Early Termination of a Trust

Jeffrey H. Kahn
Florida State University College of Law

Douglas A. Kahn
University of Michigan Law School

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By Douglas A. Kahn and Jeffrey H. Kahn


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Douglas A. Kahn is the Paul G. Kauper Professor of Law at the University of Michigan, and Jeffrey H. Kahn is the Harry W. Walborsky Professor of Law at Florida State University.

In this article, Kahn and Kahn discuss the tax consequences of an early termination of a trust and explain how the trust's income and deductions in the year of its termination pass through to the beneficiaries and are allocated among them. The authors also identify strategies a trustee might use to minimize tax consequences of making liquidating distributions.

Introduction

Unless a settlor provides or implies otherwise, the beneficiaries of a trust can cause its termination if all of them agree to it.[1] In that event, the trustee could either sell the trust's assets and distribute the proceeds to the beneficiaries, distribute the trust's assets in kind to the beneficiaries, or some combination of those two dispositions. This article will focus on the tax consequences of an early termination of a trust with a life income beneficiary and a remainderman when the liquidating distributions are made in kind. All the trusts discussed herein are of that description. We exclusively use the tax provisions that apply to a complex trust (a trust is a complex trust in any year in which it makes at least one distribution that is not a distribution of income required to be distributed currently).[2] Complex trust provisions are used in this article because a trust will make actual distributions of corpus in the year it liquidates and will therefore be a complex trust in that year.[3]

When a distribution is made to a life income beneficiary in liquidation of her income interest, a question arises whether the beneficiary will recognize a gain or loss if the amount distributed differs from her basis in her income interest. If the liquidating distribution is made with property in kind, there is also a question whether the trust will recognize a gain or loss on distributing appreciated or depreciated property. If a loss is recognized by either the trust or the beneficiary, is that loss deductible? The same questions arise regarding the trust's distribution to the remaindermen in termination of their interest. Will the remaindermen recognize gain or loss? Will the trust recognize gain or loss? Will any recognized loss be deductible?

Although this article will focus on those questions, we will also briefly discuss how the income and deductions of the trust in the year of its termination pass through to the beneficiaries and how they are allocated among the beneficiaries.

Finally, we will discuss the strategies that a trustee might use to minimize tax consequences on making liquidating distributions.

Passthrough of Income

A trust is a conduit for some purposes and a separate entity for others. A trust files an income tax return and is subject to income taxation.[4] However, the income of the trust passes through to its beneficiaries to the extent that the income is distributed or required to be distributed to them.[5] The passthrough is achieved by giving the trust a deduction for the amount of income distributed or required to be distributed and by including in the distributee's gross income the amount of income that was distributed or required to be distributed.[6] This passthrough regime uses a concept called distributable net income (DNI). Neither the amount

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[1]Mark L. Ascher, Austin Wakeman Scott, and William Franklin Fratcher, 5 *Scott and Ascher on Trusts*, section 34.1 (2006).

[2]*See* reg. section 1.661(a)-1.

[3]Reg. section 1.651(a)-3.

[4]Section 641(a) and (b) and section 6012(b)(4). The trustee files the return for the trust.

[5]Sections 651 and 652 apply to simple trusts, and sections 661 and 662 apply to complex trusts and estates.

[6]*Id*.

of the trust's deduction nor the amount recognized as gross income by the beneficiary can exceed the trust's DNI.[7]

The DNI of a trust is its taxable income for the tax year with several modifications.[8] For example, the deduction allowed to the trust for making distributions is not taken into account, and net tax-exempt interest is added to its taxable income. An important modification involves capital gains and losses. If capital gains are added to corpus, they are excluded from DNI if they are not paid, credited, or required to be distributed to a beneficiary during the tax year.[9] Capital losses are included in DNI only to the extent that they are taken into account in determining the amount of capital gains included in DNI.[10] However, on the termination of a trust, most of its unused deductions, including its unused capital losses and loss carryovers, pass through to its beneficiaries.[11] Also, on the termination of a trust, all of the trust's capital gains will be included in DNI since they will be distributed to the beneficiaries.

