1956, and was included in his gross estate at that amount for estate tax purposes as a transfer in contemplation of death. Depreciation in the amount of $750 per year was allowable for each of the taxable years 1954 and 1955. However, the taxpayer claimed depreciation in the amount of $500 for each of these years (resulting in a reduction in his taxes) and his income tax returns were accepted as filed. The adjusted basis of the property as of the date of the decedent's death is $49,000 ($50,000, the fair market value at the decedent's death, less $1,000, the total of the amounts actually allowed as deductions).
>
> Example 2. On July 1, 1952, H purchased for $30,000 income-producing property which he conveyed to himself and W, his wife, as tenants by the entirety. Under local law each spouse was entitled to one-half of the income therefrom. H died on January 1, 1955, at which time the fair market value of the property was $40,000. The entire value of the property was included in H's gross estate. H and W filed joint income tax returns for the years 1952, 1953, and 1954. The total depreciation allowance for the year 1952 was $500 and for each of the other years 1953 and 1954 was $1,000. One-half of the $2,500 depreciation will be allocated to W. The adjusted basis of the property in W's hands of January 1, 1955, was $38,750 ($40,000, value on the date of H's death, less $1,250, depreciation allocated to W for periods before H's death). However, if, under local law, all of the income from the property was allocable to H, no adjustment under this paragraph would be required and W's basis for the property as of the date of H's death would be $40,000.

Treasury Regulation section 1.1014-4(a)(1) states: "any adjustment for depreciation shall be made to the uniform basis of the property without regard to such prior sale, exchange, or other disposition." Treasury Regulation section 1.1014-4(b) provides other examples of adjustments:

> the deductions for depreciation and for depletion allowed or allowable, under sections 167 and 611, to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property not only in the hands of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under sections 167 and 611, both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 262.[45]

Another common adjustment to the basis of temporal interests occurs when a trust sells assets and reinvests the proceeds in new assets with a different basis than those that it sold.[46] Example 7 of Treasury Regulation section 1.1014-5(d) illustrates several sales of trust assets at a profit that result an increased uniform basis for those who possess an interest in the trust.[47]

If property is held in trust, the depreciation deduction under section 167(d) is apportioned between the trustee and the income beneficiaries "in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each."[48] If the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation, the deduction is first allocated to the trustee to the extent that income is set aside for a

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[45] Treas. Reg. § 1.1014-4(b).

[46] *See* Treas. Reg. § 1-1014-3(c).

[47] This example concerns a charitable remainder unitrust (CRUT), which means that under Treasury Regulation section 1.1014-5(c), the non-charitable beneficiary's portion of the uniform basis is modified. Nevertheless, the example illustrates how a change in the basis assets held in trust will change the uniform basis that is apportioned to those who own interests in the trust. *See infra* Part IV.D.

[48] I.R.C. § 167(d).

depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve is apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each.[49]

The uniform basis rules, however, require that income and remainder beneficiaries' respective basis reflect the actuarial value of their respective interests. [50] Thus, unless the trustee makes actuarially-proportionate distributions of income or the governing instrument requires actuarially-proportionate allocations of depreciation deductions, the deductions will be allocated in a manner very different from the uniform basis adjustments.[51]

Example 5: A trust's governing instrument provides that trust income is distributed to the income beneficiary and no reserve for depreciation is created. The trust has an allowable depreciation deduction of $10,000 that is ultimately deemed distributed to the income beneficiary. The deduction will reduce that basis of the trust assets by $10,000, which in turn reduces the overall uniform basis by $10,000. That lower basis is apportioned between the income beneficiary and the remainder beneficiary based on the value of the income beneficiary's life interest. Thus, the income beneficiary obtains the entire $10,000 income tax deduction, but the basis of his or her interest is reduced by a lesser amount, and the uniform basis of the remainder beneficiary, who obtained no benefit from the income tax deduction, will also be reduced by a proportionate share of the deduction.[52]

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[49] *See* Treas. Reg. § 1.167(h)-1(b). The allocation of depreciation deductions will ignore any allocation that gives a beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument except when the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation. *See* Treas. Reg. § 1.167(h)-1(b); *see also* Tiefenbrunn v. Comm'r, 74 T.C. 1566, 1575–78 (1980) (stating that trustees could not establish a reserve for depreciation under state law, so all allowable depreciation for the taxable years was deductible by the beneficiaries to the exclusion of the trustee); Dusek v. Comm'r, 45 T.C. 355, 358 (1966) (finding that trustees legally created a reserve for all depreciation and all deductions, therefore, the deductions are allocated to the trustees).

[50] *See* Treas. Reg. §§ 1.1014-4(b), 1.1014-4(a)(1).

[51] *See* I.R.C. § 167(d); *see also* Treas. Reg. § 1.167(h)-1(a) (limiting what terms of the governing instrument affect the allocation of depreciation deductions). The only provisions that may be taken into account for this purpose are those that allocate income or that provide for a reserve.

[52] For example, if the trust in Example 5 above has a $10,000 depreciation deduction that is deemed distributed to the income beneficiary, the basis of the trust's assets will be reduced by $10,000, as will the total uniform basis. However, the income beneficiary's share of the uniform basis will be reduced only by $4,432 even though the income

In effect, an income beneficiary gets the benefit of a cost recovery deduction, but the uniform basis of the temporal interest is only reduced by a fraction of the deduction because the successor interest absorbs some of the basis reduction. The same would be true if the trust instrument required that the trustee apportion the entire depreciation deduction to the trust. This seems correct as the depreciation deduction reduces the trust's basis in the depreciable asset and that is entirely consistent with rule that the overall uniform basis of all interests in the trust is the same as the trust's basis in the assets.

The trust document could direct that the trust income be apportioned between income and remainder beneficiaries based on the actuarial value of each interest, although such a division of income would be highly unusual.

Example 6: Assume the same facts as in Example 5, except that the income is divided and distributed to the remainder beneficiary and the income beneficiary, based on the actuarial value of their respective interests. The $10,000 deduction will be allocated between the income beneficiary and remainder beneficiary based on their respective interest. The deduction will reduce the basis of the trust assets by $10,000, which in turn reduces the overall uniform basis by $10,000. That lower basis is apportioned between the income beneficiary and the remainder beneficiary based on the value of the income beneficiary's life interest.

An estate must apportion the depreciation deduction between the estate and the heirs, legatees, and devisees on the basis of the estate income allocable to each.[53] For uniform basis purposes, however, the allocation of the basis reductions on depreciable property held by a decedent's estate

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beneficiary received all of the tax benefit of the depreciation deduction, and the remainder beneficiary's share of the uniform basis will be reduced by $5,568 even though the remainder beneficiary received no benefit for the depreciation deduction.

[53] *See* I.R.C. § 167(d). The circuits have split over whether the distribution of income to the beneficiaries who will be the income beneficiaries of an as-yet-unfunded testamentary trust should be taken into account in apportioning the deduction for income tax purposes. *Compare* Lamkin v. United States, 533 F.2d 303, 304–05 (5th Cir. 1976) (holding that the income beneficiaries of the yet-to-be-established trust are heirs, legatees, or devisees of the estate for purposes of the apportionment of the depreciation deduction, where the estate distributed income generated by real property to income beneficiaries of a trust to which the property was to pass), *with In re* Nissen's Estate v. Comm'r, 345 F.2d 230, 235–36 (4th Cir. 1965), *rev'g & rem'g* 41 T.C. 522 (1964) (holding that beneficiaries who would receive income from as yet unfunded testamentary trust and to whom executor distributed income before trust was funded were not "heirs, legatees, and devisees" for purposes of the allocation of the depreciation deduction; the estate was entitled to entire deduction).

remains tied to the actuarial value of the beneficiaries' respective interests. The regulations do not appear to allow a decedent's will to vary this allocation of basis, though the allocation of the income tax deduction for depreciation can be varied by discretionary distributions of estate income.

If property is owned as a legal life estate and remainder, section 167(d) states that the entire deduction in such cases belongs to the life tenant, as if he or she were the absolute owner of the property.[54] The regulations, however, state that the basis of the life tenant, the remainder owner, and every other person who holds an interest in the property must be adjusted according to the usual rules for uniform basis.[55] Thus, regardless of the fact that the deduction passes entirely to the life tenant, the basis reduction is born only partly by the life tenant. The balance is born by the remainder owner.

Example 7: In 2019, Child and Grandchild inherit Blackacre from Parent as a life estate and remainder. On the date of Parent's death, the section 7520 rate is two percent, and Child is sixty years of age.

> The actuarial value of Child's life interest is 33.466% of the total value of Blackacre.
>
> The actuarial value of Grandchild's remainder interest is 66.534% of the value of Blackacre.
>
> In 2020, Blackacre is eligible for $10,000 of depreciation deductions, and the section 7520 interest rate has not changed, though Child is one year older.

In 2020, Child's life estate represents 32.485% of the total value of Blackacre, and Grandchild's remainder is 67.515% of the value of Blackacre. Child receives the entire $10,000 income tax depreciation deduction in 2020, but Child's uniform basis in the life estate is reduced by only $3,248.50. Grandchild receives none of the income tax deduction, but Grandchild's uniform basis in the remainder interest in Blackacre is reduced by $6,751.50.

While the allocation of the income tax depreciation deduction between the income and remainder beneficiaries of a trust can be varied by the terms of a trust's governing instrument or the trustee's discretion in distributing income, there appears to be no corresponding way that the

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[54] *See* Treas. Reg. § 1.167(h)-1(a).

[55] *See* Treas. Reg. § 1.1014-4(b); *see also* Treas. Reg. § 1.1014-4(a); Mark R. Siegel, *I.R.C. Section 1014(E) and Gifted Property Reconveyed in Trust*, 27 AKRON TAX J. 33, 42 (2012); *supra* note 48 and accompanying text.

parties to a legal life estate and remainder ownership can make their depreciation deductions correspond to their basis adjustments.

IV. SALE OR TRANSFER OF A TEMPORAL INTEREST IN A TRUST

A. Sale of an Income Interest

Section 1001(e), added to the Code by the Tax Reform Act of 1969, states that upon the sale or disposition of a term interest, the term interest holder's adjusted basis, if determined pursuant to sections 1014, 1015, or 1041, is disregarded.[56] There is an exception, discussed below, when the entire interest (both the life or term interest and the remainder interest) is disposed of in the same transaction.[57]

Example 8: One million dollars of securities, with a $500,000 adjusted basis, are given to an *inter vivos* trust for the lifetime benefit of Spouse, remainder to Child. Spouse is sixty years of age when the gift is made. The section 7520 rate on the date of the gift is three percent.

> Under the actuarial tables, Spouse's life interest is worth 44.7950% of the value of the securities, or $447,950.
>
> Child's remainder interest is worth 55.205% of the value of the securities, or $552,050.
>
> Spouse's share of the uniform basis on the date of the gift is $223,975.[58]
>
> Child's share of the uniform basis on the date of the gift is $276,025.[59]

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[56] *See* I.R.C. § 1001(e)(1); Tax Reform Act of 1969, Pub. L. No. 91-172, § 516, 83 Stat. 487, 646.48 (1969); *see also* Treas. Reg. §§ 1.1001-1(f)(1), 1.1014-5(b), 1.1015-1(b); Richard L. Fox & Jonathan G. Blattmachr, *Proposed Regulations Apply Special Basis Rules to Combined Sale of Interests in Charitable Remainder Trusts*, J. OF TAX'N at 100, 104, n.31 and accompanying text (Sept. 2014). Section 1001(e) appears to reflect a legislative goal of avoiding a double basis under *McAllister v. Commissioner*, 157 F.2d 235, 236–37 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947). *See infra* Part VII. Without section 1001(e), an income beneficiary would reduce his or her gain by a share of basis on sale of the income interest, but the purchaser would be able to offset income by the amortization deduction. The effect was that the trust income, though realized, never got taxed (or was significantly under-taxed).

[57] *See* I.R.C. § 1001(e)(3); *see also* Treas. Reg. § 1.1001-1(f)(3).

[58] 44.7950% x $500,000.

[59] 55.205% x $500,000.

Ten years later, when Spouse is seventy years of age, the section 7520 rate has increased to four percent, and the securities have increased in value to $2 million.[60] The life interest is sold to Grandchild for $804,720, its actuarial value.

> Spouse's share of the uniform basis on the tenth anniversary of the gift is 40.236% on the initial value of the securities, or $201,180.
>
> However, Spouse recognizes the full $804,720 gain on this sale, rather than a $603,540[61] gain, because basis is ignored for purposes of calculating the Spouse's gain.

The trust's adjusted basis in the property remains $500,000 because the sale of Spouse's interest has no effect on the uniform basis. The buyer, Grandchild, acquires an income interest *pur autre vie* (during Spouse's lifetime), and Grandchild's share of the uniform basis is the same as Spouse's share would have been had it been retained. As explained in greater detail below,[62] Grandchild cannot amortize the cost of the purchased life estate over Spouse's life expectancy under section 167(e).

Transferring the life interest to a controlled corporation in a tax-free transaction under section 351, followed by a sale of the corporation's stock, will not provide the life tenant with basis and produces an even worse tax result. Treasury Regulation section 1.1014-5, Example 6 provides that a legal life estate owner has no basis in the stock upon a subsequent sale of the stock because of section 1001(e) and Treasury Regulation section 1.1001-1(f)(2). Moreover, the example in this regulation states that, if the corporation sells the interest contributed to the corporation, it has no basis either. As a result, the transaction would double the amount of taxable income.

B. Sale of Remainder

The "no-basis recovery" rule of section 1001(e) does not apply to the sale of a remainder interest, regardless of how it was acquired (by gift, inheritance, or purchase).[63] Basis of a remainder interest, when sold, is

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[60] This example assumes that the same securities are still held in trust so that there has been no change in the basis of the trust assets.

[61] $804,720 - $201,180.

[62] *See infra* note 132 and accompanying text.

[63] *See* I.R.C. § 1001(e)(1) (applying only to sales of term interests, which are defined in section 1001(e)(2) as not including remainder interests).

determined using the regular basis rules: the remainder owner's share of the uniform basis, determined actuarially, is applied against the consideration received to determine the amount of gain or loss.[64] An example illustrates the recovery of basis for a remainder interest:

Example 9: Assume the same facts as in Example 8, but instead of Spouse selling the life estate, Child sells the remainder interest to Grandchild for $1,195,280,[65] its actuarial value, which is assumed to be fair market value for purposes of this example. Child's gain or loss is computed using Child's actuarial portion of uniform basis, $298,820, and the gain is $896,460.

