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## Trading on Interests in Trusts Holding Unrealized IRD

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Long-term capital gains and distributions from traditional individual retirement accounts exist in separate constellations of the tax universe. But if a trust is named as beneficiary of an IRA, after the IRA owner dies, trust beneficiaries might be able to realize long-term capital gains by selling an interest in the trust, assuming the selling beneficiary held the trust interest for more than one year. That result should follow even if the trust corpus is made entirely of a beneficial interest in an IRA. When the interest sold is a life estate or other term interest for life, the sale will eliminate the risk of an untimely end to the beneficiary's life, and therefore to further rights to trust payments. For the charitably inclined, involvement of a charity -- either as remainder beneficiary, buyer, or both -- can combine charitable giving with a high degree of tax efficiency.

The same holds true for any type of income in respect of a decedent (IRD) that will produce ordinary income to its recipient, if the IRD is payable to a trust instead of to

individuals. For purposes of this article, a traditional IRA having an income tax basis of zero will be used as a proxy for the more general case of IRD.

The basis for that result is Rev. Rul. 72-243, 1972-1 C.B. 233, which concludes that selling an income interest in a trust results in the sale or exchange of a capital asset. If the income interest is held for the requisite period, long-term capital gain is realized.

In a series of private letter rulings, which may not be cited as precedent, commutations of charitable remainder unitrusts have been treated as sales by the beneficiaries of their trust interests, and, based on Rev. Rul. 72-243, gains from those deemed sales were characterized as capital gains.

Examples will be used to explore the tax consequences of a sale of an interest in a trust. Following the examples will be a discussion of applicable tax law.

All references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise indicated.


**Example 1: Bargain Sale to Charity.**

Don Smith named the Smith Marital Trust as beneficiary of his IRA. Don died on March 15, 2002. When Don died, the IRA was worth \$500,000. The trust provides income to Sheila Smith, Don's surviving spouse, for life, payable at the end of each calendar quarter. On the death of Sheila, the remainder of the trust will go to the children of Don and Sheila. Sheila is the oldest beneficiary of the trust.

There is no spendthrift clause. Therefore, the beneficiaries may sell their respective interests in the trust.


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Under the terms of the trust, the annual total of distributions from the IRA to the trust will be either required minimum distributions or income, whichever is greater. Income of the trust is defined to include income earned inside the IRA. Sheila will be paid trust income only. The trust will add IRA distributions to the trust principal, to the extent that required minimum distributions from the IRA exceed income. The terms of the IRA and the regulations regarding required minimum distributions permit distributions to be made over the life expectancy of Sheila. The

IRA and the trust both qualify for an estate tax marital deduction, if the election is made under the so-called qualified terminable interest property rules of section 2056(b)(7), in accordance with Rev. Rul. 2000-2, 2000-3 IRB 305, *Doc 2000-793*, 2000 TNT 3-6 .

Don had no income tax basis in his IRA. Therefore, all of the IRA distributions to the trust will be taxed as ordinary income. To the extent the IRA distributions constitute trust accounting income, there will be distributions to Sheila. Therefore, the ordinary taxable income of the trust will be shifted to Sheila, to the extent of the income distributions to her.

Sheila and the children who are beneficiaries of the trust cooperate and agree to a bargain sale of all of their beneficial interests to a charity that is exempt from income tax. The charity is interested in the transaction because of the bargain sale element. The parties agree on a selling price of \$450,000. The basis of each beneficiary in his or her interest in the trust is zero, because that was the basis of property transferred to the trust.

Sheila's nearest age on the date of sale is 65. Rev. Rul. 2004- 102, 2004-45 IRB 784, *Doc 2004-20385 [PDF]*, 2004 TNT 202-10 , Table 5 provides that the discount rate for determining the actuarial value of a life estate under section 7520 for transactions occurring during November 2004 is 4.2 percent. Based on standard actuarial tables prescribed under section 7520, Sheila will receive and pay a capital

gains tax on \$213,696, and the children will receive and pay a capital gains tax on \$236,304.

The charity will succeed to all future taxable distributions from the IRA. But because the charity is exempt from income taxes, it will be able to use the full \$500,000 for its charitable purposes. In most cases, the purchasing charity should be able to empty out the IRA, thus recouping its investment of \$450,000 and realizing a net receipt of contribution of \$50,000.

Simplistically viewing the economic analysis of the family, here's how they come out, assuming an ordinary income tax rate of 35 percent and a capital gains tax rate of 15 percent. State and local income taxes have been ignored.