Two-Tier System

The income of a complex trust is allocated by using two separate tiers of distributions. The first tier is an amount of income required to be distributed currently to beneficiaries.[12] This includes any amount that is required to be distributed out of either income or corpus to the extent that it is paid out of income.[13] If income is required to be distributed, it will be treated as a first tier distribution regardless of whether it is actually distributed, and the amount will be included in the Tier 1 beneficiary's gross income. The second tier includes all other amounts properly paid, credited, or required to be distributed that are not included in Tier 1.[14]

The DNI of the trust for a tax year is first allocated to the trust's Tier 1 distributions that were made or required to be made in that year. The remaining amount of DNI is allocated to the Tier 2 distributions made that year.[15] Consequently, the Tier 1 beneficiaries have all the available DNI allocated to them first, and only the remaining unused DNI (if any) is allocated to the Tier 2 beneficiaries. The character of the income allocated to a beneficiary is the same as the character in the hands of the trust.[16] For this purpose, the amount of each beneficiary's income consists of the same proportion of each class of items included in DNI that the total of each class bears to the total amount of DNI.[17] However, the terms of the governing trust instrument can allocate a specific class of income to a designated beneficiary.[18]

Distribution of Property in Kind

If a trust distributes an asset in kind to a beneficiary, the beneficiary's basis in the asset is equal to the basis that the trust had therein, plus or minus any gain or loss recognized by the trust on making the distribution.[19] Thus, when a trust recognizes a gain or loss on the distribution of an asset, the beneficiary's basis in the distributed asset is equal to its fair market value.

In applying DNI to Tier 2 distributions, the amount deemed to have been distributed to a Tier 2 beneficiary is the *lesser* of the beneficiary's basis in the distributed asset (as determined above) or the FMV of that asset.[20] However, as noted below, the trustee has an election to recognize gain or loss on the distribution of an asset, and, if that election is made, the amount distributed will be the FMV of the distributed asset.[21] If the election is made, it applies to all distributions of property in kind that are made during that tax year.[22] The election is not permitted for distributions described in section 663(a).[23]

A trust recognizes gain or loss on distributing property in kind to a beneficiary only in the following four circumstances, which are described in reg. section 1.661(a)-2(f). The distribution must be made in satisfaction of a right to receive:

1. a specific dollar amount;[24]

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[7]Sections 661(a) and 662(a).

[8]Section 643(a).

[9]Section 643(a)(3). Capital gains paid or set aside for a charitable purpose are added to DNI.

[10]*Id*.

[11]Section 642(h).

[12]Reg. section 1.662(a)-2.

[13]Reg. section 1.661(a)-2(b).

[14]Reg. section 1.661(a)-2(c).

[15]Reg. section 1.662(a)-1.

[16]Section 662(b).

[17]*Id*.

[18]*Id*.

[19]Section 643(e)(1).

[20]Section 643(e)(2).

[21]Section 643(e)(3). As to the determination of the amount distributed, this provision appears to be unnecessary because when gain or loss is recognized by a trust, the beneficiary's basis in the property will equal its FMV, and so the amount distributed will also equal the FMV of the property.

[22]*Id*.

[23]Section 643(e)(4). For example, the election is unavailable for distribution in satisfaction of a gift or bequest of a specific sum of money. Note, however, that such a distribution would cause the trust to recognize gain or loss because it is paid to satisfy a dollar amount of debt, and so no election is needed. Reg. section 1.661(a)-2(f).

[24]*See also* reg. section 1.1014-4(a)(3). This provision is an application of the *Kenan* rule that the satisfaction of a dollar obligation with property in kind causes the recognition of gain or loss. *See Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940).

2. specific property other than the property that was distributed;

3. trust income as determined for trust accounting purposes under the governing instrument and local law;[25] or

4. the trustee makes a valid election for the recognition of gain or loss under section 643(e)(3).

In all other circumstances, the trust does not recognize a gain or loss.

The regulation requiring the trust's recognition of gain or loss on distributing property in the four circumstances listed above (reg. section 1.661(a)-2(f)) states that ''gain or loss is realized by the trust or estate (or the other beneficiaries).'' In what circumstances would the other beneficiaries, rather than the trust, realize the gain or loss? It appears to us that the reference to ''other beneficiaries'' applies only when a trust that was required to distribute a specific asset to a beneficiary distributed a different asset instead. If the distributed asset was required to be distributed to another beneficiary or beneficiaries, those beneficiaries would recognize a gain for the appreciation of the substituted asset if no nonrecognition provision (such as section 1031) applied.