C. Sale or Disposition of Entire Interest

The "no-basis recovery" rule for a life or term interest does not apply, however, to a sale or other disposition that is part of a transaction in which all interests in the property are being transferred to a third-party.[66]

In Treasury Regulation section 1.1014-5, example 4, both the life tenant and the remainder interest owner join together and sell to an unrelated third-party both the legal life estate and the remainder in unimproved land. On these facts, each seller is entitled to offset his, her, or its share of the sales proceeds with a respective share of uniform basis. In the example, the life tenant realized and recognized a loss, while the remainder owner had a recognized gain.

Example 10: One million dollars of securities, with a date of death basis of $1 million, are left to a testamentary trust to pay income to Spouse for life, remainder to Child.

> Spouse is sixty years of age on the date of the decedent's death, and the section 7520 rate is three percent.
>
> Under the actuarial tables, Spouse's income interest is worth 44.795% of the value of the underlying securities,

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[64] If the remainder interest is acquired by purchase, the uniform basis determined on a sale may be changed. *See infra* Part IV.C.

[65] In Example 9, the fair market value of the property is assumed to have risen to $2 million and as a result, the actuarial value of the remainder interest following a life tenant who is seventy years of age is $1,195,280.

[66] *See* I.R.C. § 1001(e)(3); Treas. Reg. §§ 1.1001-1(f)(3), 1.1014-6(a)(1), 1.1015-1(b); *see also* Fox & Blattmachr, *supra* note 56, at 100, 104–5 n.34 and accompanying text.

> or $447,950, which is also Spouse's share of the uniform basis.
>
> Child's remainder interest is worth 55.2050% of the value of the securities, or $552,050, which is the appropriate share of the uniform basis.

Ten years after the date of the decedent's death, when Spouse is seventy years of age, the securities have increased in value to $2 million[67] and the section 7520 rate has increased to four percent. Spouse and Child together sell their interests in the trust to Grandchild for $2 million, dividing the sales proceeds between the sellers based on the actuarial value of each interest.

> The value of Spouse's income interest is then 40.221% of the value of the trust fund, or $804,420.
>
> The value of Child's remainder interest is then 59.764% of the value of the trust fund, or $1,195,280.
>
> Spouse's share of the uniform basis on the date of the sale is $443,170—that is, 44.317% of $1 million.
>
> Child's share of the uniform basis is $556,830—that is, 55,683% of $1 million.
>
> Spouse realizes a $361,250 gain on the sale,[68] and Child realizes a $638,450 gain on the sale.[69]

The Joint Committee on Taxation's *General Explanation of the Tax Reform Act of 1969* notes that "the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest[,]"[70] and thus allowing all sellers to recover basis is appropriate.

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[67] This example assumes that the same securities are still held in trust so that there has been no change in basis of the trust assets.

[68] $804,420 - $443,170.

[69] $1,195,280 - $556,830.

[70] *See* STAFF OF THE JOINT COMM. ON TAX'N., 91ST CONG., GEN. EXPLANATION OF THE TAX RETURN ACT OF 1969 175 (Comm. Print 1970).

D. Sale of Interest in a Charitable Remainder Trust[71]

Charitable remainder trusts are one of the most tax-advantaged forms of charitable giving, offering a tempting combination of income, estate, and gift tax benefits, while permitting the retention or a gift of a significant non-charitable interest in the transferred assets.[72] The structure of a qualified charitable remainder trust is highly rigid because of the tax benefits.[73]

In years past, taxpayers sought to terminate qualified charitable remainder trusts before the stated end of the non-charitable term by distributing to the non-charitable beneficiary an amount equal to the actuarial value of that beneficiary's interest, and then distributing the residue to the charitable remainder beneficiary, thus terminating the trust. The Service has repeatedly treated the commutation of a charitable remainder trust in this manner as a sale of the non-charitable beneficiary's annuity or unitrust interest to the charitable remainder beneficiary.[74] The gain realized by each non-charitable beneficiary is taxed as a capital gain, but with the selling beneficiary having a zero basis.[75]

The income tax result might be improved for the non-charitable beneficiary by selling all of the trust interests (both the non-charitable as well as the charitable interest in the trust) to a third-party at the same time, thereby permitting the non-charitable beneficiary to recover an actuarial share of the uniform basis.[76] This structure falls under section 1001(e)(3) and permits the non-charitable beneficiary to recover his or her portion of

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[71] *See generally* BROWN & HESCH, *supra* note 10; Fox & Blattmachr, *supra* note 56.

[72] *See* I.R.C. § 664(d)(1)(D) (requiring the present value of the charitable gift of the remainder to charity of a qualified charitable remainder trust be at least 10%).

[73] *See* I.R.C. § 664.

[74] *See, e.g.*, Priv. Ltr. Rul. 03-14-021 (Apr. 4, 2003); Priv. Ltr. Rul. 07-39-004 (Sept. 28, 2007); Priv. Ltr. Rul. 08-27-009 (July 4, 2008); Priv. Ltr. Rul. 01-27-023 (July 6, 2001); Priv. Ltr. Rul. 13-25-018; Priv. Ltr. Rul. 13-25-019 (June 21, 2013); Priv. Ltr. Rul. 13-25-020 (June 21, 2013); Priv. Ltr. Rul. 13-25-021 (June 21, 2013); *see also* O'Brien v. The Cath. Found., No. 11-13387, 2011 WL 13115939, at *3 (Tex. Dist. Nov. 22, 2011) (approving such a transaction).

[75] *See* Rev. Rul. 72-243, 1972-1 C.B. 233 (stating that a sale of an income interest in a trust is a sale of a capital asset).

[76] The portion to charity is income tax free, but possibly subject to certain excise taxes. *See* I.R.C. § 664(c)(1)–(2).

uniform basis, which means a lower capital gain, but potentially the same cash flow for the beneficiaries.[77]

This structure can, however, be pushed beyond the limits of IRS endurance. In Notice 2008-99, the Service described as a "transaction of interest" an arrangement in which the grantor created a charitable remainder trust and funded it with a gift of appreciated property, while retaining a non-charitable annuity or unitrust interest.[78] The trustee then sold or liquidated the appreciated assets received from the grantor and reinvested the proceeds in a diversified portfolio.[79] The trustee owed no income tax on the sale,[80] and its basis in the new assets was their purchase price, which then became the uniform basis, a proportionate share of which was allocated to the grantor's annuity or unitrust interest.[81]

The grantor and the charity then sold their respective interests to an unrelated third-party for their fair market value.[82] The grantor's sale of an annuity or unitrust interest would be nontaxable or nearly so, however, because of the grantor's share of the new uniform basis.[83]

In Notice 2008-99, the grantor claimed the following tax consequences for the transaction: (1) an income tax charitable deduction for the value of the remainder interest in the contributed assets; (2) no recognized gain from the trust's sale of the contributed assets; and (3) an offset for the amount realized on the sale of the non-charitable annuity or unitrust interest by a substantial share of the uniform basis under section 1001(e)(3).[84] Engaging in this transaction for the income tax advantage only cost the grantor the value of the gift of the remainder to the charity, which, of course, must be at least 10% at the time the trust was created.[85]

The Service stated in Notice 2008-99:

> [T]he IRS and Treasury Department are concerned about the manipulation of the uniform basis rules to avoid tax

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[77] A buyer of an entire charitable remainder trust, however, likely wants some discount in the price for being involved with the transaction, so the actual cash flow may be reduced.

[78] *See* Notice 2008-99, 2008-47 C.B. 1194.

[79] *See id.*

[80] *See* I.R.C. § 664(c)(1).

[81] *See* Notice 2008-99, 2008-47 C.B. 1194.

[82] *See id.*

[83] *See id.*

[84] *See id.*

[85] *See* I.R.C. § 664(d)(1)(D).

> on gain from the sale or other disposition of appreciated assets. . . . In particular, the IRS and Treasury Department are concerned about Grantor's claim to an increased basis in the term interest coupled with the termination of the Trust in a single coordinated transaction under § 1001(e) to avoid tax on gain from the sale or other disposition of the Appreciated Assets.[86]

The Notice classified these arrangements as "transactions [ ] of interest," but added:

> The IRS and Treasury Department are not concerned about the mere creation and funding of a charitable remainder trust and/or the trust's reinvestment of the contributed appreciated property, and such events alone do not constitute the transaction subject to this notice.[87]

In 2015, the Treasury and the Service finalized regulations limiting the ability of qualified charitable remainder trusts to use the uniform basis rules in this fashion by limiting the amount of income tax basis that may be allocated to an annuity or unitrust interest in a charitable remainder trust when the income interest and the charitable remainder interest are simultaneously sold to a third party.[88] The regulations accomplish this by reducing the uniform tax basis otherwise attributable to the annuity or unitrust interest by the amount of undistributed ordinary income and capital gain income of the charitable remainder trust that is attributable to such interest.[89] As a result, the regulations significantly limit the amount of uniform basis allocable to an annuity or unitrust interest in a charitable remainder trust. Nevertheless, this result is still better than in the context of an early termination of a charitable remainder trust by a sale of the non-charitable interest to the charity, where the Service has consistently ruled that the basis of the non-charitable annuity or unitrust interest is always equal to zero under section 1001(e)(1).[90]

These regulations attempt to create an exception to the clear language of the Code, and that may fail even the general tests of reasonableness set

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[86] Notice 2008-99, 2008-47 C.B. 1194.

[87] *Id.*

[88] *See* Treas. Reg. § 1.1014-5 (c).

[89] *See id.*

[90] *See* Treas. Reg. § 1.1014-5; *see also* Prop. Treas. Reg. § 1.11014-5, 79 Fed. Reg. 3142-01 (Jan. 17, 2014).

forth in *Chevron U.S.A., Inc. v. Natural Reserves Defense Council, Inc.*[91] The statutory language is clear and unambiguous, and the regulations attempt to create an entirely different structure for calculating the tax on a sale of a term interest in a charitable remainder trust.

On the other hand, the regulations cause the seller of the non-charitable interest in a charitable remainder trust to realize the undistributed income that would otherwise be deferred under section 664. The Treasury Department, perhaps, could have more reasonably required that the seller realize all undistributed income at the time of sale, including both capital gains and ordinary income. Instead, it chose to reduce the share of uniform basis. Arguably, this is more favorable than immediate realization because the seller gets to treat the income interest as a capital asset under *McAllister v. Commissioner*.[92]

Other than this special rule under the regulations, the uniform basis rules treat charitable remainder trusts the same as non-charitable trusts.

V. COMMUTING OR TERMINATING EARLY TRUSTS BY AGREEMENT OR COURT ORDER

The Service has a long-standing letter ruling position that commutation or early termination of a trust (including a charitable remainder trust), in which the term interest holder(s) and remainder interest holder(s) receive their respective actuarial shares of the underlying assets, is a sale of the life or term interest to the remainder interest holder.[93] As a consequence, it applies the "no-basis recovery" rule of section 1001(e)(1) to the term interest because all of the property is not sold to a third party.[94] Therefore, the term interest holder realizes gain for the full amount received in exchange for the term interest. According to the Service, the remainder interest holder does not realize gain on the exchange of the remainder interest for trust assets but may realize gain to the extent appreciated assets are used to acquire the life or term interests.[95]

[91] 467 U.S. 837, 842–43 (1984).

[92] *See infra* Part VII.

[93] *See, e.g.*, Priv. Ltr. Rul. 2002-10-018 (Mar. 8, 2002); Priv. Ltr. Rul. 2002-31-011 (Aug. 2, 2002); Priv. Ltr. Rul. 2006-48-016 (Dec. 1, 2002); Priv. Ltr. Rul. 2006-48-017 (Dec. 1, 2006); *see also* Plaine, *supra* note 1, at 486.

[94] *See* Priv. Ltr. Rul. 2002-10-018 (Mar. 8, 2020).

[95] *See id.*

A. The Service's Ruling Position Applied

The Service applied its ruling position in 2019 in ten related letter rulings concerning the same trust.[96] These letter rulings involved the early termination of a generation-skipping trust by commutation.[97] The settlor in the rulings created an irrevocable trust for the benefit of his son, the lifetime beneficiary, with the intent of providing the lifetime beneficiary an income stream for his support.[98] The trust instrument directed the trustees to distribute all trust net income to the lifetime beneficiary for life and then to distribute the remainder to his then-living issue, per stirpes.[99] No principal distributions were authorized during the income beneficiary's lifetime.[100]

A non-judicial agreement among the trust beneficiaries provided for early termination and distribution, with the assets of the trust to be distributed to the various beneficiaries based on the actuarial values of their respective interests, on a pro rata or in-kind basis.[101] The early termination and distribution were contingent upon a local court approval and a favorable private letter ruling.[102] Pursuant to state law, the local court agreed, finding that continuing the trust was not necessary to achieve any material purpose because of the lifetime beneficiary's greatly increased personal net worth.[103]

As to the income tax issues, the Service determined that, while the proposed commutation takes the form of a distribution of the present values of the respective interests, the commutation is in fact a sale by the life beneficiary to his children and a sale by the issue of the children to the children who might take if a child did not survive the life beneficiary.[104] As a result, the trust termination causes the life beneficiary and the issue of the children to recognize long-term capital gain on the exchange of their

[96] *See* Priv. Ltr. Ruls. 2019-32-001–2019-32-010 (Aug. 9, 2019).

[97] *See* Priv. Ltr. Rul. 2019-32-001 (Aug. 9, 2019).

[98] *See id.*

[99] *See id.*

[100] *See id.* Son had four living adult children (current remainder beneficiaries) and eight living grandchildren (successor remainder beneficiaries), four of whom were adults. Son and a bank were co-trustees.

[101] *See id.*

[102] *See id.*

[103] *See id.*

[104] *See id.* (citing Rev. Rul. 69-468, 1969-2 C.B. 159).

interests in the trust for trust assets.[105] Moreover, the life beneficiary is not permitted to recover any of the uniform basis in his interest because all interests in the trust are not being sold to a third party.[106] Similarly, the amounts received by the issue of the life beneficiary's children are amounts received from the sale or exchange of a capital asset to the children on which gain is recognized, but they are entitled to offset any gain by their proportionate share of the trust's uniform basis.[107]

The letter rulings do not take the position that the commutation of the trust by the children's purchase of the other interests in the trust is a sale by the children. Nevertheless, the ruling concludes that the children recognize gain on the unrealized appreciation (that is, the amount the fair market value exceeds adjusted basis) in the trust's assets used to buy the interests of the other beneficiaries.[108] It does not appear that the children will have gain for the amount the fair market value of their interests exceed their share of uniform basis. This portion of the letter rulings is consistent with prior letter rulings.[109] The 2019 rulings are not, however, without some cloudy language.

