Think Twice Before You End A Trust – Income Tax Consequences of Trust Commutations and "Early Terminations"

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Despite the Rule Against Perpetuities (which basically says a trust can't go on forever) being repealed in many states, most trusts, as a practical matter, don't go on forever. In an ideal scenario, the terms of the trust indicate when the trust is to end and who will receive the assets at that time. Often, that's exactly what happens; and, thankfully, the income tax treatment is favorable. The recipient takes the trust's basis in the property distributed, and the no capital gain or loss is recognized by either the trust or the recipient.[1],[2]

But sometimes the trust doesn't make it that far. Family feuds and litigation, changed circumstances, and changing tax laws all create situations in which a trust either should be ended, or must be ended. In most scenarios, there are two broad "classes" of beneficiaries of the trust who must be satisfied when a trust ends before its time – the income (or life) beneficiaries, and the remainder beneficiaries.

Income beneficiaries receive the trust's current income (i.e. money thrown off by the trust's assets, such as rent or dividends), and the remainder beneficiaries can expect the actual assets of the trust itself (the principal) when the trust is ended. When a trust ends early[3], there's a fundamental tension between these two classes. The remainder beneficiaries want all of the principal, but the income beneficiaries are expecting the income they were certain to receive had the trust continued. If the two classes can't agree on their own regarding a division of the trust that is ending, most state laws provide for what's known as a "commutation."

A commutation is, generally speaking, splitting the trust according to the relative values of the life (or income interest) in the trust property and the remainder interest in the trust property. Arkansas (and other states[4]) have methods to value the life (or income) interest, and the trust property can then be split among the income beneficiaries and the remainder beneficiaries according to the applicable method. This is all pretty straightforward at the state law level, but there's a big hiccup on the federal tax income side when this occurs.

Without going too deep into policy or history, it's always been a general rule of the income tax laws that property received by reason of a death or by gift is not subject to taxation, but for just as long, the rule has been that the *income* from that same property is fully taxable. This is so even if the taxpayer's right to the property will terminate within a set period of years or upon the taxpayer's death.

To protect this early policy choice, in 1969 Congress changed the law to where, upon the sale *or other disposition* of a life estate, estate for term of years, or *an income interest in a trust*, 100% of the proceeds received by the life tenant or income beneficiary is fully taxable as capital gain with no basis offset.[5]

Basically, this rule ensures that (just as would have been the case if the income beneficiary had received income) the proceeds from a disposition of the income interest that an income beneficiary receives will still be fully taxable. There are important exceptions from this general rule[6], as the primary abuse Congress took aim at was an income beneficiary selling his or her income interest to one or more remainder beneficiaries of the same trust.

But the IRS doesn't limit the application of this harsh rule to direct sales of the income interest from an income beneficiary to the remainder beneficiaries, it applies the rule to trust commutations and other types of early terminations as well. The IRS has a long-standing position that trust commutations are, in substance, a distribution of the entire trust interest to the remainder beneficiaries, who then "pay out" the income beneficiary for his or her income interest, which the IRS then characterizes as functionally equivalent to a sale of the income interest by the income beneficiary to the remainder beneficiaries.[7] The income beneficiary then has capital gain in the entire amount of the proceeds received when the trust is terminated – which is not a great tax result.

But even if a state law commutation method is not used to end the trust early, the IRS still applies this rule in certain other situations. The most common is when there is a distribution of all of the trust's assets that is not authorized under the trust's terms (such as when a trust is ending early) and such a distribution is not "pro-rata" among the trust's beneficiaries.[8] This would happen in a scenario where the various income and remainder beneficiaries agreed to take certain assets from the terminating trust, rather than dividing each asset on an actuarial basis. The IRS, in Rev. Rul. 69-486, deems this type of approach (unless authorized by the terms of the trust) to be a distribution of all assets pro-rata, followed by *exchanges* between the various beneficiaries. Once there's an *exchange* made by an income beneficiary, well, you get the picture…. Rev. Rul 69-486, despite its age, has been the basis for the IRS applying the tax result discussed in this blog post in several recent private letter rulings.[9]

The reason it is important to watch for this issue is that every trust has an income interest held by someone. If the trust is not terminating pursuant to its terms and the income beneficiary is receiving something at this early termination, there's a very good chance they could be in for a tax surprise, and not the good kind.

There are, as mentioned above, clear exceptions to the treatment I've described, and there are also various approaches to achieve the same functional result without triggering a walloping capital gain for the income beneficiary. But, this post about a somewhat arcane area of the income tax law is already long enough. Suffice it to say, when terminating a trust before its terms say the time has come, it is important to be aware of the potential income tax consequences.

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[1] I.R.C. (Internal Revenue Code) §643(e).

[2] There are exceptions. *Kenan* gain to the trust must be recognized. Also, it's possible to elect for the trust to recognize gain so the recipient of the property can take a stepped-up basis.

[3] And while the trust is in operation – ask any trust officer.

[4] E.g. VA. CODE ANN. §55.1-500, N.Y. Real Prop. Acts. Law § 403.

[5] I.R.C. §1001(e).

[6] *See* I.R.C. §1001(e)(3).

[7] *See, e.g.*, PLRs 2002-10-018, 2002-31-011, 2006-48-016, 2006-48-017.

[8] Rev. Rul. 69-486.

[9] *See, e.g.*, PLRs 2019-32-001 through 2019-32-010.