A beneficiary does not recognize gain or loss on receiving a distribution.[26] However, to the extent that DNI is allocated to the distribution, trust income will be passed through to the beneficiary. The beneficiary's basis in the distributed property is the same as the basis the trust had in it immediately before making the distribution, adjusted for any gain or loss recognized by the trust.[27]

What effect does a distribution to a life income beneficiary have on the beneficiary's basis in her income interest in the trust? A life income beneficiary's basis in her interest is a fraction of the trust's basis in its assets.[28] For this purpose, cash held by the trust is treated as basis. The life income beneficiary's fraction is determined by using tables provided by the regulations and by the IRS, which are based on actuarial calculations.[29] The fraction used to determine the basis of a life income beneficiary and of the remaindermen will change each year because the life income beneficiary's life expectancy will be less than it was the year before.[30]

A trust's distribution reduces the aggregate basis that the trust has in its assets because the distributed assets are no longer held by the trust. Since a life income beneficiary's (and a remainderman's) basis in her trust interest is a fraction of the trust's basis, a reduction of the trust's basis will also reduce the basis that the beneficiaries have in their trust interests.

Liquidating Distributions

When an item of property in kind is distributed in liquidation of a life income beneficiary's interest, does the trust recognize gain or loss? The regulations state that the trust will recognize gain or loss to the extent that property in kind is paid to the beneficiary in satisfaction of a requirement that the trust distribute that year's income to the beneficiary.[31] For trust accounting purposes, a trust's income typically will not include capital gains. However, the trustee can choose the trust properties that are distributed to the life income beneficiary in satisfaction of that beneficiary's right to receive an amount equal to the current income of the trust, and the trustee is not obliged to choose appreciated properties.

The total amount of the liquidating distribution made to the life income beneficiary will exceed the trust's current income since it will include an amount of property having a value that is equal to the present value of the remaining years of the life income beneficiary's interest. Will the trust recognize gain or loss on the distribution of that property as well? If the trust does recognize a loss on any of its distributions, that loss cannot be deducted because of section 267(a)(1) and (b)(6).

As noted previously, there are four circumstances in which a distribution of property in kind causes the trust to recognize income. The only three that might be applicable here are: (1) a distribution of the trust's income; (2) a distribution in satisfaction of a right to a specific dollar amount; and (3) an election by the trustee to recognize a gain or loss.[32] We will assume in this article that no election for

[25]*See also* reg. section 1.641(b)-1.

[26]Although the regulations discuss the allocation of DNI to distributions and the resulting passthrough of income, they do not say that the beneficiary recognizes any other income. That omission suggests that beneficiaries do not recognize any other income. Also, since the trust's basis in a distributed asset is transferred to the beneficiary (section 643(e)(1)), that strongly implies that no gain or loss is recognized by the beneficiary. Even if a beneficiary were permitted to recognize a loss, it would not be deductible because of section 267(a)(1) and (b)(6). Also, in the unlikely event that an income beneficiary would be held to recognize a gain on receiving a distribution in liquidation of her interest, it would be a capital gain. *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946); and Rev. Rul. 72-243, 1972-1 C.B. 233. *See* Douglas Kahn, ''Gain From the Sale of an Income Interest in a Trust,'' 30 *Va. Tax Rev*. 445 (2010).

[27]Section 643(e)(1).

[28]Reg. sections 1.1014-4(a)(1) and 1.1015-1(b).

[29]*See, e.g.*, reg. section 1.642(c)-6(e)(6).

[30]Reg. section 1.1015-1(b).

[31]Reg. sections 1.661(a)-2(f) and 1.651(a)-2(d).

[32]Reg. section 1.661(a)-2(f).

recognition is made. In our view, the first circumstance refers to currently earned income and does not apply to a distribution in satisfaction of the right to future income. However, there is no authoritative determination of that issue. In any event, it might be moot in light of the likely applicability of the second circumstance in which gain is recognized, as discussed below.

The value of the income beneficiary's interest is determined by applying a fraction (determined actuarially) to the value of the trust's assets. If the income beneficiary has a life income interest, the fraction will depend on her life expectancy. The application of that fraction to the trust's value will yield a dollar amount. Presumably, the amount distributed will equal (or approximately equal) that amount. The distribution can thus be seen as the satisfaction of the right to a dollar amount, which will cause the trust to recognize gain or loss on its distribution of appreciated or depreciated property. Because any gain recognized from the distribution to the life income beneficiary will have been distributed to that beneficiary, it will be included in DNI and passed through to the life income beneficiary who received it. The beneficiary's basis in an item of distributed property for which the trust recognized a gain or loss will equal its FMV, since the beneficiary will have the same basis that the trust had adjusted for any gain or loss it recognized.