The 2019 rulings state that the early termination of the trust leaves the children as the owners of the entire trust because they acquired all interests held by others.[110] The rulings further state that, to the extent that the children exchange property for the temporal interests of the others, the children will recognize gain or loss.[111] The children should not, however, recognize gain or loss merely by having purchased the interests of other beneficiaries, unless they do so with other appreciated property (regardless of the source of the appreciated property).[112] While not discussed in the rulings, it seems that a purchase with cash, the children's note, or unappreciated property should not result in recognition of gain by the children.

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[105] *See id.*

[106] *See id.*

[107] *See id.*

[108] *See id.*

[109] *See, e.g.*, Priv. Ltr. Rul. 2008-33-012 (Aug. 15, 2008) (discussing a net income charitable remainder unitrust); Priv. Ltr. Rul. 2008-27-009 (July 4, 2008) (discussing a net income charitable remainder unitrust); Priv. Ltr. Rul. 2006-48-017 (Dec. 1, 2006) (discussing a non-charitable trust); Priv. Ltr. Rul. 2006-48-016 (Dec. 1, 2006) (discussing a non-charitable trust).

[110] *See, e.g.*, Priv. Ltr. Rul. 2019-32-001 (Aug. 9, 2019).

[111] *See id.*

[112] *See id.*

Furthermore, the rulings do not state that the children are permitted to offset any gain realized by their basis in the property they exchange for the interests they acquire.[113] Of course, the rulings also do not state that they are not permitted to do so, and as a result one should infer that the usual basis rules would apply to the children as well as to their issue.

B. Is Commutation or Early Termination as a Taxable Event the Correct Result?

One problem with the Service's analysis, however, is that a remainder beneficiary in these situations does not actually buy the term interest at all, much less buy it with appreciated assets. The Service appears to deem some type of purchase to have occurred, but none of the parties nor the applicable state law evidences a purchase. However, section 1001 requires only a "sale or other disposition of property"[114] to give rise to a taxable event; a sale is not the only event that comes in with the coverage of section 1001 and thus gross income under section 61. In addition, Treasury Regulation section 1.1001(a) provides: "the gain or loss realized from . . . the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."[115]

This analysis is also consistent with the general rule of the regulations that all realized gain or loss is recognized, unless there is a specific statutory or regulatory provision providing for nonrecognition.[116] The Treasury has also provided that exceptions to the general rule of recognition are to be strictly construed.[117]

1. Case Law Support

The Service's position is not without some case law support. In particular, the various letter rulings do not cite *McAllister v. Commissioner*,[118] but this case supports the application of section 1001. In

[113] *See id.*

[114] I.R.C. § 1001(a).

[115] Treas. Reg. § 1.1001-1(a). An alternative view of the tax consequences of terminating a trust early is discussed in Jeffrey H. Kahn & Douglas A. Kahn, *Early Termination of a Trust*, 151 Tax Notes 791 (May 6, 2016). The authors postulate that an early termination of a trust causes the trust to realize gain or loss when the trust distributes appreciated assets in satisfaction of the amount due the income beneficiary because the amount due the future income beneficiary, an unascertained amount, has been converted into a sum certain in the termination process.

[116] *See* Treas. Reg. § 1.1002-1(a).

[117] *See* Treas. Reg. § 1.1002-1(b).

[118] 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947).

the Second Circuit decision, a trust was created by a decedent in 1926, and by the time of the tax controversy in 1940, the trust benefitted the decedent's daughter-in-law for life, with his son as the remainder beneficiary.[119] To settle a controversy between the life tenant and the remainder beneficiary, the life tenant brought suit in the New Jersey Court of Chancery to terminate the trust.[120] Under a settlement reached between the parties, the life tenant was paid $55,000 to release her interest in the trust, and the trust was terminated and cancelled by court order with beneficiary consent.[121] The court dismissed any distinction or significance that the early termination was accomplished by court order instead of agreement by the parties and declined to find any distinction, other than semantics, between surrendering an income interest in a trust and assigning it.[122] When distinguishing *McAllister* from other precedent cited by the government, the court determined that "at the conclusion of the transaction the remainderman had the entire estate and the life tenants had a substantial sum of money."[123] What is most significant is that the Second Circuit concluded that the life tenant's interest in the trust "was a right in the estate itself" and a dispositive transaction however structured. *McAlister* is considered in greater detail with the character of the income for commuted interests in Part VII, *infra.*[124] Additional case law support is discussed in Part V(5), *infra.*

2. State Law Changes and Trust Decanting

The Uniform Trust Code and the laws of many states provide a number of routes to change or prematurely terminate trusts.[125] It might be

[119] *See id.* at 235.

[120] *See id.*

[121] *See McAllister*, 157 F. 2d at 235. To settle the dispute, the parties agreed that the remainderman would pay the income beneficiary $55,000 in consideration for her interest in the trust and her consent to its termination. It is not clear from the court's opinion whether the actual source of payment was made from the settlor's son directly, from the existing trust *res*, or from assets the son contributed to the trust so it could make the payment. In all events, the payment was part of an integrated transaction that culminated with the court approved termination as the court noted: "at the conclusion of the transaction the remainderman had the entire estate and the life tenants had a substantial sum of money." *Id.* at 236.

[122] *See id.* at 235.

[123] *See id.*

[124] *See infra* Part VII.

[125] *See* UNIF. TRUST CODE § 411 (UNIF. LAW COMM'N 2004) (allowing modification or termination of non-charitable irrevocable trust upon consent of the grantor and all

suggested that this relatively recent development in state law dictates a different income tax result: that is, it is not a taxable event if a trust is terminated early by agreement, pursuant to a court order, or both. The various beneficiaries receive an amount equal to the current fair market value of their interests along with basis of the assets determined under the uniform basis rules.

The question of exchanging interests in trusts may arise in the context of a trust decanting. Generally, decanting involves the distribution of assets of one trust (the first trust) to another trust (the second trust), to be held for the benefit of one or more of the beneficiaries of the first trust on terms different from those of the first trust.[126] The Service issued Notice 2011-101 requesting comment on trust decanting,[127] and it has added most of the tax consequences of decanting to its no-rulings list.[128]

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beneficiaries, regardless of if consistent with material purpose of the trust); UNIF. TRUST CODE § 412 (allowing modification or termination because of unanticipated circumstances); UNIF. TRUST CODE § 413 (allowing Cy Pres for charitable trusts); UNIF. TRUST CODE § 414 (allowing modification or termination of uneconomic trust); UNIF. TRUST CODE § 415 (amended 2011) (allowing reformation to correct mistakes); UNIF. TRUST CODE § 416 (allowing modification to achieve settlor's tax objectives); UNIF. TRUST CODE § 417 (allowing combination and division of trusts).

[126] For more on decanting, see Farhad Aghdami & Jeffrey D. Chadwick, *Decanting Comes of Age*, 23 PROB. PRACT. REP. 1 (May 2011); Richard C. Ausness, *Sherlock Holmes and the Problem of the Dead Hand: The Modification and Termination of "Irrevocable" Trusts*, 28 QUINNIPIAC PROB. L.J. 237 (2015); Scott Bieber & Sarah J. Chang, *Spinning Straw Into Gold—Modifying Irrevocable Trusts*, 46 EST. PLAN. 3 (Jan. 2019); Jonathan G. Blattmachr, Jerold I. Horn & Diana S.C. Zeydel, *An Analysis of the Tax Effects of Decanting*, 47 REAL PROP. TR. & EST. L.J. 141 (2012); Jonathan G. Blattmachr & Diana S.C. Zeydel, *Tax Effects of Decanting—Obtaining and Preserving the Benefits*, 111 J. TAX'N 288 (Nov. 2009); William R. Culp & Briani Bennett Mellen, *Trust Decanting: An Overview and Introduction to Creative Planning Opportunities*, 45 REAL PROP. TR. & EST. L.J. 1 (2010); John Fritz, *The Wild, Wild West: The Mechanics and Potential Uses of Trust Decanting*, 19 WYO. L. REV. 327 (2019); Jason Kleinman, *Trust Decanting: A Sale Without Gain Realization*, 49 REAL PROP. TR. & EST. L.J. 453 (2015); Thomas E. Simmons, *Decanting and Its Alternatives: Remodeling and Revamping Irrevocable Trusts*, 55 S.D. L. REV. 253, 253–8 (2010).

[127] *See* Notice 2011-101, 2011-52 I.R.B. 932 (Dec. 27, 2011).

[128] *See* Rev. Proc. 2019-3, §§ 5.01(7), 5.01(12), 5.01(13), 2019-1 I.R.B. 130 (Jan. 2, 2019). Specifically, the Service will not rule on

> "[w]hether 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[,]" "[w]hether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a 'decanting')

In a thorough law review article, Jason Kleinman considered whether decanting a trust might cause a recognition of gain.[129] Mr. Kleinman states of the comments to Notice 2011-101:

> Common themes include: a beneficiary who is not involved in the decanting process should not be taxable on the resulting gain because she has not, herself, exchanged property; a decanting that is permitted to occur pursuant to local law or the trust's governing instrument is not an exchange; and only changes to a beneficiary's economic interest should trigger realization.[130]

These comments suggest that an exchange of a life income interest in one trust for specific assets of a trust is not a change in the beneficiary's economic interest, and, therefore, that such a change should not be taxable, in the absence of any clear authority to the contrary. However, the comments reflect the view of the commenters and not necessarily the Service's view. Moreover, a trust decanting, as described above, generally does not result in the trust beneficiaries walking away with direct ownership of property previously held in trust as is the result with a commutation or early termination of a trust.

3. *Cottage Savings*

A no-tax event may have an initial, superficial appeal, but there are several income tax principles that may prevent such a tax-free result, apart from the Service's long-standing position. Section 1001 provides that a taxpayer recognizes a gain or loss only when a disposition of property

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resulting in a change in beneficial interests is a gift under § 2501[,]" or "[w]hether 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." *Id.*

[129] *See* Kleinman, *supra* note 126, at 465.

[130] *Id.*

occurs;[131] mere fluctuations in value do not themselves yield either income or deductions.[132]

Treasury Regulations provide that "[e]xcept as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."[133]

The issue of what is materially different was addressed by the Supreme Court in *Cottage Savings Association v. Commissioner*,[134] in which the taxpayer, a financial institution, sold or exchanged participation interests in a group of mortgages and, simultaneously, bought or received in an exchange approximately the same value of participation interests in another group of mortgages from the four acquirers of its mortgages.[135] On its 1980 income tax return, the taxpayer claimed a loss for the difference between the then fair market value and the income tax basis of the loans it exchanged.

The Commissioner disallowed the loss deduction and argued that the properties must be "materially different" for an exchange to occur, and that a material difference exists only if the assets "differ in economic substance."[136] The Commissioner's position was not supported by a specific regulation,[137] and the Supreme Court resorted to case law to define "materially different."[138] The Court derived a rule that realization occurs

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[131] *See* Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 559 (1991), *rev'g & rem'g* 890 F.2d 848 (6th Cir. 1989), *rev'g* 90 T.C. 372 (1988). The Supreme Court also affirmed the decision of the Fifth Circuit in *Centennial Savings Bank FSB v. United States*, 887 F.2d 595 (5th Cir. 1989), *aff'g in part and rev'g in part* 682 F. Supp. 1389 (N.D. Tex. 1988); *see also* Plaine, *supra* note 1 at 552; Loren D. Prescott, Jr., Cottage Savings Association v. Commissioner: *Refining the Concept of Realization*, 60 FORDHAM L.R. 437 (1991).

[132] *See* SCOTT SHIMICK, 4 MERTENS LAW OF FED. INCOME TAX'N § 22:7 (2019).

[133] Treas. Reg. § 1.1001-1(a).

[134] 499 U.S. 554 (1991).

[135] *See id.* at 556–58. The facts of *Cottage Savings* are somewhat confusing. At one point the Court describes the transaction as a sale and purchase of mortgages among the five institutions involved, but then the Court describes the transaction as an exchange of mortgages. *See id.* In all events, the taxpayer reported the disposition of the mortgages as a loss recognition event. *See id.*

[136] *Id.* at 562.

[137] *See id.*

[138] That inquiry led first to a classic case in early tax controversy, *Eisner v. Macomber*, which dealt with "realization" under section 1001 and held that a pro rata stock dividend was not income. 252 U.S. 189, 215 (1920). Three additional Court decisions

when "the property entitlements are not identical . . . ."[139] For purposes of section 1001(a), the Court stated, a material difference is one in which the respective possessors enjoy legal entitlements that are different in kind or extent.[140] It found that mortgage loans made by different borrowers and secured by different properties embodied distinct legal entitlements, and therefore, the taxpayer realized losses when it exchanged interests in the loans.[141] The Court also noted that the statute itself supported this reading of section 1001, under which dispositions of property are recognized unless one of the statutory exceptions specifically applies.[142] For example, section 1031 provides for nonrecognition of realized gains and losses when property of like kind is exchanged.[143] The Court reasoned that section 1031's nonrecognition rule would not be necessary if exchanging similar property did not result in a realization event.[144]

Since the *Cottage Savings* decision, the Service has not provided any formal guidance as to how *Cottage Savings* applies to trusts.[145] A number of letter rulings have paid lip service to *Cottage Savings*; many have

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involving exchange of corporate stock in reorganizations refined the principle in *Macomber*. Two of these transactions were realization events because the corporations changed domicile. *See* United States v. Phellis, 257 U.S. 156, 173 (1921); Marr v. United States, 268 U.S. 536, 541 (1925). The third was not because the new corporation was in the same state. *See* Weiss v. Stearn, 265 U.S. 242, 254 (1924).

[139] *Cottage Sav. Ass'n.* 499 U.S. at 564–65.

[140] *See id.*

[141] *See id.* at 566.

[142] *See id.*

[143] *See id.*

[144] *See id.* at 568–72. Justices Blackmun and White concurred in part and dissented in part, arguing that the exchange of mortgages in Cottage Savings Association was not actually material.

[145] *See* Treas. Reg. § 1.1001-1(h) (permitting tax-free severances of trusts, even if there is non-pro rata division of assets, but the Regulation does not extend to trust terminations). But see Treasury Regulation section 1.643(b)-1, which provides:

> A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 . . . . A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 . . . .

This Regulation suggests the Treasury Department and the Service believe something less dramatic that a commutation or early termination may be a section 1001 recognition event.

considered *Cottage Savings* when a trust is divided into separate trusts,[146] but none have addressed the issue in the context of terminating a trust early.