By selling her interest to charity in a bargain sale, Sheila realizes \$181,642, net of capital gains taxes. Also, Sheila may claim a charitable income tax deduction of the \$50,000 bargain element times the actuarial factor associated with her life estate. That results in a charitable income tax deduction of \$23,744 and tax savings of \$8,310, assuming the alternative minimum tax does not reduce or eliminate that benefit. Adding the tax savings to the after-tax sale proceeds, Sheila has received a total value of \$189,952.

Without the sale, the present value of Sheila's life estate in the IRA, net of income taxes, is \$154,336. By selling her income interest to charity in a bargain sale, Sheila is better off by \$35,616. Sheila also receives her

value now, rather than over whatever time period she happens to survive.

The sale by Sheila of her income interest in the trust will be treated as a taxable transfer by gift of the value of the remainder interest, under section 2519. If a gift tax is payable, the net value received by Sheila and the children will be reduced. Possibly the value of the rest of Sheila's taxable estate received by her children when she dies will also be reduced, because lifetime gifts always affect estate taxes. In any event, Sheila will be required to file a gift tax return and report the section 2519 gift. Note that if the remainder beneficiary of the trust had been a qualifying charity instead of the children, there would be no gift taxes payable because there would be a charitable gift tax deduction to offset the section 2519 gift.

Applying a similar analysis to the children, they are better off by \$39,384, and they receive the value of their interest now, rather than after Sheila dies.

The family as a whole is better off by \$75,000, not taking into account potential estate or gift tax effects. In reality, taking IRA distributions slowly over Sheila's life expectancy would have extended income tax deferral on IRA investments over Sheila's lifetime. That in turn would have increased the present value of IRA distributions. However, that increased value depends on investment performance within the IRA and after-tax investment performance outside the IRA. Sophisticated financial models can

provide a more refined portrayal of how a sale of trust interests compares with doing nothing and stretching out IRA distributions.

To imitate the effect of income tax deferral lost by selling all interests in the trust, other forms of sales could be considered, such as an installment sale, or a charitable gift annuity.

**Example 2: Charitable Remainder Unitrust.** The facts are identical to Example 1, except that Don Smith names the Donald and Sheila Smith Charitable Remainder Unitrust as beneficiary. The unitrust provides annual unitrust payments to Sheila Smith, Don's surviving spouse, for life.

The unitrust will pay the greatest fixed percentage, but not less than 5 percent nor more than 50 percent, of the net fair market value of its assets, valued annually, to Sheila for life, that will qualify under section 664(d)(1)(A), which requires that the actuarial value of the remainder interest be at least 10 percent. Thus, the payout percentage will be 20.5 percent, the present value of the remainder interest will be 10.027 percent of the value of the IRA, or \$50,135, and the present value of Sheila's unitrust interest will be \$449,865.

Note that the arrangement will qualify for the estate tax marital deduction, under section 2056(b)(8).

The trustee of the unitrust may withdraw the entire IRA and invest the proceeds without paying income taxes. Instead, unitrust distributions will be taxed to Sheila at ordinary income rates under section 644(b).

It is a mathematical feature of unitrusts that the present value of both the noncharitable term interest and the remainder interest are largely insensitive to the discount rate under section 7520. The discount rate [P. 213] affects the value based only on how frequently distributions are made within each year and when distributions are made relative to the annual valuation date. Because the unitrust distribution is determined each year based on a fixed percentage applied to values that change from year to year, the life and remainder beneficiaries share proportionately in the investment returns, for better or for worse. In the case of a unitrust that pays once annually at or near the valuation date of each year, varying the section 7520 rate will have no effect on actuarial values. Therefore, if the actuarial tables are to be believed, Sheila's present value is predictable, independent of future investment returns. It is very close to \$449,865. Assuming an individual ordinary income tax rate of 35 percent, Sheila's present value net of income taxes should be \$292,412.

If, after holding her unitrust interest, Sheila sells it to the charitable remainder beneficiary based on a valuation of \$500,000 of unitrust corpus, she will instead pay capital gains taxes of 15 percent, producing

a realized value net of income taxes of \$382,385. The sale represents an improvement of \$89,973.

The sale by Sheila of her lifetime interest in the unitrust will not be treated as a taxable gift of the value of the remainder interest, under section 2519, which applies only to QTIPs. Therefore, no gift tax will be payable.

As in Example 1, the above analysis turns out to be an oversimplification. Tax deferral on future unitrust payments might be worth something. Also, the present value factor of Sheila's life interest one year after formation will be less than 90 percent, because she will age a bit. At that time, one or more distributions will have been taken. Because of that, in real life, it would be prudent to produce a better model. However, Sheila will have realized the actuarial value without having to worry about how long she lives.