If the trust recognizes a loss on the distribution of depreciated property, the loss is not deductible because of section 267(a)(1) and (b)(6). As noted above, the beneficiary's basis in the depreciated property will be its FMV. However, section 267(d) will provide the beneficiary nonrecognition of gain on a subsequent sale of the item, up to the amount of the trust's disallowed loss. So if the item later appreciates in the hands of the beneficiary, at least a portion of the realized gain will not be recognized.

As shown below, there is a ground for a contention that a trust does not recognize gain or loss on the distribution to a life income beneficiary in satisfaction of the present value of the right to future income, but will unlikely be accepted by the IRS and has little chance of prevailing in litigation.

The distribution of property in kind to remaindermen will not cause the trust to recognize gain or loss unless an election is made under section 643(e)(3). We will assume that no election is made. Any of a trust's DNI that is not allocated to a Tier 1 distribution will be allocated to the Tier 2 liquidating distributions made to the remaindermen and the life income beneficiary and cause a passthrough of trust income to them.[33] For example, if the trust had capital gain that was not distributed to the life income beneficiary, it would be included in the liquidating distributions made to the remaindermen and therefore be added to the trust's DNI and cause the remaindermen to recognize income. The remaindermen's basis in each item of distributed property will equal the basis that the trust had in it immediately before the distribution since, in the absence of an election, the trust will not recognize any gain or loss on making the distribution.

The remaindermen receive all of the trust's assets that remain after the distribution is made to the life income beneficiary. The dollar value of the remaindermen's interest can be determined by applying a fraction to the value of the trust. That fraction is complimentary to the fraction used to value the income interest. In one sense, then, the distribution to the remaindermen can be seen as made in satisfaction of a right to a dollar amount. Yet it is not so treated, and no gain or loss is recognized by the trust.

Consider a related situation: A trust is created in which A, B, and C are each to receive one-third of the trust's assets on its termination. When the trust terminates, the trustee chooses not to give each of the three beneficiaries a one-third interest in each asset the trust holds. Instead, the trustee distributes to A assets with a value equal to one-third of the trust's FMV, and the trustee makes similar distributions to B and C. That conceivably could have been viewed as the satisfaction of a right to a dollar amount, but it is not so treated. Alternatively, the transaction could be seen as an exchange of the distributee's right to one-third of the properties not distributed to her in exchange for two-thirds of the property that was distributed to her. Again, the transaction has not been so characterized and has not been treated as a taxable transaction.

Those last two examples suggest that even though a remainderman's right to a liquidating distribution can be expressed as the right to a dollar figure, it is not treated as a taxable exchange. Can the same be said for a liquidating distribution to a life income beneficiary? If so, the trust would recognize gain or loss only on the property distributed in satisfaction of the beneficiary's right to current income. To the contrary, as previously stated, it is far more likely that that contention would be rejected and the trust would be required to recognize a gain or loss.

[33]If a life income beneficiary receives a distribution in excess of her right to receive current trust income, the excess amount would be a Tier 2 distribution, and so the life income beneficiary can have both Tier 1 and Tier 2 distributions.

Strategy

In the event of a decision to terminate a trust before its expiration date, how should the trustee proceed in order to minimize tax consequences? Of course, nontax considerations may outweigh tax benefits and dictate a different plan of disposition.

First, consider the disposition of depreciated assets. If any such asset is distributed to a remainderman, the trust will not recognize a loss unless an election to recognize gain or loss has been made, and there is little benefit to making that election since section 267 prohibits a deduction for a loss recognized on a transaction between a trust and its beneficiary. However, the built-in loss is transferred to the remainderman, whose basis in the asset is the same as the one that the trust had. On the other hand, although the trust may recognize a loss on the distribution of a depreciated asset to a life income beneficiary, the loss cannot be deducted because of section 267.

Consequently, from a tax viewpoint, the optimum liquidating disposition of a depreciated asset is for the trustee either to sell it to an unrelated person and distribute the proceeds or to distribute the asset to a remainderman. If the trust sells the asset, it can recognize a loss on the sale. That loss will be passed through to its beneficiaries, who can deduct it.