The Jason Kleinman article, mentioned above, considered whether decanting a trust might invoke the *Cottage Savings* rule.[147] His analysis separated discretionary interests and mandatory income interests and concluded that *Cottage Savings* should not apply to either because to treat the decanting as a deemed sale would undermine the conduit theory of trust taxation.[148] Furthermore, he noted that even if *Cottage Savings* did apply, the installment sales rules should also apply.[149]

The basis for his view that *Cottage Savings* does not apply to a trust decanting, however, seems inapplicable to a trust commutation or early termination. When beneficiaries' temporal interests in a trust are substituted for a direct fee ownership of trust property, the legal entitlements seem "different in kind or extent," and therefore embody distinctly different legal entitlements.[150]

4. Additional Case Law

The case law before the enactment of section 1001(e) and the decision in *Cottage Savings* provides some additional insight. In 1958, the Tax Court, in *Evans v. Commissioner*,[151] considered the tax treatment of an exchange of a trust income interest for an annuity. The court concluded that gain would be realized on the exchange because the beneficiary exchanged an entitlement to dividends paid by a corporation owned by the trust for payments of fixed sums annually for life.[152]

The Seventh Circuit's decision in *Silverstein v. United States*[153] is more favorable for the taxpayer. In that case, the beneficiary of a trust

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[146] At least one of the rulings noted that "a partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result of the. Thus, neither gain nor loss is realized on the partition." Priv. Ltr. Rul. 97-09-028 (Feb. 28, 1997) (citing Rev. Rul. 56-437, 1956-2 C.B. 507).

[147] *See* Kleinman, *supra* note 126.

[148] *See id.* at 488.

[149] *See id.*

[150] Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 565 (1991).

[151] 30 T.C. 798 (1958), *acq.* 1958-2 C.B. 3.

[152] *See id.* at 808.

[153] 419 F.2d 999 (7th Cir. 1969), *aff'g* 293 F. Supp. 1106 (N.D. Ill. 1968), *cert. denied* 397 U.S. 1041 (1970).

exchanged an income interest in a trust for a right to specified annual payments from the remainderman.[154] After the exchange, the taxpayer was entitled to the same annual payments directly from the remainderman as she had been receiving before the exchange.[155] The court distinguished *Evans,* finding that a taxable exchange had not occurred, stating: "[T]he amount of Mrs. Evans' interest in the trust was not definitive. It varied with the dividend return on the trust stock. She exchanged this 'uncertainty' for definitely ascertained yearly payments from her husband."[156]

The Service subsequently distinguished *Evans* and *Silverstein* in Private Letter Ruling 2002-31-011, in which Grandchild, as beneficiary of a trust, was entitled to trust income, subject to a maximum and a minimum.[157] The trust was reformed judicially, and after the reformation, Grandchild was entitled to annual payments of "seven percent of the net fair market value of the property held in trust."[158] The Service stated that beneficiary's interest would "entail legal entitlements different from those he currently possesses" and thus the exchange was taxable.[159] It should be noted that 2004 amendments to Treasury Regulation section 1.643(b) would likely change the conclusion in the letter ruling that the conversion of a trust income interest to a unitrust payment is a taxable event, but the ruling is helpful in evaluating how the Service interprets *Evans* and *Silverstein.*[160]

As a result of the interpretations in *Evans* and *Silverstein*, it is hard to argue that an "indefinite" income interest in a trust and a sum certain or specific assets realized in a commutation or early termination are not materially different.

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[154] *See id.* at 1000.

[155] *See id.*

[156] *Id.* at 1003.

[157] *See* Priv. Ltr. Rul. 2002-31-011 (Aug. 2, 2002). This ruling was discussed extensively in Lloyd Leva Plaine, *Cottage Savings is a Loss to Trust Beneficiaries*, SJ073 ALI-ABA 477, 522 (2004).

[158] Priv. Ltr. Rul. 2002-31-011 (Aug. 2, 2002).

[159] *Id.*

[160] *See* Treas. Reg. § 1.643(b) (authorizing changes between a right to income of a trust and a right to a unitrust payment without the change being a taxable event). For a discussion of the safe harbor, see Jonathan G. Blattmachr & Mitchell Gans, *The Final 'Income' Regulations: Their Meaning and Importance*, 103 Tax Notes 891 (2004); *see also* Plaine, *supra* note 1.

5. Additional Issues

If the commutation is a section 1001(a) realization event and thus (likely) a taxable event, the beneficiaries need to meet an exception to section 1001(c) recognition of income for tax-free treatment. The exchange does not qualify as a section 1031 exchange of like-kind property. In a commutation or an early termination, a beneficiary is exchanging a beneficial interest in a trust for a fee interest in property. With the 2017 amendments to section 1031 restricting section 1031 to real property, the early termination of a trust would not qualify as an interest in a trust that is not real property.[161] In addition, if the commutation or early termination of a trust is a section 1001 realization event for the life or term interest as the Service asserts and as discussed above, the recognition of gain is likely even if the termination is accomplished by a court order over the objection of a beneficiary as is possible under UTC section 7-411.[162] Section 1001(c) provides that section 1001(a) gain realized from the sale of disposition of property is recognized unless "otherwise provided [for] in this subtitle" and thus is includible in gross income.[163] By analogy, an involuntary conversion of property from a casualty or a condemnation avoids recognition of gain only if the requirements of section 1033 are satisfied. For a sale or early termination

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[161] *See* I.R.C. § 1031(a)(1); *see also* Amendment to the 1986 code, Pub. L. 115-97, Title I, § 13303(a), (b)(1) to (5) (Dec. 22, 2017), 131 Stat. 2123. If instead of an interest in a trust, the commutation involves the division of a legal life and a remainder interest in real property, section 1031 might be satisfied.

[162] The Reporter's Comment for UTC section 411 provides:

> Subsection (e) allows the court to fashion an appropriate order protecting the interests of the nonconsenting beneficiaries while at the same time permitting the remainder of the trust property to be distributed without restriction. The order of protection for the nonconsenting beneficiaries might include partial continuation of the trust, the purchase of an annuity, or the valuation and cashout of the interest.

[163] *See* I.R.C. section 1001(c). Moreover, Treasury Regulation section 1002-1(b) provides for strict construction to exceptions to the general rule of section 1001(a). It provides:

> 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.

This Regulation was promulgated for Code section 1002, which was repealed by recodification as Code section 1001(c). *See* Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976). The Regulation has not been withdrawn.

of a trust, there appears no exception from a section 1001(c) recognition and lack of choice should not matter for tax purposes. However, a fiduciary who causes an unwanted tax consequences for a beneficiary may have exposure to a breach of trust claim.

6. *Revenue Ruling 69-486*

The letter rulings in this area rely on Revenue Ruling 69-486, which provides that non-pro rata trust distributions of property made without authorization by either the governing instrument or state law are treated as a taxable exchange of the distributed property by the beneficiaries.[164] In essence, the Service treats an early termination as a taxable event, unless the early termination has been authorized.[165] Such authorization in the governing instrument could be an express right to make discretionary, non-pro rata distributions to various trust beneficiaries, or even a power in the trustee or a third party to terminate the trust and make non-pro rata distributions of the trust assets to the beneficiaries.

Although the Service might cite stronger authority than Revenue Ruling 69-486 for its position, as described herein, the commutation or early termination of a trust is substantively more similar to a sale of trust interests or assets to third parties than to a terminating distribution to beneficiaries. An exchange takes place, rather than a distribution pursuant to the terms of the trust; this is the essential point made by Revenue Ruling 69-486.

State law authorization is more problematic. Courts may approve terminating a trust when asked to do so, but in fact, the court is being asked to approve an exchange of interests in the trust for other specific assets. Therefore, the court approved termination is still an "exchange or other disposition of property" by the taxpayer and is gross income under sections 1001 and 61.

7. *Does Subchapter J Preempt Section 1001?*

It can be argued that the general rules of Subchapter J, and more specifically sections 661 and 662, determine the tax consequences of a trust commutation or early termination under the rules for the taxation of distributions of trust assets. When a trust concludes according to its terms, these sections apply, and generally no income is realized. Moreover, the rules of Subchapter J do not seem applicable to an exchange between a

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[164] *See* Rev. Rul. 69-486, 1969-2 C.B. 159.

[165] *See id.*

trust and a beneficiary; they apply to distributions from a trust to a beneficiary. Subchapter J was enacted as a part of the Internal Revenue Code of 1954 as a system to determine what income of an estate or trust was taxed to the entity and what portion of that income is deemed distributed.[166] With a commutation or early termination, the trust is not involved as an income recognition or reporting entity.

When beneficiaries agree to exchange their interests for trust assets, the Service does not rely on the rules of Subchapter J, though it has not yet explained in a letter ruling or otherwise why those rules do not apply. The Service's letter ruling view is that one beneficiary acquires the interest of another beneficiary in a taxable event that is outside scope of Subchapter J, but instead is controlled by section 1001. The idea that a trust beneficiary might have a taxable event while the trust has none seems possible. The reverse of this occurred in *Kenan v. Commissioner*,[167] in which a trust realized income when it paid a specific bequest to a trust beneficiary although there was no taxable event for the beneficiary.[168]

8. Is an Early Termination a Severance?

A final argument for a nontaxable commutation or early termination could be based on Treasury Regulation section 1.1001-1(h), which permits the severance of a trust, including a qualified severance of a generation-skipping trust under Treasury Regulation sections 26.2642-6 or 26.2654-1(b).[169] The Regulation provides:

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[166] *See* Joseph M. Dodge, *Simplifying Models for the Income Taxation of Trusts and Estates*, 14 AM. J. TAX POL'Y 127, 134 (1997), which states: "Subchapter J, enacted in essentially its present form in 1954, generally follows a hybrid approach under which distributions carry current trust or estate (ordinary) income to beneficiaries, with nondistributed, i.e., accumulated, income (including capital gains) being taxed separately to the trust[,]" (citing M. CARR FERGUSON ET AL., FEDERAL INCOME TAXATION OF ESTATES, TRUSTS, AND BENEFICIARIES § 4.1 (2d ed. 1994) (with annual supplements); JOHN PESCHEL & EDWARD D. SPURGEON, FEDERAL TAXATION OF TRUSTS, GRANTORS AND BENEFICIARIES (1978) (with supplements); ARTHUR MICHAELSON & JONATHAN G. BLATTMACHR, INCOME TAXATION OF ESTATES AND TRUSTS (1980) (with supplements)). For background on the enactment of Subchapter J, see Sherwin Kamin et al., *The Internal Revenue Code of 1954: Trusts, Estates, and Beneficiaries*, 54 COLUM. L. REV. 1237 (1954); H. Brian Holland et al., *A Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates-The American Law Institute Draft*, 53 COLUM. L. REV. 316 (1953); H.R. REP. NO. 83-1337, A 194 (1954); S. Rep. No. 83-1622, 343 (1954).

[167] 114 F.2d 217 (2d Cir. 1940).

[168] *See id.* at 220.

[169] *See* Treas. Reg. § 1.1001-1(h).

> The severance of a trust (**including without limitation a severance that meets the requirements of § 26.2642–6 or of § 26.2654–1(b) of this chapter**) is not an exchange of property for other property differing materially either in kind or in extent if—
>
> (i) An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and
>
> (ii) Any non-pro rata funding of the separate trusts resulting from the severance (including non-pro rata funding as described in § 26.2642–6(d)(4) or § 26.2654–1(b)(1)(ii)(C) of this chapter), whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.[170]

The emphasized parenthetical phrase above was added in response to a commenter's request that the Regulation not be limited to GST severances.[171] This suggests that the Regulation is applicable to other trust divisions similar to GST severances such as those authorized by UTC section 417. The Preamble to the final Regulation does not otherwise indicate that the Regulation should apply beyond a division of a single trust into two or more trusts as would be done in, but not exclusively, a qualified GST trust severance. The literal language of the Regulation does not support a broad application of the term "severance," and Treasury Regulation section 1.1002-1(b) requires a strict construction of exceptions

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[170] Treas. Reg. § 1.1001-1(h)(1) (emphasis supplied).

[171] *See* 73 Fed. Reg. 42291 at 42293 (Aug. 2, 2008). The preamble to these final regulations states:

> One commentator noted that § 1.1001-1(h)(1) of the proposed regulations provides favorable income tax treatment only with respect to a qualified severance. The commentator requested that the regulations also address the income tax treatment of all other trust modifications and severances. The commentator noted that the failure to address, for example, the income tax consequences of severances that are not qualified severances for GST tax purposes implies that such severances are taxable events for income tax purposes. In response to these comments, the category of severances to which § 1.1001-1(h)(1) will apply has been broadened. No inference should be drawn with respect to the income tax consequences under section 1001 of any severance that is not described in § 1.1001-1(h)(1).

to section 1001(c)(f).[172] The authors believe that the early termination or commutation of a trust is very different from a scheduled termination of a trust or a trust severance.

VI. AMORTIZATION OF A LIFE INTEREST

A. History

The income of a trust distributed to an income beneficiary is not income tax free.[173] Rather, the gross income of the trust is carried out to the beneficiary, through the medium of distributable net income.[174] Nevertheless, courts have held that the life interest is a capital asset and the Service clearly agrees.[175] This capital asset necessarily declines in value as the life tenant ages because the remaining time during which income will be generated diminishes. As a result, even early in the life of the current federal income tax, taxpayers sought to claim an income tax deduction for the declining value. In response, the 1921 Income Tax Act disallowed the amortization deduction, enacting what is now section 273 of the 1986 Code.[176]

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[172] Treasury Regulation section 1002-1(b) provides for strict construction to exceptions to the general rule of section 1001(a). It provides:

> 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.

This Regulation was promulgated for Code section 1002, which was repealed by recodification as Code section 1001(c). *See* Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976). The Regulation has not been withdrawn.

[173] *See* I.R.C. § 102(a); *see also supra* Part II.

[174] *See* I.R.C. § 643; *see also* discussion in F. LADSON BOYLE & JONATHAN G. BLATTMACHR, BLATTMACHR ON INCOME TAXATION OF ESTATES AND TRUSTS § 3.3 (Practicing Law Inst. 15th ed. 2007); ROBERT T. DANFORTH, NORMAN H. LANE & HOWARD M. ZARITSKY, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS, ¶ 3.01 (Thomson-Reuters, 3d ed. 2001).

[175] *See* Rev. Rul. 72-243, 1972-1 C.B. 233.

