Pulling the Plug on Perpetual Trusts

Legal and Tax Considerations for Early Termination of an Irrevocable Trust in Colorado

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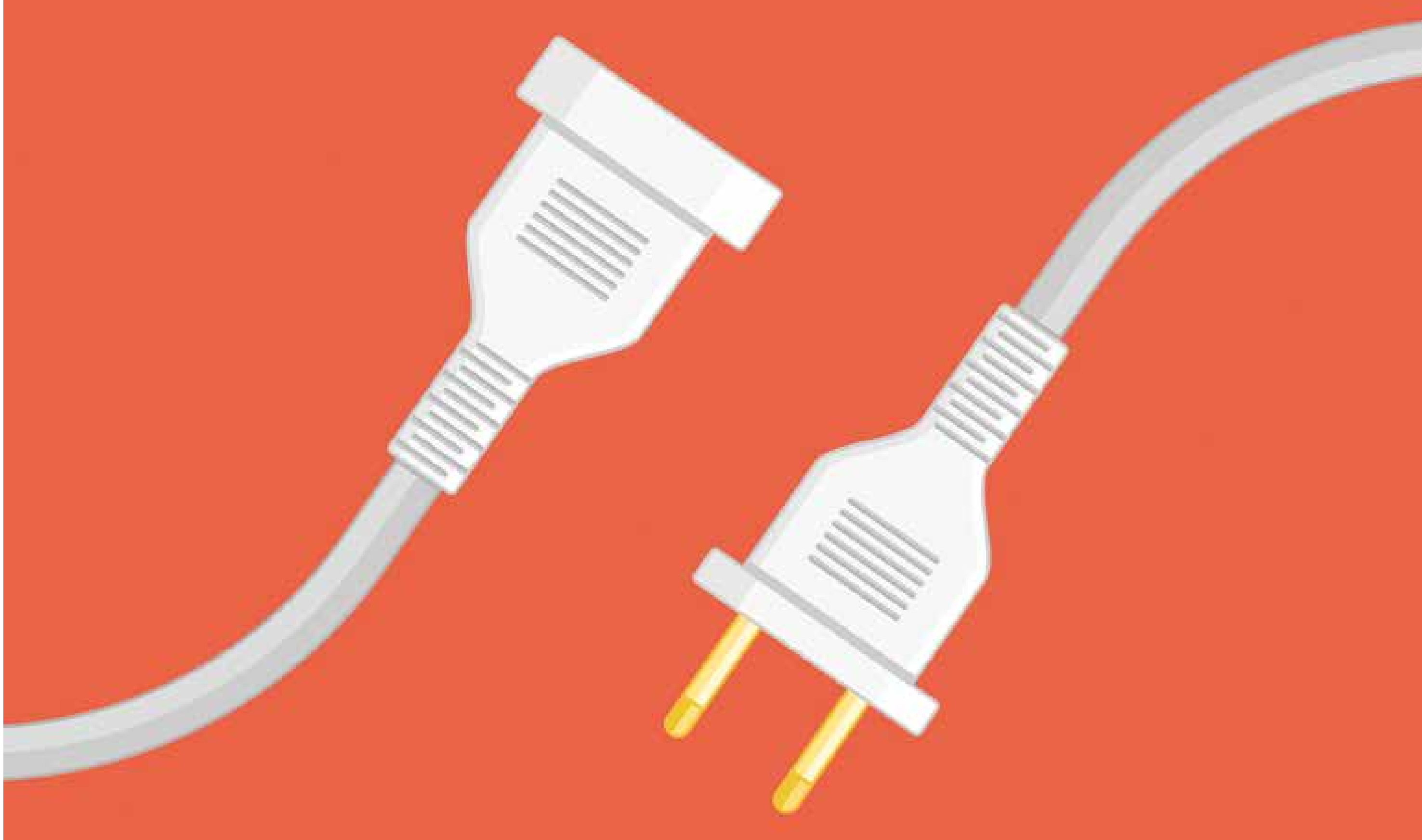

This article explains why multigenerational trusts are becoming more common and discusses legal and tax issues that clients could face when terminating a multigenerational trust.

Perpetual trusts allow wealth to grow and be distributed to beneficiaries for many generations while protecting assets from estate and gift taxes, creditors, and divorce settlements. Due to changes to the rule against perpetuities, along with tax and family law considerations, multigenerational trusts are becoming more common across a broader range of income levels. This article provides an overview of trust structure, highlights circumstances in which perpetual trusts may be particularly advantageous, and outlines common reasons clients may seek an early termination of a trust. It also examines the legal and tax implications of terminating an irrevocable trust.

Nature of Trusts: Split Interests

A trust is a division of legal and equitable title between a trustee, who holds legal title, and the beneficiaries, who hold equitable title.[1] There are many ways in which the rights of trust beneficiaries can be divided. A beneficial interest in a trust is classified as either a present interest or a future interest.[2]

A present income interest in a trust can be either mandatory or at the discretion of the trustee. It can be held by one or more income beneficiaries who are entitled to distributions based on trust income such as rents, royalties, dividends, and interest. An income interest is often measured by the lifespan of the income beneficiary, though sometimes it is measured as a term of years or by life events (e.g., a beneficiary attaining a certain age or level of education). A beneficiary of a present interest may be entitled to either mandatory or discretionary distributions of principal before the trust terminates.