Sheila does not have to take all the sales proceeds at once. She can achieve income tax deferral on her capital gains taxes by taking from the buyer an installment sale or a charitable gift annuity.

As explained below, a commutation of the interests will produce the same results as a sale by Sheila to the charitable remainder beneficiary.

**Example 3: Sale Between Family Members.** The facts are identical to Example 1. On November 15, 2004, Sheila

sells her income interest to the remainder beneficiaries for the actuarial value of her life estate in the trust. At the time of the sale, the IRA is still worth \$500,000. Using standard actuarial tables prescribed under section 7520, the actuarial value of Sheila's interest in the trust is 0.47488 of the value of trust corpus. Accordingly, the selling price is \$237,440 (\$500,000 times 0.47488). Sheila's income tax basis in her life estate is zero, under section 1001(e). Sheila has a long-term capital gain of \$237,440.

Next, the trust distributes the right to receive future distributions from the IRA to the remainder beneficiaries, who have no income tax basis in the property they receive from the trust. The remainder beneficiaries must withdraw required minimum distributions over Sheila's lifetime and pay ordinary income tax on each distribution. However, it is possible that the beneficiaries of the remainder may amortize the purchase price of the income interest. The deduction is claimed ratably over Sheila's remaining life expectancy. The match from year to year between the amortization deduction and IRA distributions is bound to be imperfect. That is because the amortization deduction is a constant amount each year. Required minimum distributions, however, vary, and the variations can be dramatic.

In summary, Sheila will pay a capital gains tax on \$237,440. The children will pay ordinary income tax on \$500,000, less amortization deductions, if allowable. If the amortization deduction is not available, the family as a whole is worse off for having engaged in the transaction.

As discussed in Example 1, the sale by Sheila of her income interest in the trust will be treated as a taxable gift of the value of the remainder interest, under section 2519.

### **Rev. Rul. 72-243: Sale of an Income Interest**

The sale of a life estate by the life tenant in a testamentary trust was found to be a sale of a capital asset giving rise to recognition of a capital gain in *Estate of Beulah Eaton McAllister v. Commissioner*, 157 F.2d 235 (1946), *cert. denied* 330 U.S. 826 (1946). The IRS acquiesced in Rev. Rul. 72-243, adopting the general rule that selling an income interest results in the sale or exchange of a capital asset.

*McAllister* involved a life estate in a trust to which Beulah Eaton succeeded following the death of her husband. The trust contained a spendthrift provision. The estate of Beulah's late husband was illiquid. To terminate family litigation and provide liquidity for the estate, Beulah petitioned for and was granted termination of the trust by order of the New Jersey Court of Chancery. Under the order, the remainder beneficiary made a

payment to Beulah and her interests in the trust were extinguished.


In holding that a sale of a capital asset occurred, the Second Circuit relied on *Blair v. Commissioner*, 300 U.S. 5, 57 S.Ct. 330, 81 L.Ed. 465 (1937), 94 TNT 241-9 ☐, which held that an interest in a trust is a property right. The court distinguished *Hort v. Commissioner*, 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168 (1941), 94 TNT 241-70 ☐, which held that ordinary income resulted from the receipt of a lump sum payment in cancellation of a lease for a term of years because the consideration was held to be a substitute payment for the rent as it fell due.




In LTR 200027001, *Doc 2000-18421*, 2000 TNT 132-47 ☐, a surviving spouse sold her income interest in a trust to the remainder beneficiaries. A local court approved that, setting aside a spendthrift provision to do so. The IRS concluded that the gain was a capital gain, citing Rev. Rul. 72-243. Because the spouse had held the trust income interest for at least 12 months from the deceased spouse's date of death, the gain was a long-term capital gain.

### **Charitable Remainder Trusts**

If an income interest is a property right, the sale of which creates a capital gain, the same should be true of an annuity interest or a unitrust interest in a trust, including a charitable remainder trust.

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In LTR 200314021, *Doc 2003-8521* [PDF], 2003 TNT 66-27 , the life beneficiary and the remainder beneficiary of a charitable remainder unitrust under section 664 petitioned for and obtained a court order that terminated and divided the trust according to actuarial values. The life beneficiary was also the grantor of and donor to the trust. The IRS concluded that the life beneficiary was accorded capital gains treatment, citing Rev. Rul. 72-243. Also, under section 1001(e)(1), the portion of the adjusted uniform basis assigned to the individual's interest in the trust was disregarded.