[176] The U.S. Treasury Department's notes to the House Ways and Means Committee on the Revenue Act of 1918 state:

> It has been suggested that it is desirable also to clear from doubt the status of life interests or estates. Life tenants have made claim for an obsolescence allowance based upon shrinkage due to the mere passage of time in the so-called capital value of the life interest. Certain State statutes and the decisions thereunder give color to the claim that the value of a life interest at the time received is such a capital value as may serve as the basis of deductions for obsolescence. If these claims be

B. Section 273

Section 273 provides that the holder of a life or term interest acquired by gift or inheritance is not entitled to an income tax deduction for shrinkage in the value of life or term interest caused by a lapse of time. Section 273 bolsters the policy of section 102(b), which provides that gifts of income or income from property are not excluded from gross income. To allow an amortization of the life tenant's interest would effectively permit the life tenant to reduce the gross income received by the amount of an amortization deduction, making some or all the income not taxable.

Nevertheless, a buyer of a life or term interest may be able to amortize his or her cost over the life expectancy of the selling life tenant—that is *pur autre vie.*[177] The same would be true for the purchaser of a term

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> allowed, cases would arise in which a clear income from an unimpaired corpus divided between a life tenant and remainderman would entirely escape taxation—the income from the property being wiped out by the annual shrinkage or obsolescence of the so-called capital value of the life estate.

UNITED STATES DEPT. OF THE TREASURY, NOTES ON THE REVENUE ACT OF 1918, (Government Printing office 1919).

The Conference Committee Report on the 1921 Revenue Bill of 1921 states:

> Under existing law persons receiving by gift, bequest, devise, or inheritance a life or other terminable interest in property, frequently capitalize the expected future income, set up the value of this expectation as corpus or principal, and thereafter claim a deduction for exhaustion of this so-called principal on the ground that with the passage of time the "principal" or corpus is gradually shrinking or wasting. This section explicitly provides that no such deduction shall be recognized.

H.R REP. NO. 67-350, at 12 (1921).

In debate on this provision in the House of Representatives, Rep. Robt. Hawley (R-Tex.) added:

> Section 219 [Sec. 215(b) of the Act] provides that the holder of a life or terminable interest acquired by gift, bequest, devise, or inheritance shall not be reduced if the property is sold at a loss—that is, if I am receiving a $5,000 income from a trust estate and the trustee sells out the estate and takes a loss of $3,000, my income can not [sic] be held to be reduced for the purposes of taxation by the amount of the loss. I am not to be allowed that $3,000 loss. I must pay taxes on my $5,000 income. The trust estate will be allowed to claim the $3,000 loss in its accounts. This was a source of frequent attempts at evasion.

61 CONG. REC. 5203 (1921); *see also* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAW 1938-1861, 842 (1938).

[177] *See* Bell v. Harrison, 212 F.2d 253, 254 (7th Cir. 1954), *aff'g* 108 F. Supp. 300 (N.D. Ill. 1952); Fry v. Comm'r, 31 T.C. 522, 527 (1958), *aff'd*, 283 F.2d 869 (6th Cir. 1960) (The Service has acquiesced in these decisions.); Rev. Rul. 62-132, 1962-2 C.B. 73; *see also* Grant v. United States, 202 F. Supp. 608, 612 (W.D. Va. 1962).

certain, except the amortization deduction would be allowed over the time period of the term interest purchased. A life interest purchased for the buyer's lifetime is similarly amortizable.[178] However, as discussed below, an amortization is not permitted if the buyer and the remainder beneficiary are related.

For example, in *Kissel v. Commissioner*,[179] the life tenant in property expended her own funds to make capital improvements to the property. The Board of Tax Appeals permitted her to amortize the cost over her life expectancy but denied any depreciation deduction.[180]

Moreover, in *Manufacturers Hanover Trust Co. v. Commissioner*,[181] the taxpayer bought a 72% life estate and contingent remainder in another trust for $1.2 million.[182] The taxpayer began amortizing this amount using a straight-line method over a projected period of 6.21 years, the life expectancy of the measuring life.[183] The taxpayer received over $500,000 of income from the trust in 1932, of which $58,000 was tax-exempt bond interest.[184] The taxpayer took the amortization deduction without reduction for that portion that was attributable to tax-exempt interest.[185] The Tax Court and the Second Circuit both held that the amortization deduction was appropriate for a purchased life estate, and the amortization deduction was not disallowed under section 265.[186]

The applicable Regulation contains several examples of life interests transferred for value.[187] In the first three examples, a legal life estate is sold.[188] In the first two examples, the sale is to the life tenant's nephew, who would not be a related party under section 267.[189] In the third example, a legal life estate is sold to a buyer who is not a family member

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[178] *See* Kuhn v. United States, 392 F. Supp. 1229, 1240 (S.D. Tex. 1975) (concerning the purchase of a life interest in a community property trust).

[179] 15 B.T.A. 705 (1929).

[180] *See id.* at 709–10.

[181] 431 F.2d 664 (2d 1970), *aff'g* T.C. Memo. 1969-132, *nonacq. recommended* by AOD, 1969 WL 20979 (Sept. 19, 1969).

[182] *See id.*

[183] *See id.*

[184] *See id.*

[185] *See id.* at 665.

[186] *See id.* at 666; *see also* I.R.C. § 265 (disallowing expenses and interest relating to tax-exempt income).

[187] *See* Treas. Reg. § 1.1014-5(d), Exs. 1–6.

[188] *See id.*

[189] *See id.*

of either the life tenant or the remainder owner.[190] Each example states that the buyer may amortize the purchase price over the selling life tenant's remaining life expectancy.[191]

In the fifth example, Decedent leaves nondepreciable property to Husband for life and, after his death, to Daughter, for life, with remainder to Grandson.[192] Thereafter, Husband sells his life estate to Daughter. Daughter can recover her $32,000 cost by amortization deductions over Husband's life expectancy.[193]

In the second part of the fifth example, Daughter then sells both life estates (Husband's and Daughter's) to Grandson.[194] Before her sale of the two life estates, Daughter was allowed a deduction for the amortization of Husband's life estate.[195] This deduction reduces Daughter's adjusted basis in the life estate she bought from Husband, and increases the amount realized by her on its sale.[196] Grandson is entitled to amortize over Husband's life expectancy that part of the purchase price that is attributable to Husband's life estate.[197] That part of the price that is attributable to Daughter's life estate may be amortized by Grandson beginning with Husband's death.[198]

The Regulation examples were modified in 1971 to take into account the 1969 adoption of section 1001(e)[199] but were not modified after 1989 to reflect the adoption of section 167(e), which is discussed immediately below. Section 167(e) disallows the amortization of a purchased life interest when the buyer and the remainder beneficiary are related as they were in example five.[200]

C. Section 167(e)

The ultimate entitlement to an amortization deduction for a life estate or term-of-years is complex because of the interaction of the uniform basis

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[190] *See id.*
[191] *See id.*
[192] *See id.*
[193] *See id.*
[194] *See id.*
[195] *See id.*
[196] *See id.*
[197] *See id.*
[198] *See id.*
[199] *See* T.D. 7142, 1971-2 C.B. 295.
[200] *See* I.R.C. § 167(e).

rules with other Code sections. Section 167(e)(1), added in 1989,[201] prevents the buyer's amortization of the acquisition cost of a life estate or term interest if a related person owns the remainder interest.[202] The section 167(e) disallowance rule does not state specifically that it applies if the owner of the remainder interest is the buyer, nor does it specifically exclude sales to the remainder owner from its operation. Its application on a sale of the term interest by the term holder to the remainder holder would, nonetheless, seem reasonable as they are one and the same owner.

When section 167(e)(1) applies, the amortization deduction is disallowed, but the term-interest owner's adjusted basis is still reduced by that amount, and the remainder owner's basis is increased by an equivalent amount.[203] The remainder owner's basis is not increased, however, if the buyer of the term interest is (1) a tax-exempt organization or (2) a nonresident alien individual or foreign corporation, and income from the term interest is not effectively connected with the conduct of a trade or business in the United States.[204] In these cases, the term-interest owner's

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[201] *See* Pub. L. No. 101–239, title VII, §§ 7622(b)(1), (d)(1), 7645(a), 103 Stat. 2378, 2381 (1989).

[202] A "related person" is defined with reference to sections 267(b) and 267(e). *See* I.R.C. § 167(e)(5)(B). Under this cross-reference, a related person includes (1) the family of an individual, meaning only his or her siblings (whether by the whole or half-blood), spouse, ancestors, and lineal descendants; (2) an individual and a corporation more than fifty percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; (3) two corporations that are members of the same controlled group (as defined in section 267(f), which refers in turn to section 1563(a)); (4) a grantor and the fiduciary of any trust; (5) a fiduciary of a trust and a fiduciary of another trust if the same person is a grantor of both trusts; (6) a fiduciary of a trust and a beneficiary of such trust; (7) a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts; (8) a fiduciary of a trust and a corporation more than fifty percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a grantor of the trust; (9) a person and a tax-exempt educational or charitable organization that is controlled directly or indirectly by that person or, if the person is an individual, by members of his or her family; (10) a corporation and a partnership if the same persons own more than 50% of the value of the outstanding stock of the corporation, and more than fifty percent of the capital or profits interests of the partnership; (11) two S corporations if the same persons own more than fifty percent of the value of the shares of each; (12) an S corporation and a C corporation if the same persons own more than 50% of the value of the shares of each; and (13) except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate. *See* I.R.C. § 267(b), (c)(4). Special rules are applied to determine how interests of a pass-through entity are attributed to the persons holding interests in that entity. *See* I.R.C. § 267(e).

[203] *See* I.R.C. § 167(e)(3).

[204] *See* I.R.C. § 167(e)(4)(A).

basis is reduced by the barred amortization deduction, with no offsetting increase in the basis of the remainder owner.

If a buyer is not a related person, section 167(e) does not apply, and amortization of the term interest is permitted, but the manner in which the amortization deductions are calculated is not wholly clear. In example 1 of Treasury Regulation section 1.1014-5(d), the life tenant is forty-eight years of age.[205] The regulations determine her life expectancy based on Regulation section 20.2031-7A(c), which was used to determine the estate tax value of life estates, terms-for-years, and remainder interests before the 1988 enactment of section 7520.[206] Treasury Regulation section 20.2031-7A(c) produced a life expectancy of 30.7 years. Which actuarial tables are used to determine the value of the term interest can alter the life expectancy and, therefore, the amortization deduction. If the 2000 census table were used, the life tenant's life expectancy would be 31.6 years.[207] If the tables under Treasury Regulation section 1.72-9 were used, the actuarial life expectancy would be 34.9 years.

Furthermore, if the life tenant dies in less than the expected life expectancy, it is unclear whether the purchasing life tenant can continue to amortize the cost or claim a final deduction. By analogy, when a depreciable asset is abandoned or discarded for whatever reason, a taxpayer may deduct any remaining basis.[208] Therefore, a final deduction seems appropriate.

D. Technical Advice Memorandum 83-29-005

In a 1983 Technical Advice Memorandum,[209] the Service determined that a purchased life interest was amortizable by the purchaser. Quoting from *Elrick v. Commissioner*, the Service stated:[210]

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[205] *See* Treas. Reg. § 1.1014-5(d), Exs. 1-3.

[206] *See* Pub. L. No. 100–647, title V, § 5031(a), 100th Cong., 2d Sess., 102 Stat. 3668, (1988).

[207] The 2000 census table are the basis for the section 7520 actuarial valuations. *See* United States Census Bureau, https://www.census.gov/main/www/cen2000.html [perma.cc/B3JF-RG23].

[208] *See* Treas. Reg. § 1.167(a)-8(a).

[209] *See* Tech. Adv. Mem. 83-29-005. The Technical Advice Memorandum does not disclose whether the purchaser was related to a remainder beneficiary. If they are related, no amortization would be allowed currently because of Code section 167(e). Under I.R.C. section 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

[210] 485 F.2d 1049, 1052 (D.C. Cir.1973) (including facts where a taxpayer sought to amortize legal fees incurred to enforce promised gift that was settled by additional transfers

> An intangible asset may be the subject of such a deduction and it is well established that the *purchaser* of a life estate in income producing property is entitled to amortize the cost basis of his acquisition over the period of the life expectancy of the beneficiary (in this case the taxpayer herself) by ratable annual deductions.[211]

But to compute the amortization deduction, the Technical Advice Memorandum relied on Table 1 under the section 72 annuity regulations, stating that those tables were "the most appropriate vehicle to use in valuing this interest, as opposed to any of the tables found under section 20.2031-10 of the Estate Tax Regulations."[212] In the Technical Advice Memorandum, the deduction was computed on a straight-line method of amortization, with daily proration for part years.[213] Using Table 1 of the Section 72 Regulations to determine the life expectancy of a 48-year old individual would produce a life expectancy of 34.9 years, instead of 31.6 as determined using the 2000 Census tables, resulting is a somewhat smaller deduction over a longer period of time: $10,602 per year, if acquired on January 1 of the tax year. A purchase on any other day than January 1 results in a proration of the first-year and last-year deduction.

E. Sections 62 or 63

The next potential hurdle to an amortization deduction is whether the deduction is an adjustment to gross income (an "above-the-line deduction" under section 62) or an itemized deduction (a "below-the-line" deduction allowed when computing taxable income under section 63).[214]

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of property to an existing trust for her benefit), *rev'g* 56 T.C. 903 (1971), *nonacq.* 1978-2 C.B. 1.

[211] *Id.* (citing Gist v. United States, 296 F. Supp. 526 (D.C. Cir.1969), *aff'd,* 423 F.2d 1118 (9th Cir. 1970); Comm'r v. Fry, 283 F.2d 869 (6th Cir.1960), *aff'g* 31 T.C. 522 (1958); Bell v. Harrison, 212 F.2d 253 (7th Cir. 1954); Estate of Christ v. Comm'r, 54 T.C. 493 (1970); Hrobon v. Comm'r, 41 T.C. 476, 503 (1964); Keitel v. Comm'r, 15 B.T.A. 903 (1929)); *see also* SHIMICK, *supra* note 132, § 23.63a.

[212] Tech. Adv. Memo. 83-29-005.

[213] *See* Tech. Adv. Mem. 83-29-005. Straight line seems proper as it is the only method of depreciation permitted for an intangible asset that may be depreciated. *See* Treas. Reg. § 1.167(a)-3(b)(3). However, a legal life estate in real estate is an interest in the real estate, so it is not an intangible and some other method of depreciation might be permissible.

[214] Neither of these sections authorize a tax deduction but merely instruct a taxpayer where the deduction is permitted when computing an income tax liability.

The issue is significant for many reasons, but particularly in tax years between 2017 and 2025, as many itemized deductions are disallowed by section 67(g) for those tax years.[215] To be an above-the-line deduction and not an itemized deduction, the amortization must qualify under section 67(a)(5), which provides an above-the-line adjustment: "In the case of a life tenant of property, or an income beneficiary of property held in trust, or an heir, legatee, or devisee of an estate, . . . for depreciation allowed by section 167 and the deduction allowed by section 611."[216] None of the other subsections of section 62 appear applicable.