If it is undesirable to sell a depreciated asset, it would not be optimum for tax minimization purposes to distribute it to the life income beneficiary as part of the satisfaction of that beneficiary's right to current income. In that case, although the trust will recognize a loss, the loss is not deductible because of section 267(a)(1). The beneficiary will have a basis in the asset equal to its FMV. The beneficiary will have the benefit of section 267(d) to insulate from recognition all or part of the gain realized from a subsequent appreciation of the item, but a greater benefit can be achieved by distributing the depreciated asset to the remaindermen.

If the item were distributed to a remainderman, while no loss would be recognized unless a section 643(e)(3) election is made,[34] the remainderman would have the same basis that the trust had in that asset. Any built-in loss in the asset would be passed over to the beneficiary. That is a more desirable result than the position a life income beneficiary would hold of having a lower basis with a potential insulation from gain for later appreciation. Consequently, distributing a depreciated asset to a remainderman provides a greater tax benefit than does a distribution to the life income beneficiary.

For appreciated assets, the trustee will typically wish to recognize as little gain as possible. If so, the trustee should endeavor to distribute to the remaindermen the items with the greatest amount of appreciation. No gain will be recognized on those distributions. The trustee should keep to a minimum the appreciation and depreciation distributed to life income beneficiaries. Thus, the optimum selection of properties to be distributed to life income beneficiaries is properties with as little appreciation or depreciation as is available. If any appreciated or depreciated property needs to be distributed to a life income beneficiary, it would be preferable not to distribute it in satisfaction of the beneficiary's right to current income since there is no question that the appreciation or depreciation will then be recognized as gain or loss. If, instead, that property is distributed in satisfaction of the right to future income, although the gain or loss will likely be recognized, there is a slim possibility that it will not. The trustee should designate which items are distributed in satisfaction of which of the beneficiary's rights. The trustee could first make a distribution of the trust's current income and later make a distribution in liquidation of that beneficiary's income interest. Even if the trustee's specific allocations were disregarded, and that seems unlikely, the parties' tax consequences would be no worse than they would have been otherwise.

Of course, tax reduction is not the only consideration in deciding how to allocate the trust's assets. For example, if the trustee were to distribute most or all of the appreciated assets to the remaindermen, they would bear the tax for all those items, albeit not until they disposed of them; and the life income beneficiary would bear little or none of the subsequent tax incurred because of that appreciation. The trustee might not wish to favor the life income beneficiary to such an extent, and that favoritism might contravene the trustee's fiduciary obligation to treat all the beneficiaries fairly.

Conclusion

The regulations state that a trust will recognize a gain on distributing appreciated property in satisfaction of the right to current trust income. That gain will pass through to the life income beneficiary, who will be taxed on it. The distribution of appreciated property in satisfaction of the right to future income will likely also cause the trust to recognize gain, but there is a slight chance that it will not. A beneficiary who receives property from the trust in

[34]If the trust has significant appreciation in some of its distributed assets, the trustee will likely not want to make the election because it would apply to all of the trust's distributed assets and therefore cause a significant amount of gain recognition. Even if the amount of appreciation were small, the tax benefit of transferring the trust's basis to the remainderman is more useful than recognizing a loss that is not deductible and allowing some insulation from recognition of gain to the beneficiary.

liquidation of her interest will not recognize a gain or loss on her terminated trust interest, but the trust's income and most deductions will pass through to the beneficiaries.

For tax purposes, it would be preferable either to sell depreciated assets or to distribute them to remaindermen. If selling is undesirable and depreciated assets thus need to be distributed, to the extent feasible, they should be distributed to a remainderman who will retain the built-in loss in the asset by virtue of taking the same basis in the asset that the trust had. Having a basis greater than FMV is more useful than having a lower basis with section 267(d) insulation from recognition of gain for appreciation that may take place in the hands of the beneficiary.

For appreciated property, the immediate recognition of gain can be held to a minimum if the trustee chooses assets with the largest amount of appreciation to distribute to the remaindermen. However, that selection discriminates against the remaindermen who thereby will ultimately bear the tax attributable to that appreciation since their basis is the same as the basis the trust had in those assets. Remaindermen will likely object to that allocation, and it might violate the trustee's obligation not to favor one beneficiary over another. Other nontax considerations should also be taken into account.