See also LTRs 200127023, *Doc 2001-18443* [PDF], 2001 TNT 131-32 , 200324035, *Doc 2003-14405* [PDF], 2003 TNT 115-78 , and 200403051, *Doc 2004-1011* [PDF], 2004 TNT 12-79 . In each of those letter rulings involving the division of a charitable remainder unitrust, the life beneficiary was never treated as having received a unitrust distribution by reason of the sale. Nor were the beneficiaries treated as having received a share of assets to which they were entitled, which would have avoided treatment as a taxable sale or exchange. Instead, the life beneficiary was treated as having, in substance, sold the life interest in a sale or exchange subject to income taxation. Further, the composition of the assets held in trust was not a factor in determining the character of the gain.

The rulings also conclude that, because a sale of the trust interest occurred, section 664(b), regarding the character of distributions to

beneficiaries, will not operate to carry out to the noncharitable beneficiary any ordinary taxable income or capital gains previously realized inside the trust but not previously distributed. The entire amount received by the life beneficiary was concluded to be the amount realized in the sale of a capital asset.

The upshot of the letter rulings is that the result of a taxable sale, exchange, or commutation of a unitrust or annuity trust interest is the immediate imposition of income tax at capital gain rates, just as in the case of a life estate in a trust.

### **The Assignment of Income Doctrine**

The assignment of income doctrine is rooted in tax cases decided by the courts. Under the doctrine, a taxpayer cannot shift certain types of taxable income to some other taxpayer. Generally, a taxpayer who possesses the right to income that has been realized from property cannot somehow shift to some other person the burden of income tax on that income. Also, personal service income is taxable to the person who renders the services and cannot be shifted elsewhere. See, for example, *Blair v. Commissioner*, 300 U.S. 5 (1937) and *Lucas v. Earl*, 281 U.S. 111 (1930). (An exhaustive discussion of the assignment of income doctrine is beyond the scope of this article.)

In each of the examples above, a trust holds the right to receive IRA distributions. A sale of an interest in

a trust is not an assignment of IRA distributions that the trustee has a right to receive. However, an ineffective assignment or sale of an interest in a trust will leave the beneficiary seeking to make the assignment or sale in the same tax position as though the assignment or sale had not occurred. Therefore, trusts having spendthrift clauses should be approached with particular caution.

One situation in which the assignment of income doctrine might apply -- and that is by no means certain -- is in a so-called IRA conduit trust. That trust is required by its terms to make trust distributions to the trust beneficiary of all IRA distributions immediately on receipt by the trustee. Because an IRA conduit trust serves no purpose that differs materially from the purpose of an ordinary IRA beneficiary designation form, the trust beneficiary could be viewed as being in the same position as any IRA beneficiary entitled to all IRA distributions, rather than as a trust beneficiary. In that case, the IRS might seek to treat a sale of the trust beneficiary's interest in the trust in the same manner as a sale by an IRA beneficiary: Ordinary income would result from the sale. However, it might be that the existence of a trust cannot be ignored. If the trust is not a grantor trust, the beneficiary of the trust cannot be treated as the "owner" of the IRA.

### **Stub Income as of Date of Sale**

As a matter of right, and of good housekeeping, the trustee and the

parties to the sale should formally agree that the trust will distribute to the income beneficiary all trust income that the income beneficiary has a right to, determined through the date of the sale. In the case of a unitrust or annuity trust, the payout would be prorated.

### **Amortization Deduction**

Section 167 permits a deduction for wasting assets, whether tangible or intangible. The terms "depreciation" and "amortization," being similar in concept, may be used interchangeably. Typically, amortization is associated with intangible assets.

Reg. section 1.167(a)-(3) provides that amortization may be claimed only if the period of income production of the intangible asset acquired is ascertainable. Reg. section 1.014-5(c), examples 1, 3, and 4, recognized the availability of that deduction when a life estate is purchased.

The court found that a life estate in income-producing property is subject to depreciation deductions in *Elrick v. Commissioner*, 485 F.2d 1049, 1052 (D.C. Cir. 1973). The court stated:

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. *Gist v. United States*, 296 F.Supp. 526 (1969) aff'd 423 F.2d 1118 (9th Cir. 1970); *Commissioner 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 Daisy F. Christ*, 54 T.C. 493 (1970); *May T. Hrobon*, 41 T.C. 476, 503 (1964); *Elmer J. Keitel*, 15 B.T.A. 903 (1929); see also 4 J. Mertens *Law of Federal Income Taxation*, § 23.63a (1966 rev.).