The inclusion of a depreciation deduction as an adjustment to gross income has been in the statute since the concept was adopted in 1944.[217] Moreover, the language of section 62(a)(5) permitting a depreciation deduction has been in the tax law since 1928 when it was adopted to clarify who was entitled to the depreciation deduction for property held in trust or owned as a life tenant.[218] The literal language of section 62(a)(5) arguably authorizes the amortization of a purchased life estate, but it might be argued that it refers only to the depreciation deduction authorized by section 167(d). Nevertheless, the Tax Court in *Gordon v. Commissioner*[219] stated (in dictum, because the depreciation deduction was not allowed) that the amortization deduction is permitted by section 167(d) and is an above-the-line deduction under section 62(a)(5).

If the amortization deduction is an itemized deduction, it appears to be disallowed in tax years 2017-2025. The disallowance of miscellaneous itemized deductions includes some specific exceptions, but section 273 amortization deductions are not included among the exceptions. The disallowance rule of section 67 is not a suspension of the deduction but rather a total loss of the deduction, so that the remainder beneficiary should

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[215] Some itemized deductions are not subject to the disallowance rule of section 67, but there is a finite list and the amortization deduction does not appear in that list. *See* F. Ladson Boyle & Jonathan G. Blattmachr, *The Tax Act of 2017 Impacts Itemized Deductions and the Pass-Through of Excess Deductions*, 30 PROBATE PRACTICE REPORTER, NO. 2, at 1 (Feb. 2018).

[216] I.R.C. § 62(a)(5).

[217] *See* Individual Income Tax Bill of 1944, 4646, 78th Cong. § 22(n) (2d Sess. 1944).

[218] *See* Revenue Act of 1928, H.R. 1, 70th Cong. § 23(k) (1st Sess. 1928); *see also* S. Rep. No. 70.960 at 20 (1927); H. Rep. No. 70-1882 at 12 (1927).

[219] 85 T.C. 309 (1985).

not receive an addition to basis as is otherwise permitted by section 167(e) for a disallowed amortization deduction because of the related parties.[220]

If the life tenant and the remainder beneficiary are not related under section 167(e), an itemized amortization deduction should be allowed in tax years after 2025 under section 63. If the life tenant does not itemize deductions for a particular year, the deduction, again, appears to be lost and not made available as a basis adjustment for the remainder beneficiary.

VII. NATURE OF GAIN - CAPITAL GAIN OR ORDINARY INCOME[221]

At one time, it was disputed whether the gain on the disposition of a life interest was an anticipatory assignment of income or was the sale of a capital asset. The debate revolved around the Supreme Court's decisions in *Hort v. Commissioner*[222] and *Blair v. Commissioner*.[223] In *Hort*, the taxpayer received a lump sum settlement for rent due in the future under a lease.[224] The Court held that the payment was not made for a capital asset but rather in exchange for future rent under the lease.[225] In *Blair*, the taxpayer assigned a portion of his income interest in a trust to his children.[226] The Court held that the assignment was effective under state law and effective for federal income tax purposes so that he was not taxable on the portion of trust income associated with the gift.[227]

The court resolved the capital asset issue in *McAllister v. Commissioner*,[228] which involved a trust created by a decedent in 1926.[229]

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[220] The Committee Report for the Omnibus Budget Reconciliation Act of 1989 provides that the remainder beneficiary's increase in basis is allowable only if it is otherwise deductible. *See* H.R. REP. NO. 101-386, at 626 (1989) (Conf. Rep.).

[221] In 2010, Professor Douglas Kahn of the University of Michigan published a thorough article that supports the conclusion that the sale interest in a trust is the sale of a capital asset. *See* Douglas A. Kahn, *Gain from the Sale of an Income Interest in a Trust*, 30 VA. TAX REV. 445 (2010).

[222] 313 U.S. 28 (1941).

[223] 300 U.S. 5 (1937).

[224] *See* 313 U.S. at 29.

[225] *See id.* at 32–33. Taxpayers who have won state lotteries have taken the position that after accepting periodic payments from the state lottery commission, a sale of the remaining payments are a sale of a capital asset. The courts have not been receptive to the argument. *See, e.g.*, Lattera v. Comm'r, 437 F.3d 399 (3d Cir. 2006).

[226] *See* 300 U.S. at 7.

[227] *See id.* at 13-14.

[228] 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947).

[229] *See id.*

By the time of the tax controversy in 1940, the trust benefitted the decedent's daughter-in-law for life, with his son as the remainder beneficiary.[230] To settle a controversy between the life tenant and the remainder beneficiary, the life tenant was paid $55,000 to release her interest in the trust and the trust was terminated and cancelled.[231] The life tenant then claimed a tax loss of almost $9,000, this being the difference between the amount she received and her share of the uniform basis.[232]

The court dealt with the issue of whether the "sale or release" of the taxpayer's interest in the trust was an assignment of income resulting in ordinary income treatment or the sale of a capital asset resulting in long-term capital gain or loss.[233] The court, relying on *Bell's Estate v Commissioner*[234] and *Blair v. Commissioner*,[235] concluded that the transfer of the life interest was a sale of a capital asset and permitted the loss because the taxpayer's basis (her share of the uniform basis) exceeded the amount realized.[236]

In the 1969 Tax Reform Act,[237] Congress reversed a portion of *McAllister*[238] with the adoption of section 1001(e),[239] which denies a recovery of basis when the income interest is sold apart from a sale of all trust interests to a third party, which means that the taxpayer in *McAllister* would have realized a capital gain instead of a capital loss.[240] Congress did not, however, change the basic *McAllister* characterization of an interest in trust as a capital asset. Thus, having reversed only one aspect of *McAllister* and having refrained from reversing the other, Congress appears implicitly to have accepted the capital gain treatment.

The Service adopted the capital asset conclusion in Revenue Ruling 72-243, which provides that the proceeds received by a life tenant of a trust in exchange for the life tenant's entire interest are treated as the "amount

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[230] *See id.*

[231] *See id.*

[232] *See id.*

[233] *See id.*

[234] 137 F.2d 454 (8th Cir. 1943).

[235] 300 U.S. 5 (1937).

[236] *See McAllister*, 157 F.2d at 237.

[237] Pub. L. No. 91-172, 83 Stat. 487.

[238] *See* 157 F.2d at 235.

[239] *See* I.R.C. § 1001(e).

[240] *See* 157 F.2d at 235.

[paid for] the sale or exchange of a capital asset under section 1222."[241] The Service has followed this position in a number of letter rulings over the years, as discussed in Section V.[242] The letter rulings expand the scope of the capital asset view to sales of some remainder interests, citing *Helvering v. Gambrill*.[243]

More recently in 2014, the Treasury Department and Service reaffirmed capital gain or loss treatment for the disposition of temporal interest in a trust. The Preamble to Proposed Treasury Regulation section 1.1014-5(c) provides:

> [I]n the case of a sale or other disposition that is part of a transaction in which all interests in the property (or trust) are transferred as described in section 1001(e)(3), the capital gain or loss of each seller of an interest is the excess of the amount realized from the sale of that interest over the seller's basis in that interest.[244]

Regular holding period rules apply to determine long-term or short-term capital gain or loss on the sale or exchange of an interest in a trust.[245] Nevertheless, when the interest is in an estate, rather than a trust, the holding period begins when the decedent dies and not when the trust is funded or assets are transferred from the estate.[246] Moreover, section 1223(9) deems testamentary gifts as long-term in determining holding period.[247]

The deduction of any loss that would be short-term or long-term capital loss is limited to the taxpayer's capital gains for the year, plus a maximum of $3,000, but is subject to a carryover to future years.[248]

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[241] Rev. Rul. 72-243, 1972-1 C.B. 233. However, section 1245 should not be overlooked when determining the character of the gain, to the extent of prior depreciation deductions, recapture rules would apply and override capital gain treatment. *See* Kahn, *supra* note 222; *see also* BROWN & HESCH, *supra* note 10, at 19-9.

[242] *See supra* note 78 and accompanying text.

[243] 313 U.S. 11 (1941).

[244] Prop. Treas. Reg. § 1.1014-5(c), 79 Fed. Reg. 3142, 3143 (Jan. 17, 2014). For the judicial weight given preambles to federal regulations, see Halo v. Yale Health Plan, 819 F.3d 42, 52–53, 55 (2d Cir. 2016).

[245] *See supra* notes 21–25 and accompanying text.

[246] *See supra* notes 34–41 and accompanying text.

[247] *See* I.R.C. § 1223(9).

[248] *See* I.R.C. §§ 1211, 1212.

Moreover, recognition of any loss on a deemed sale to a related taxpayer may be disallowed by section 267.[249]

A. Section 1239

Section 1239 denies capital gain treatment with respect to property that is depreciable in the hands of the buyer under sections 167, 168, or 169. Section 1239 does not seem applicable to most sales or commutations of a life or other term interest because it requires a sale to a control entity, such as a corporation or a partnership in which the seller owns, directly or indirectly, more than fifty percent after attribution rules are applied.[250] Section 1239 may also apply if the sale is to a trust in which the taxpayer or the taxpayer's spouse is a beneficiary.[251] Section 1239 may apply if the sale is between an estate and an estate beneficiary.[252]

B. Section 1041

Section 1041 states that "[no] gain or loss [is] recognized on a transfer of property from an individual to (or in trust for the benefit of) the individual's former spouse incident to their divorce or to the individual's spouse."[253] Rather, such a transfer of property is treated as a transfer by gift for income tax purposes and the transferee takes the transferor's adjusted basis.[254] Thus, section 1041 would cause no gain or loss to be recognized on a sale of a trust interest from one spouse to another or from one former spouse to another incident to their divorce.

C. Depreciation Recapture

Some portion of the gain may be ordinary income because of section 1245. Professor Kahn, in his 2010 article, *Gain from the Sale of an Income Interest in a Trust*, noted that some of the selling life interest's gain may be subject to depreciation recapture because of previous depreciation deduction that passed out of the trust to the life tenant under section 167(d).[255]

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[249] *See* I.R.C. § 267.

[250] *See* I.R.C. § 1239(b)(1).

[251] *See* I.R.C. § 1239(b)(2).

[252] *See* I.R.C. § 1239(b)(3).

[253] I.R.C. § 1041(a).

[254] *See* I.R.C. § 1041(b).

[255] *See* Kahn, *supra* note 222 (supporting the conclusion that the sale interest in a trust is the sale of a capital asset).

VIII. THE REMAINDER

A. Transfer of a Vested Remainder Interest at Remainder Owner's Death

No adjustment is made to the basis of property held in trust or property owned as a life or term interest with a remainder when a vested remainder beneficiary predeceases the life tenant.[256] Nevertheless, the basis of the remainder beneficiary's heir, legatee, or devisee of their inherited interest is adjusted for the difference between the value of the remainder interest included in the remainder beneficiary's estate and the basis of the remainder interest immediately prior to the remainder beneficiary's death.[257] This is similar to the difference between basis of assets owned by an S corporation and its shareholders' basis in their stock.

Although the basis of trust assets does not change by virtue of the death of a remainder beneficiary, the change in the basis of the remainder interest can be significant when the trust distributes assets to beneficiaries or terminates. The adjustment to the basis of assets held in a trust occurs when the assets are distributed to "the heir, legatee, or devisee upon termination of a trust (or legal life estate) or at any other time (unless included in the gross income of the legatee or devisee)."[258] It also might be significant if the remainder beneficiary disposes of his or her interest before the trust terminates.

The following example is based on an example in the regulations:

Example 11: One million dollars of securities, with a date of death basis of $1 million, are left to a testamentary trust for lifetime benefit of Spouse, forty-eight years of age, vested remainder to Child or Child's estate.

> The section 7520 rate on the date of death is 2.2%.
>
> Under the actuarial tables, Spouse's life estate is worth 48.042% of the value of the securities, or $480,420, based on the figures applicable on the date of death and is Spouse's share of the trust's uniform basis in the securities.

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[256] *See* Treas. Reg. § 1.1014-8(a)(1) (vesting the child in the remainder is sometimes done to avoid potential GST issues).

[257] *See id.*; *see also* Priv. Ltr. Rul. 6906060320A (June 6, 1969), correcting Priv. Ltr. Rul. 6803120320A (Mar. 12, 1968).

[258] Treas. Reg. § 1.1014-8(a)(2).

> Child's remainder interest is worth 51.958% of the value of the securities, or $519,580, which is also Child's share of the trust's uniform basis.

Twelve years later, Spouse is sixty years of age, the section 7520 rate has increased to 3.2%, and the trust assets are worth $3 million.[259] Child dies and is survived by Grandchild, the only beneficiary of Child's estate.[260]

The value of Child's remainder interest is then $1,597,590 and is included in Child's gross estate for federal estate tax purposes. Grandchild's basis in the remainder interest is adjusted because of the estate tax inclusion.

Before adjustment, Child's share of uniform basis is $532,530.[261] Added to that is a portion of the estate's basis in the remainder interest computed as follows:

> The value of the estate tax inclusion ($1,597,590) divided by the fair market value of the trust assets ($3 million) multiplied by the amount of the appreciation in the trust assets ($2 million), or .53253 multiplied by $2 million, or $1,065,060. This amount is added to the share of uniform basis when Child died ($532,530) for a total basis for Child's estate of 1,597,590.
>
> ($1,597,590/$3,000,000) x $2,000,000 = $1,065,060
>
> $532,530 + 1,065,060 = $1,597,590

The new basis for Child's estate does not change the basis of the assets held in the trust.[262] However, as time passes, Grandchild's basis will continue to increase by the amount Spouse's basis decreases. Five years

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[259] This example assumes that the same securities are still held in trust so that there has been no change in basis of the trust assets.

[260] Grandchild, as the only beneficiary of Child's estate, would inherit the vested remainder interest based on these facts.

[261] The value of a life estate of a sixty-year old person when the section 7520 rate is 3.2% is 46.747%. The value of a remainder following such a life estate is 53.253%. 0.53253 x $3,000,000 = $1,597,590. The value of the life estate is $1,402,410 [$3,000,000 - $1,597,590].

[262] *See* Treas. Reg. § 1.1014–8(a)(1) (vesting the child in the remainder is sometimes done to avoid potential GST issues).

later, the value of Spouse's share of uniform basis is $406,330[263] and Grandchild's share of uniform basis increases by $61,140 to $1,658,730 if the section 7520 rate is 3.2% and the value of the trust's assets are still $3 million.

If Spouse dies at the beginning of the next year, the balance of Spouse's share of uniform basis ($406,330) is added to Grandchild's basis ($1,658,730) for a total basis of $2,065,060, which becomes Grandchild's basis in the assets distributed from the trust.

