

General reasons for change.—The treatment described above had the effect of allowing a large part, and in some cases, almost all of the income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sold his interest. The life tenant was not taxed on the income to the extent of the basis which he was treated as having in the life estate when he sold it. In addition, the purchaser of the life estate was not taxed on most of the income because he was allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. In some cases the seller's basis even exceeded the amount he received upon its sale, and, as a result, he was permitted to take a deductible loss.

From JCS-16-70

Explanation of provision.—In general, the Act provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is taxable, rather than only the excess of the amount received over the seller's basis for his interest.

From JCS-16-70

Specifically, the Act provides that for purposes of determining the amount of gain or loss in such a case, any portion of a taxpayer's adjusted basis determined under the provisions dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust (secs. 1014 and 1015) is to be disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property. Thus, in the type of situations considered here, there is no basis to be offset against the proceeds received on a disposition of this type of interest; and, accordingly, the person disposing of the interest must treat the entire amount he receives from the disposition of his interest as a gain.

From JCS-16-70

The Act does not, however, change present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly. Thus, for example, where a life tenant and remainderman hold all of the interests in property which they simultaneously sell in a single transaction, the transaction is to be treated in the same manner as under existing law; that is, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his adjusted basis in the life estate. This exception appeared appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

From JCS-16-70

the "no rulings" list

Rev. Proc. 2008-3, 2008-1 I.R.B. 110

- sec. 4.01, "ordinarily" no advance rulings on whether commutation is treated as

- sale or disposition under sec. 1001(a),
or

- sale or exchange of capital asset under
sec. 1221(a)

Rev. Proc. 2015-3, 2015-1 I.R.B. 129

- both items moved to sec. 3.01, no advance
rulings, period

the "no rulings" list, cont'd

Rev. Proc. 2008-3, 2008-1 I.R.B. 110

- sec. 5.01, no advance rulings pending formal guidance on whether commutation disqualifies trust under section 664(d)

[moved to sec. 4.01 in Rev. Proc. 2010-3, 2010-1 C.B. 107]

[moved to sec. 3.01 in Rev. Proc. 2015-3, 2015-1 C.B. 129]

another shoe dropping

Notice 2008-99, 2008-47 I.R.B. 1194

- "transaction of interest"
- "coordinated" sale of income and remainder interests to *unrelated* third party, where appreciated assets contributed to the trust had been sold and proceeds reinvested

[emphasis supplied]

- exploiting exception at section 1001(e) (3)

Notice 2008-99, cont'd

- parties required to report per Reg. 1.6011-4
(b) (6) include

- "each recipient of the term interest"
- the trust itself
- the charity, unless it disposed of its interest on or before 10/31/08
 - "material advisor" paid more than \$5k

[but not the purchaser]

Notice 2008-99, cont'd

Conrad Teitell, writing for ACGA, commented:

- in event of either commutation or sale to third party, income bene's basis should be calculated with reference to "uniform" basis rules, adjusted by undistributed gains per Reg. Sec. 1.664-1

- formal guidance should allow qualified appraisal of net income interests

contingent, defeasible interests

PLR 8805024 (11/05/87)

- no deduction for partial surrender of spouse's contingent successive interest, because *defeasible* by settlor's exercise of reserved testamentary power to revoke

[in PLR 9550026 (09/18/95) and PLR 9721014 (02/19/97), spouse renounced]

contingent, defeasible interests, cont'd

note Rev. Rul. 79-243, 1979-2 C.B. 343

- reserved testamentary power to revoke
successive income interest renders transfer
incomplete for gift tax purposes

- could be used for successive interest in
spouse, regardless of section 2523 (g)

contingent, defeasible interests, cont'd

PLR 200802024 (09/14/07)

- settlor released reserved testamentary power, spouse joined in surrender to remainderman

- completed gift eligible for marital deduction per section 2523(g), despite fact her successive interest is contingent, and despite fact others might possess or enjoy a part of her interest if the contingency fails

contingent, defeasible interests, cont'd

note Rev. Rul. 79-295, 1979-2 C.B. 349

- individual transferred undivided half interest in trust remainder to charity [vested, but not in possession]