If the property acquired has no ascertainable period over which to amortize, the deduction will be denied. Accordingly, the deduction may be denied if interests other than the income interest are acquired. That would apparently be the case when the value of the income interest is not acquired in a way that isolates it from other [\[P. 215\]](#) acquired interests. See *Henry W. Sohosky v. Commissioner*, 57 T.C. 403 (1971), *aff'd* 473 F.2d 810 (8th Cir. 1973).

Even if the income and remainder interests will merge after the purchaser acquires the income interest, resulting in the transfer of all interests in the property to the purchaser, the deduction may be claimed. The IRS so ruled in Rev. Rul. 62-132, 1962-2 C.B. 73, where it announced that it will permit the deduction to be claimed, following the decisions in *Commissioner v.*

*William N. Fry, Jr. et al.*, 283 F.2d 869 (6th Cir. 1960), and *Laird Bell v. Harrison et al.*, 212 F.2d 253 (7th Cir. 1954). In those cases, the IRS argued that, because the income and remainder interests had merged, the cost basis could be recouped only when the property was later sold by the acquirer.

Section 167(e) bars an amortization deduction for a term interest when the taxpayer is related to the holder of the remainder interest. That would, for example, defeat the amortization deduction when one sibling buys a life estate from the other sibling, who owned a fee simple interest in the property. The definition of a term interest found in section 1001(e) is incorporated by reference. The related person definitions of sections 267(b) and (e) are also incorporated by reference. That includes families and a lengthy list of entities (corporations, trusts, partnerships, and so forth), including passthrough rules. The family of an individual includes only brothers and sisters (whether by the whole or by half blood), spouse, ancestors, and lineal descendants. Note, for example, that aunts, uncles, cousins, nieces, and nephews are not included. To the extent that an amortization deduction is disallowed, the taxpayer must reduce basis; the holder of the remainder interest is permitted a corresponding increase in basis. Additional provisions of section 167(e) not related to this article are not discussed here.

In Example 3 above, the children hold the remainder interest and purchase their mother's income

interest. Does section 167(e) bar the amortization deduction? The income interest is not being acquired from the holder of the remainder interest. But to be barred, the acquirer need only be related to the holder of the remainder interest. The list of related persons does not include oneself, so perhaps the deduction is not barred.

There appears to be no clear guidance on whether the income tax deduction may be claimed in arriving at adjusted gross income or, in the alternative, must be claimed as an itemized deduction. That determination may rest on the nature of the income produced by the underlying property interest acquired.

### **Gift Tax and Section 2519**

An estate or gift tax marital deduction may be elected and claimed for a bequest or a gift of certain QTIP. One requirement to meet the definition of QTIP is that the spouse or surviving spouse must be granted the right to all income for life. If the marital deduction was elected for that property, section 2519 treats any disposition by the spouse or surviving spouse of any part of the income interest as a transfer for all purposes of chapter 11 (estate tax) and chapter 12 (gift tax) of all interests in the property, other than the qualifying income interest.

Neither section 2519 nor the regulations identify the transferee. If the transferee is a qualifying charity, a gift tax charitable deduction would be available. In Example 1 above,

the transferees before the sale are the children, who are the remainder beneficiaries of the trust. But the sale of all interests in the trust to a charity occurs at the same time in consequence of the same transaction. At the instant that Sheila disposes of her interest in the trust, the entire trust passes to charity. It is unclear whether the transferee for purposes of section 2519 is the charity. Because the children receive a portion of the economic value of the trust by participating in the sale, the IRS might construct an argument that some or all of the transfer under section 2519 is to the children. However, if the children, in an unrelated transaction, sell their interests before Sheila's sale, then, at the time of Sheila's sale, the remainder interest belongs to the charity and a gift tax charitable deduction should be available. So the fact that the children sell should not by itself determine whether a gift tax charitable deduction is available.

Section 2207A(b) provides a right to recover the gift tax imposed under section 2519. Because of that, it will be the children, not Sheila, who will bear the economic burden of the gift tax. That right of recovery can be waived voluntarily by Sheila.

### **Conclusion**

A sale of an interest in a trust can be subject to tax as a long-term capital gain rather than as ordinary income. The composition of trust assets has no bearing on that result. Even if the trust corpus consists of IRD, such as a traditional IRA, that sale could also be taxed as a long-term capital gain.

When a charity is the remainder beneficiary, that charity may be willing to buy out the interests of noncharitable beneficiaries. When a charity is not the remainder beneficiary, a charity might nevertheless be induced to purchase the interests of all parties in a bargain sale or in exchange for a charitable gift annuity or an installment sale. Use of an installment sale or a charitable gift annuity can provide income tax deferral to the seller.