Example 11 assumes that the trust's basis in its assets remained a constant $1 million. Therefore, Grandchild's basis in his or her inheritance is $1,065,060 in excess of the basis of the assets received from the trust on termination. For example, if the trust only owns publicly-traded common stock of one company, Grandchild's basis in the stock would be $2,065,060 ($1,000,000 + $1,065,000).

How that excess basis is allocated among multiple assets of a trust is not clear. If the trust owned a diversified portfolio, there is no authority stating how the excess basis would be apportioned. The most reasonable approach, however, seems to require that the extra basis be allocated based on the relative fair market values of the trust assets without regard to the trust's basis in individual assets at the time of distribution because that is what is being indirectly acquired.[264]

On the other hand, the fair market value of the trust assets could have decreased in value since the trust was created, that is, the basis of the trust assets is in excess of the fair market value. An example illustrates:

Example 12: One million dollars of securities, with a date of death basis of $1 million, are left to a testamentary trust for the lifetime benefit of Spouse, remainder to Child or Child's estate. The section 7520 rate on the date of death is 2.2%.

Under the actuarial tables, Spouse's life estate is worth 48.042% of the value of the securities, or $480,420, based on the figures applicable on the date of death and is Spouse's share of the trust's uniform basis in the securities.

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[263] Value of Spouse's uniform basis when Child died ($467,470) less value of Spouse's uniform basis five years later ($406,330), or $61,140.

[264] It might be argued that a proportional allocation based on relatively fair market values is correct, with no asset having a basis increase above fair market value, but there is no reason to limit the basis adjustment to fair market value. This is the result in a partnership liquidation under I.R.C. § 732(b), (c).

Child's remainder interest is worth 51.958% of the value of the securities, or $519,580, which also is Child's share of the trust's uniform basis.

Twelve years later, Spouse is sixty years of age, the section 7520 rate has increased to 3.2%, and the trust assets have decreased in value and are worth $900,000. [265] Child dies survived by Grandchild, the only beneficiary of Child's estate.[266]

The value of Child's remainder interest is then $479,277 and is included in Child's gross estate for federal estate tax purposes. Grandchild's basis in the remainder interest is adjusted because of the estate tax inclusion. Before adjustment, Child's basis is $532,530. Subtracted from that amount is a portion of the estate's basis in the remainder interest computed as follows:

> The value of the estate tax inclusion ($479,277) is divided by the fair market value of the trust assets ($900,000) multiplied by the amount of the depreciation in the trust assets ($100,000), or .53253 multiplied by $100,000, or $53,253. This amount is subtracted from the share of uniform basis when Child died ($532,530) for a new total basis for Child's estate of $479,277.
>
> ($479,277/$900,000) x $100,000 = $53,253
>
> $532,530 - $53,253 = $479,277

The new basis for Child's estate does not change the basis of the assets held in the trust. As time passes, however, Grandchild's basis will continue to increase by the amount Spouse's basis decreases. Thus, five years later, the value of Spouse's basis is $406,330, and Grandchild's basis increases by $61,140 to $540,517, if the section 7520 rate is 3.2%.

If Spouse dies at the beginning of the next year, Grandchild's basis is now the $479,277 (the inherited basis), plus the amount of the uniform basis that shifted over time since Child died from Spouse to Grandchild, or $406,330 for a total basis of $946,747, which becomes Grandchild's basis in the assets distributed from the trust.

This example provides Grandchild with a basis in excess of the fair market value of the assets received from the trust. Again, as with basis in

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[265] This example assumes that the same securities are still held in trust so that there has been no change in basis of the trust assets.

[266] Grandchild, as the only beneficiary of Child's estate, would inherit the vested remainder interest based on these facts.

excess of the basis of trust assets, how the reduction in basis of multiple assets received from the trust is allocated is not certain.

While one might question this result or the ability of Grandchild to make use of the loss, it is similar to the result if Child had not died so that, when Spouse died, the trust would have terminated in accordance with its own terms and Child would have received $900,000 of assets with a $1 million basis.

Even more problematic is what happens if the trust sold all its assets, paid any income taxes, and distributed cash in a commutation.

Example 13: Same basic facts as Example 12: One million dollars of securities, with a date of death basis of $1 million, are left to a testamentary trust for lifetime benefit of Spouse, remainder to Child or Child's estate. The section 7520 rate on the date of death is 2.2%. Twelve years later Spouse is sixty years of age, the section 7520 rate has increased to 3.2%, and the trust assets have decreased in value and are worth $900,000.[267] Child dies survived by Grandchild, the only beneficiary of Child's estate.[268] Grandchild has a basis of $479,277 (see Example 12).

If after Child dies, the trust assets are sold, and the trust would realize a $100,000 loss, which lowers the total uniform basis by $100,000 to $900,000. Thereafter, Spouse dies. Grandchild's basis then becomes all of the trust's basis ($900,000) reduced by the amount Grandchild's inherited basis was deceased when Child died ($53,253) for a net of $846,747. As a result, Grandchild will have a $53,253 gain when cash is received on the trust's termination. However, if the trust's $100,000 loss is recognized in the trust's final year, the $100,000 loss should pass out to Grandchild under section 642(h)(1). If the loss is not realized in the final year, but has not been fully used by the trust before the trust terminates, the unused capital loss will pass out to Grandchild under section 642(h)(1). So, in effect, a loss deduction is permitted.

B. Transfer of a Contingent (Non-Vested) Remainder

The question of basis is more complex if the remainder interest is contingent but does not fail on account of the remainder beneficiary's death because the value of such a contingent remainder interest will be included in the beneficiary's gross estate. For example, A creates a trust

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[267] This example assumes that the same securities are still held in trust so that there has been no change in basis of the trust assets.

[268] Grandchild, as the only beneficiary of Child's estate, would inherit the vested remainder interest based on these facts.

for B, and upon B's death the trust is payable to C, if then living, but if not, the trust is payable to D or D's estate.[269] If D dies at a time when both B and C are alive, D's remainder interest is not vested.

This situation is relatively common in documents creating a Grantor Retained Annuity Trust (GRAT).[270] This type of trust often provides that if the grantor dies before the GRAT term expires, at least a portion of the GRAT will terminate in favor of the grantor's spouse, if there is one. If there is no surviving spouse, the entire GRAT will be payable to the remainder beneficiary or the remainder beneficiary's estate. Based on these facts, if the remainder beneficiary dies before the Grantor and before the grantor's spouse, the remainder beneficiary is not vested in the remainder interest, but the remainder beneficiary's estate will vest in the remainder if the grantor survives the GRAT term or dies without a surviving spouse. In other words, the remainder beneficiary has a contingent remainder interest in a portion of the GRAT at his or her death.

Treasury Regulation section 1.1014-8(a)(1) discussed above does not apply in this situation because the remainder interest is not vested. Nevertheless, Treasury Regulation section 1.1014-8(a)(2) provides an equivalent basis adjustment for a contingent remainder interest. The language of Treasury Regulation section 1.1014-8(a)(2) is almost identical, and the basis adjustment is the same as that of Treasury Regulation section 1.1014-8(a)(1), except that section 1.1014-8(a)(2) applies only when "any property [is] distributed to the heir, legatee, or devisee upon termination of a trust (or legal life estate) or at any other time (unless included in the gross income of the legatee or devisee) . . . ."[271] Because Treasury Regulation section 1.1014-8(a)(1) is not applicable if

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[269] This structure for a trust might result because A does not want the trust assets to pass to C's issue and incur a generation-skipping transfer tax under section 2601.

[270] A GRAT is an irrevocable trust in which the grantor retains an annuity or unitrust interest for a stated term-of-years, after which the trust assets pass to, or in further trust for, one or more family members. The trust is created because the value of the gift of the remainder interest is determined by subtracting the value of the retained annuity or unitrust interest, thereby reducing the gift tax on the transfer. *See* I.R.C. § 2702(b); Treas. Reg. § 25.2702-3. For more information on GRATs and GRUTs generally, see Mitchell Gans, *GRIT's, GRAT's and GRUT's: Planning and Policy*, 11 VA. TAX REV. 761 (1992); William Scanlan, Jr., *Grantor Retained Income Trusts: Their Utility and Drafting Problems; Analysis and Use of GRITs, GRATs, and GRUTs*, 18 ACTEC NOTES 166 (1992); William Scanlan, Jr., *GRITs, GRATs & GRUTs: A Phoenix Rises from the Ashes of Section 2036(c)*, 27th U. MIAMI EST. PLAN. INST. ¶ 1401 (1993); Pamela Schneider, *Section 2702 or GRITS, GRATS, and GRUTS (What Does Your Client Want?)*, 26th U. MIAMI EST. PLAN. INST. ¶ 1201 (1992).

[271] Treas. Reg. § 1014-8(a)(2).

the interest is not vested, no adjustment to basis should be made until the trust terminates and trust assets are distributed to contingent beneficiary's heirs. Moreover, under Treasury Regulation section 1.1014-8(a)(2), the basis adjustment should occur only for the trust's assets that are distributed to "the heir, legatee, or devisee" of the deceased remainder beneficiary.[272] If the contingency occurs, so that neither the contingent beneficiary's estate nor its successor receive trust assets, the prior estate tax inclusion does change the basis of the assets distributed when the trust terminates.

The regulations do not state what, if anything, happens to the estate's basis in the remainder interest if it does not ultimately vest. The inclusion of the remainder interest in the deceased beneficiary's gross estate would seem to warrant a basis adjustment under section 1014, but none appears to be provided. The next taker in line appears to assume the remainder share of the uniform basis, without any adjustment for the estate tax inclusion in the contingent beneficiary's estate.[273]

Example 14: *A* transfers $1 million of securities, with an adjusted basis of $1 million, to a trust to pay income for life to *B*, sixty years of age. Upon *B*'s death, the trust assets will be distributed to *B*'s twin, *C*, if then living. If *C* does not survive *B*, when the trust terminates at *B*'s death, and its assets are paid to *D* or *D*'s estate. Ten years after year one, *D* dies survived by *B* and *C*, each of whom is now seventy years of age. The value of the trust assets has increased to $2 million and the section 7520 rate is now 3%.

The value of a vested remainder interest following a life estate of a seventy-year-old is $1,345,820. Because the remainder is contingent, the amount included in *D*'s estate is less than $1,345,820. The probability that *C* will survive *B* is 50% (*C* and *D* are twins), so the value of *D*'s contingent remainder interest is 50% of $1,345,820, or $672,910. This amount is included in *D*'s gross estate for federal estate tax purposes. The basis of *D*'s estate in the contingent remainder interest is not adjusted because of the inclusion of this interest in *D*'s gross estate. It remains the same because *D*'s interest was not vested and Treasury Regulation section

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[272] *Id.*

[273] One might think that the deceased contingent remainder beneficiary's estate (or its successors) should be entitled to a loss deduction, but neither the Code nor the Regulations appear to provide one. Obviously, if a loss were allowed, one would need to determine whether the death of the remainder beneficiary effected a sale or exchange, without which no capital loss can be produced. The estate has a basis in an asset that is a capital asset but without direct ownership of the underlying assets, and the nature of those assets might not matter.

1.1014-8(a)(1) does not apply. However, section 1.1014-8(a)(2) applies the basis adjustment if (and when) there is a distribution of property from the trust.

If *C* predeceases *B*, then upon *B*'s death,[274] the basis of *D*'s successors in the trust assets is now the uniform basis of the assets left in trust,[275] plus a portion of the basis attributable to the estate tax inclusion compute as follows:

> The value of the estate tax inclusion ($672,910) divided by the fair market value of the trust assets at the time of *D*'s death ($2 million) multiplied by the amount of the appreciation in the trust assets ($1 million), or .5 multiplied by $672,910, or $336,455. This amount is added to the uniform basis when *D*'s successors receive the assets from the trust, that is, $1 million (the trust's basis) plus $336,455, for a total basis of $1,336,455.
>
> ($672,910/$2,000,000) x $672,910 x .50 = $336,455.
>
> $1,000,000 + $336,455 = $1,336,455.

If *C* survives *B*, the value of the contingent interest owned by *D*'s estate becomes zero, although estate taxes were potentially paid on the value of that interest.

IX. PURCHASE OF TERM INTEREST BY THE REMAINDER BENEFICIARY WITHOUT TERMINATING THE TRUST

While not common, or even likely, it is possible that a term-interest holder could sell her or his trust interest to the remainder beneficiary, without the trust terminating before originally scheduled. In such a situation, the remainder beneficiary receives annual income distributions from the trust until the term-interest ends. In the case of a sale of a lifetime income interest, the remainder beneficiary would hold a life estate *per autre vie* continuing for the lifetime of the former life tenant.

When this happens, section 1001(e) does not permit the life beneficiary to offset the gain by any portion of the uniform basis.

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[274] Assuming there is no estate tax inclusion in *B*'s gross estate.

[275] All the uniform basis shifted to *D*'s successors when the trust terminated.

Moreover, section 167(e) applies because the parties are related,[276] and as a result, the remainder beneficiary who buys the life interest cannot amortize the purchase price. Amortization deductions not allowed may be added to the remainder beneficiary's basis and eventually recovered when the trust terminates.[277] If the entire interest in the trust is thereafter sold by the remainder beneficiary before the trust terminates, the full amount of the remainder beneficiary's uniform basis (both the income and remainder portions), plus the amount of the purchase cost of the life interest, may be recovered.[278]

Example 15: One million dollars of securities, with a $500,000 adjusted basis, are given to an *inter vivos* trust for the lifetime benefit of Spouse, remainder to Child or Child's estate. Spouse is sixty years of age when the gift is made. The section 7520 rate on the date of the gift is 3%.

> Under the actuarial tables, Spouse's life estate is worth 44.7950% of the value of the securities, or $447,950.
>
> Child's remainder interest is worth 55.205% of the value of the securities, or $552,050.
>
> Spouse's share of the uniform basis on the date of the gift is $223,975.[279]
>
> Child's share of the uniform basis on the date of the gift is $276,025.[280]
>
> Ten years later, when Spouse is seventy years of age and the section 7520 rate has increased to 4%, the securities have increased in value to $2 million.[281] The life interest is sold to Child for $804,720, its actuarial value.

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[276] The life tenant and the remainder beneficiary are one in the same. This is about as close a relationship as one can envision. The authors welcome, and even invite, suggestions for any possible closer relationships.

[277] This assumes that section 67 does not apply.

[278] There is no adjustment for amortization deductions because none are allowable.

[279] 44.7950% x $500,000.

[280] 55.205% x $500,000.