- deduction allowable under section 2522(c) (2), because

- transfer not made in further trust and
- transferor had no other interest in the property at or before the time of transfer

contingent, defeasible interests, cont'd

note Rev. Rul. 2008-41 re division of remainder trust in event of divorce

- "situation 2" supposes unitrust or annuity payout in equal shares, or all to survivor

- safe harbor supposes each spouse relinquishes survivorship right

[many PLRs involve scenarios outside this harbor]

contingent, defeasible interests, cont'd

PIR 200912036 (12/22/08)

- nonjudicial commutation
- five pct. NIMCRUT payable jointly to husband and wife, and after death of survivor in equal shares to two sons
 - no reserved testamentary power to revoke successive interests to sons
 - husband has shortened life expectancy
 - all three reconvey to wife
 - she agrees to disregard husband's life in calculating values

exchange for gift annuity

only one ruling on point

PLR 200152018 (09/26/01) , surrender of straight five pct. unitrust for gift annuity

- treated as bargain sale
- deduction for amount by which present value of unitrust interest exceeds present value of gift annuity
 - subject to 30 pct. deduction limit
 - undistributed realized gains not recognized

exchange for gift annuity, cont'd

- Long term gain in amount of present value of annuity over [zero] basis, recognized ratably over expected return multiple

- exception at section 1001(e)(3) not applicable "because the remainder beneficiary is not receiving the entire interest in [the trust] in a single transaction"

- but what if the settlor had reserved a power to redesignate [cf. Notice 2008-99]

32 the quick brown fox jumps

28 the quick brown fox jumps over the

24 the quick brown fox jumps over the lazy

22 the quick brown fox jumps over the lazy dog

putting some numbers to it

- effective July, 2011 the ACGA imposed an additional requirement that the present value of the residuum of a gift annuity be at least 20 pct.
- with the 7520 rate at 1.8 pct., an annuity at the recommended rate, paid quarterly at the end of the quarter, would not meet that requirement for an annuitant younger than 54
- the recommended rate for an annuitant aged 54 is 3.9 pct.

putting some numbers to it, cont'd

- with the 7520 rate at 1.8 pct., the present value of a five pct. straight unitrust, paid quarterly at the end of the quarter, for a benefited 54 is 69.359 pct.

- if the unitrust is holding \$1M, the nominal payout is \$50k, and the present value of the unitrust interest is \$693,590

- funded in that amount, a gift annuity paying 3.9 pct. would pay \$27,050

putting some numbers to it, cont'd

- of that amount, \$18,656 would be treated as long term gain and \$8,384 would be treated as ordinary income

- the expected return multiple is 29.5 years, after which the entire \$27,050 would be treated as ordinary income

- the transfer would generate a charitable deduction of \$142,952

state law issues

1. many of the surrender rulings rely on the common law doctrine of merger not having been abrogated
2. many of the judicial commutation rulings involve state law that requires the participation of the state attorney general
3. as adopted in some states, including Oregon, the Uniform Trust Code
 - at sec. 411(a), permits nonjudicial modification or termination of on consent of settlor and all benes, even if inconsistent with "material purpose" of trust

state law issues, cont'd

- at sec. 411(b) , permits judicial termination of a *noncharitable* irrevocable trust on consent of all beneficiaries, if continuation not necessary to achieve "material purpose "
- at sec. 411(c) , states that a spendthrift provision is not presumed to constitute "material purpose "
- at sec. 412(a) , permits judicial modification or termination of a *noncharitable* irrevocable trust if, because of unanticipated circumstances, to do so would "further the purposes of the trust"

Sections 410 through 417 provide a series of interrelated rules on when a trust may be terminated or modified other than by its express terms. The overall objective of these sections is to enhance flexibility consistent with the principle that preserving the settlor's intent is paramount. Termination or modification may be allowed upon beneficiary consent if the court concludes that the trust or a particular provision no longer serves a material purpose or if the settlor concurs; by the court in response to unanticipated circumstances or to remedy ineffective administrative terms; or by the court or trustee if the trust is of insufficient size to justify continued administration under its existing terms. Trusts may be reformed to correct a mistake of law or fact, or modified to achieve the settlor's tax objectives. Trusts may be combined or divided. Charitable trusts may be modified or terminated under cy pres to better achieve the settlor's charitable purposes.