[281] Assumes that the same securities are still held in trust so that there has been no change in basis of the trust assets.

> Spouse's share of the uniform basis on the tenth anniversary of the gift is 40.236%, or $201,180. However, Spouse recognizes the full $804,720 gain on this sale, rather than a $603,540[282] gain, because basis is ignored for purposes of calculating Spouse's gain.
>
> Assuming that section 167(e)(3) applies but that section 67 does not apply, Child will have an additional $804,720 of basis in the trust's assets when the trust terminates (or when all interests in the trust are sold to a third party).[283]

Whether Child in the preceding example may add the amortization deduction to his or her basis depends on whether the amortization deduction is an above-the-line adjustment to gross income or a below-the-line itemized deduction. If the deduction is a below-the-line itemized deduction, Child cannot add the amount of the amortization deduction not allowed each year to his or her basis in the remainder interest in tax years 2017-2025 because the deduction would be a miscellaneous itemized deduction, which is disallowed during those tax years, and section 167(e)(3) applies only if the deduction is otherwise available.[284]

Giving the remainder beneficiary all the uniform basis plus the basis obtained by the purchase of the life interest might at first blush appear to allow the remainder beneficiary to stack basis unreasonably. This result, however, is exactly what section 167(e) permits, acknowledging that the buyer of a life interest has a basis in the purchased life interest independent of the uniform basis. The purchase of the life interest and any amortization deduction does not affect uniform basis. If the amortization is disallowed because the parties are related, then the disallowed deduction may be added to the remainder beneficiary's basis under section 167(e)(3), subject to section 67. The effect is to provide the remainder beneficiary more basis than just an actuarial share of uniform basis or all the uniform basis under

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[282] $804,720–$201,180.

[283] If section 167(e) does not apply, an annual amortization deduction of $47,500–$57,550 would be allowed, but of course Child is not permitted to amortize the cost of the life interest because of section 167(e): the parties are related. See *supra* Part VI.D. for a discussion of the amortization deduction and I.R.S. Tech. Adv. Memo. 83-29-005 (Mar. 25, 1983).

[284] *See* H.R. REP. NO. 101-386, at 626 (1989) (Conf. Rep.) ("[T]he conferees intend that the remainder-man's basis in the property is incorrect only if the term holder's amortization deduction would be allowed but for the provision.").

section 643(e) when the trust terminates. Having more basis than the beneficiary's share of uniform basis is permitted by Treasury Regulation section 1.1014-8(a) when a remainder beneficiary owns an interest in the trust that is included in his or her gross estate for federal estate tax purposes.[285] The total basis is independent of the basis in the remainder interest (because of an estate tax inclusion) or as in a purchase of a life interest.[286]

The examples in Treasury Regulation section 1.1014-8(a) only change the beneficiary's basis by the amount the estate tax value differs from the remainder beneficiary's share of uniform basis when the decedent dies.[287] But a full basis adjustment in the case of a purchased life or term interest appears correct. A full change to basis is appropriate because section 167(e) permits the buyer of a life interest to amortize the full amount of the amount paid for the life or term interest and not just the difference between the amount paid and the life or term interest's share of uniform basis in the trust's assets at the time of the sale.[288] This result is an anomaly permitted by the Code and Regulations as discussed above.

X. COMMUTATION OR TERMINATION OF A TRUST

As discussed above,[289] the Service's ruling position is that terminating a trust early by distributing to each beneficiary the actuarial fair market value of his or her interest (a commutation) constitutes a sale of the term interest to the remainder beneficiary. Under this analysis, the tax consequences should be the same in a commutation or when the remainder beneficiary buys the life beneficiary's interest directly, causing the trust to terminate. It should not matter whether the early termination is accomplished in one integrated transaction, such as a commutation, or by the remainder beneficiary buying the life interest and thereafter terminating the trust in a separate transaction. In either case, the trust interests are commuted, and the Service contends that the life tenant is not entitled to recover any basis because of section 1001(e)(1).[290] Section 1001(e)(3) does not, therefore, apply in these situations. The remainder

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[285] *See* Treas. Reg. § 1.1014-81 (a).

[286] *See id.*

[287] *See id.*

[288] *See* I.R.C. § 167.

[289] *See supra* Part V.

[290] *See id.*

beneficiary should, however, receive the life tenant's share of the uniform basis under section 643(e), plus the cost of the purchased life interest.[291]

Example 16: One million dollars of securities, with a $500,000 adjusted basis, are given to an *inter vivos* trust for the lifetime benefit of Spouse, remainder to Child or Child's estate. Spouse is sixty years of age when the gift is made. The section 7520 rate on the date of the gift is 3%.

> Under the actuarial tables, Spouse's life estate is worth 44.7950% of the value of the securities, or $447,950.
>
> Child's remainder interest is worth 55.205% of the value of the securities, or $552,050. Spouse's share of the uniform basis on the date of the gift is $223,975.[292]
>
> Child's share of the uniform basis on the date of the gift is $276,025.[293]
>
> Ten years later, when Spouse is seventy years of age and the section 7520 rate has increased to 4%, the securities have increased in value to $2 million.[294] The beneficiaries agree to a commutation of the trust with each receiving the value of his or her actuarial interest.
>
> Spouse receives $804,720 for his or her interest. Spouse recognizes the full $804,720 gain on the sale, rather than a $603,540 gain, because basis is ignored for purposes of calculating Spouse's gain. Child receives the balance of the trust assets, $1,195,280.

The Service's view of the transaction in Example 16 is that Child bought Spouse's interest in the trust and used some of the trust's assets to make the purchase. For this to occur, Child must be "deemed" to have simultaneously received the trust's assets at the time of the commutation and to have used some of those assets to make the purchase. However, the source of Child's funds to make the purchase should not matter. Child might use funds independent of the trust's assets to acquire the spouse's

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[291] *See* I.R.C. § 643(e).

[292] 44.7950% x $500,000.

[293] 55.205% x $500,000.

[294] Assuming that the same securities are still held in trust so that there has been no change in basis of the trust assets.

life interest, or even a note that may be satisfied later, in which event, there is no income tax consequence to Child in the commutation other than acquiring additional basis.

In Example 16, this should give Child a basis in assets received from the trust of $500,000 under section 643(e), as Spouse is not allowed any basis recovery in the sale. In addition, Child should have an addition to basis for purchase price of the life estate: in the example, the $804,720 paid for the life interest. The two amounts give Child a total basis of $1,304,720, which is less than the fair market value of the trust's assets. Then, Child will have gain on any appreciated assets used to buy the life interest. If in the example, the trust owns only publicly-traded stock of one corporation, it would take 40.236%[295] of the stock (fair market value of $804,720) with a basis of $524,967[296] to make the purchase with assets of the trust, producing a gain to Child of $279,753. In addition, Child might have additional gain if additional stock is sold to pay the income taxes on the $279,753 gain. However, Child might use other sources to make the purchase of Spouse's interest, in which event there is no income tax consequence to Child.

If the trust owns more than one asset, there is no express authority detailing how that extra basis should be allocated among the distributed assets. The trust beneficiary is receiving the trust assets, and it seems reasonable to allocate the extra basis among the various assets based on their relative fair market values, without regard to the trust's basis in the assets.[297] The basis allocation will be important if the lifetime beneficiary is bought out in a non-pro rata acquisition with assets that have less appreciation than other assets distributed to the remainder beneficiary from the trust.[298] Also, the allocation of basis might be significant if the beneficiary's total basis exceeds the fair market value of all trust assets

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[295] $804,720 / $2,000,000.

[296] 40.236% x $1,304,720.

[297] It might be argued that a proportional allocation based on relatively fair market values is correct, with no asset having a basis increase above fair market value, but there is no reason to limit the basis adjustment to fair market value. *See supra* Example 15. This is the result in a partnership liquidation under I.R.C. § 732(b), (c).

[298] The 2019 Private Letter Rulings all involved a pro-rata distribution of assets. *See supra* Part V. However, if it is assumed that the remainder beneficiary received all the assets and then purchased the lifetime beneficiary, there seems no reason why the remainder beneficiary could not pick and choose which assets to use in the purchase of the life interest. Therefore, any application of Rev. Rul. 69-486, 196-2 C.B. 159, seems misplaced.

received in the commutation,[299] but that is the same result when the trust terminates in normal course and the trust assets have a basis in excess of fair market value: the beneficiary is entitled to the higher basis.[300]

The tax effect of the commutation is to deny the life tenant any basis recovery and to transfer that basis to the remainder beneficiary. This means that the collective net tax cost is the same, assuming both taxpayers are in the same tax bracket, after considering the addition to basis for the purchased life estate. The remainder beneficiary gains additional basis by the amount of the purchase price so that there is a no net tax cost when a global perspective is taken.

Example 17: The same facts as in Example 16: Child picked up an additional $804,720 of basis in the commutation. With the commutation, Child has stock with a built-in gain of $695,280,[301] if it is assumed that the stock is later sold for $2 million. This gain, when added to Spouse's current gain of $804,720, combines for a total gain of $1,500,000.[302] To make an "apples-to-apples" comparison, assume that instead of buying the life interest, Child waited for Spouse to die. Child would then receive the stock with a $500,000 basis and a built-in gain of $1.5 million. So, if time value of money is ignored and tax rates for the Spouse and Child are the same, there is no cost to the commutation—just a question of who pays and when.

XI. OTHER CONSIDERATIONS AND CHOICES

Several disadvantages in terminating a trust early and voluntarily incurring income taxes exist, although there are advantages as well as alternatives that might be considered.

A. Disadvantages

The life tenant pays a current income tax, which could equal the present value of the future income taxes to be paid on the annual income, if the tax rate were the same. If instead, the trust continues, then the upfront taxes are not paid and the trust has the use of the money that will eventually pay income taxes to produce more income or growth that will be lost in part, but not in its entirety, to additional income taxes.

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[299] If the parties are related, section 267 would disallow recognition of the loss on the deemed sale. *See* I.R.C. § 267(a)(1).

[300] *See* I.R.C. § 643(e)(1).

[301] $2,000,000 – $1,304,720.

[302] $695,280 + $804,720 = $1,500,000.

If the trust assets are substantially appreciated and will ultimately be included in the life beneficiary's gross estate for federal estate tax purposes, then the future estate tax inclusion will provide a new, tax-free step up basis in many instances.[303] This is particularly appealing if, because of the available estate tax exemption and marital deduction, the life beneficiary's estate will not actually pay any federal estate taxes.[304] If the trust continues, the estate tax inclusion will increase the trust's basis in its assets and will increase the uniform basis of the various beneficiaries, and this negates capital gains taxes if the trust thereafter terminates.

B. Advantages

Any tax rate differential between the life tenant who sell or commutes his or her interest as compared to retaining the life income interest should not be overlooked.[305] The life tenant who sells his or her interest pays income taxes at favorable capital gains rates.[306] The income of the trust—whether taxed to the income beneficiary or to the trust—may be taxed at a higher rate unless all of the income is "qualified dividends"[307] taxed at capital gain rates or is tax-exempt income.[308] Interest income, rental income, and anything else that is not taxed at capital gains rates is potentially taxed at a much higher marginal income tax rate.[309] The federal income rate differential could be as much as 17%, plus whatever state income tax rate differential may exist.

If assets will not be included in the life beneficiary's estate and the life beneficiary will have a taxable estate, the early termination allows the life beneficiary to pay the income taxes on the appreciated trust assets, which reduces the life beneficiary's gross estate and provides the remainder beneficiary with more basis in the assets eventually distributed from the trust. Nevertheless, this scenario has the potential to increase the size of the life beneficiary's gross estate because the net assets received from the trust termination, after income taxes, are then owned outright and

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[303] *See* I.R.C. § 1014.

[304] The federal estate tax exemption equivalent is $11,580,000 in 2020. *See* Rev. Proc. 2019-44, 2019-47 I.R.B. 1093.

[305] *See* BROWN & HESCH, *supra* note 10, at 19-1, 19-5 to 19-10 (providing a mathematical analysis of the rate differential).

[306] *See* I.R.C. § 1(h)(1).

[307] *See* I.R.C. § 1(h)(11).

[308] *See* I.R.C. § 103.

[309] *See* I.R.C. § 1(a)-(d) (providing a maximum rate of 37% in 2020).

potentially included in the life beneficiary's gross estate.[310] This consequence should, however, be balanced by the fact that a continuing income interest, instead of a commutation, will added the annual net income received to the life beneficiary's gross estate. As a result, there may be no net gain in the value of the gross estate with a commutation, and the life beneficiary has gained access to principal to potentially make additional gifts.

Another consideration is the cost savings by the elimination of a trust. For example, the trust will no longer incur trustee fees, the cost of tax return preparation, or the additional costs incurred for a trustee to meet fiduciary duties such as accountings, periodic appraisals, and possible legal expenses for whatever reason. Balancing against this is the potential loss of investment expertise of a professional fiduciary and the loss of creditor protection of the assets from the beneficiaries' creditors or spousal claims.

XII. CONCLUSION

For estate and trust practitioners, temporal interests, whether in trust or otherwise, are a common, if not ubiquitous, aspect of their practice. Clients often choose trusts for their gifting vehicles, notwithstanding that gifts in trust and outright gifts can produce different income tax results, as Part II illustrates. Consequently, the concepts discussed above permeate the transactions that practitioners plan and the documents that they draft and administer. Oddly, the income tax aspects that arise when disposing of such interests, at least to the extent those aspects affect the interest holders, remain relatively obscure.

In some instances, the trust instrument creating a temporal interest will also supply sufficient paths for early termination and distribution of assets. In those cases, Subchapter J of the Code typically governs the transaction and generally provides that terminating the trust and distributing its assets be treated as nonrecognition events. However, one must look beyond the confines of Subchapter J when trust beneficiaries participate in the disposition without a settlor-provided power to do so. With beneficiary-involved dispositions, the focus must shift away from Subchapter J and towards the uniform basis and property disposition rules of section 1001 for the tax treatment.

The income tax issues related to disposition of temporal interests are not limited to the disposition of interests by the original beneficiaries.

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[310] *See* I.R.C. § 2033.

Additional issues include whether subsequent interest holders are entitled to additional basis, and if so, the methods that the Code and Regulations prescribe for establishing, maintaining, and potentially recovering basis. Moreover, post-mortem income tax issues can crop up involving basis adjustments for vested and contingent remainder interests that transfer during the administration of a trust.

The uniform basis rules have been around for one hundred years, but their scope, and even their operation, is not entirely clear and is based on limited authority. As a result, caution is in order when advising on premature disposition of trust interests. Nevertheless, the idea that any trust may be terminated tax free simply by distributing trust assets of equivalent value is at least problematic and likely incorrect.