**from prefatory note to
Uniform Trust Code (2010 rev.)**

Under the Uniform Trust Code, when a trust has both charitable and noncharitable beneficiaries only the charitable portion qualifies as a “charitable trust (paragraph (4)). The great majority of the Code’s provisions apply to both charitable and noncharitable trusts without distinction. The distinctions between the two types of trusts are found in the requirements relating to trust creation and modification. Pursuant to Sections 405 and 413, a charitable trust must have a charitable purpose and charitable trusts may be modified or terminated under the doctrine of cy pres. Also, Section 411 allows a noncharitable trust to in certain instances be terminated by its beneficiaries while charitable trusts do not have beneficiaries in the usual sense. To the extent of these distinctions, a split-interest trust is subject to two sets of provisions, one applicable to the charitable interests, the other the noncharitable.

**from comment to section 103,
Uniform Trust Code (2010 rev.)**

Under the express terms of Code § 55-544.12(A), the circuit court had authority to modify or terminate the trust only in "circumstances not anticipated by the settlor" and when such "modification or termination will further the purposes of the trust." The moving parties argue that the settlor could not have foreseen that the beneficiaries would "rather have [their] money today than wait" and that they would resort to expensive litigation among themselves. We do not agree. Unfortunately, an examination of the records of this Court and others having similar jurisdiction demonstrates that beneficiaries of wills and trusts have, for centuries, engaged in such litigation with depressing frequency. It may

**from Ladysmith Rescue Squad v. Newlin,
694 S.E.2d 604, 280 Va. 195 (06/10/10)**

The division of the trust was merely a device to accomplish the moving parties' desires without having to seek the approval of Ladysmith, the only party expressing a desire to defend the settlor's intent. Even that preliminary step "adversely affect[ed] achievement of the purposes of the trust" for the reasons stated above, and therefore contravened the provisions of Code § 55-544.17.

**from Ladysmith Rescue Squad v. Newlin,
694 S.E.2d 604, 280 Va. 195 (06/10/10)**

some rulings involving CRATs

- current income in excess of amount required to pay annuity
- principal in excess of amount required to fund annuity payout

some rulings involving CRATs, cont'd

PLR 9929033

- already paying excess income
- nonjudicial modification to permit distribution of principal

PLR 200010035

- judicial modification to require distribution of excess income and to permit distribution of principal

PLR 200052035

- judicial modification to permit distribution both of excess income and of principal

some rulings involving CRATs, cont'd

PLR 200617026

**- judicial modification to permit distributions
of principal**

PLR 200950032

- same parties, adding a second tier

some rulings involving CRATs, cont'd

PLR 200922013 through 200922027 (fifteen rulings)

- already paying excess income
- judicial termination as to excess over amount required to fund annuity payout
- remainderman to purchase commercial annuities payable to family groups

<https://www.charitableplanning.com/commentary/comments/1445830>

applying similar reasoning to CRUTs

Reg. 1.664-3 (a) (4)

- permits trust instrument to allow current distributions, apart from the unitrust payout, to exempt entity, provided that if the distribution is made in kind, adjusted basis of property distributed is "fairly representative" of adjusted basis of "property available" for distribution
- similar provision at Reg. 1.664-2 (a) (4) re annuity trusts

applying similar reasoning to CRUTS, cont'd

statutory defn. CRAT at section 664 (d) (1) and
statutory defn. CRUT at section 664 (d) (2)

both state minimum five pct. payout in terms of
distributions to one or more persons "at least one
of which is not" a section 170(c) org

thus, one could modify to cut the remainderman in
on a piece of the current payout

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