A future interest in a trust may be held by one or more remainder beneficiaries. When the trust terminates, the remaining assets may be distributed to the remainder beneficiaries or transferred to a trustee to be held in another trust. In the case of multigenerational or perpetual trusts, trusts may hold beneficial interests for future generations indefinitely.

Longevity of Trusts

Since the 17th century, the common law rule against perpetuities (RAP) has limited the duration of property interests, particularly those held in a trust.[3] In the 1980s, however, American legal scholars began debating whether the RAP should be reformed to mitigate its sometimes harsh outcomes.[4] In 1986, the Uniform Law Commission responded by publishing the Uniform Statutory Rule Against Perpetuities (USRAP), which employed a 90-year "wait and see" approach to determine whether a (remote) contingency would occur and thus violate the RAP.[5] In 1991, Colorado adopted the Colorado Statutory Rule Against Perpetuities (CSRAP), modeled on USRAP.[6] After two amendments, the CSRAP now provides that, for trusts created after June 30, 2006, property interests are invalid unless they vest or terminate within 1,000 years of their creation.[7] Other states have repealed the RAP entirely.[8]

Rising Popularity of Multigenerational Trusts

Several legal and tax reforms have contributed to the popularity of multigenerational trusts in recent years. Three developments are particularly noteworthy.

First, Colorado's 1,000-year vesting period has effectively eliminated concerns about violating the RAP, making it possible to structure trusts in Colorado with a practically indefinite duration.

Second, the federal generation-skipping transfer (GST) tax exemption steadily increased from $3.5 million in 2009 to $13.9 million in 2025. Recent legislation permanently sets this exemption at $15 million per person ($30 million for a married couple), indexed for inflation beginning in 2026.[9] This tax exemption limits the amount a donor can transfer to grandchildren and more remote descendants without triggering gift or estate taxes. Taxpayers can allocate their federal GST tax exemption to multigenerational trusts, allowing the trusts to benefit multiple generations free of transfer taxes.

Third, statutory and case law unique to Colorado treats certain beneficial interests in trusts as either a property interest (e.g., a remainder interest upon termination) or an economic circumstance (e.g., a discretionary present interest in income and/or principal) for purposes of dividing the marital estate.[10] Settlors who want their trust to be considered an economic circumstance avoid creating remainder interests that vest outright; instead, they design their trust with discretionary distributions for the entire lifetime of the beneficiary. Frequently, the trust is drafted such that after the beneficiary's death, the trust is divided into equal shares for the beneficiary's descendants, and those descendants' trusts are further administered on the same terms as the older generation's trust.

Reasons for Early Termination

The aggregation of these various trust, tax, and family law considerations encourages the creation of long-term, multigenerational trusts that avoid termination and outright distributions. At the same time, it is not uncommon for beneficiaries—and in some cases trustees and settlors—to seek the termination of an irrevocable trust, even if the trust's terms do not expressly provide for it.

For example, before 2025, when the estate tax exemption was expected to decrease, many high-net-worth clients were advised to "use or lose" their estate tax exemption by making lifetime gifts to irrevocable trusts. But because the One Big Beautiful Bill Act instead extended the record-high lifetime exemption amounts,[11] these clients may be realizing they achieved less tax savings than anticipated. They may be feeling "giver's remorse" for the lifetime gifts they made to irrevocable trusts leading up to 2024.

Practical reasons why early termination and distribution of a trust might be sought include:

- **Litigation risk:** Litigation between beneficiaries and trustees (or co-trustees or co-beneficiaries) may result in a settlement agreement that terminates the trust.
- **Changed family circumstances:** Beneficiaries of GST-exempt dynasty trusts who do not have children may find that they do not need the GST-exempt operation of the trust.
- **Reduced need for divorce protection:** A trust intended to protect property from becoming divided in a divorce may benefit a beneficiary who is and probably will remain unmarried (or whose premarital agreement already causes trust appreciation to be treated as separate property).
- **Shifting tax considerations:** Tax reasons for continuing the trust may become moot or even disadvantageous due to changes in tax legislation, such as an increased federal gift and estate tax exemption.
- **Estate-planning constraints:** The trust may hinder lifetime or testamentary tax and estate planning goals.
- **Practical limitations:** It may be difficult or cumbersome to pledge a trust's sole asset as collateral.
- **Changed risk profile:** Changes in the beneficiary's circumstances, such as a diminished need for creditor protection, may make trust continuation less beneficial or desirable.

For these and other reasons, trust and estate attorneys may increasingly find themselves not only designing multigenerational trusts but also advising clients on how to terminate trusts before their stated terms. Practitioners must be prepared to address the legal and tax issues that arise when considering early trust termination.

Terminating an Irrevocable Trust: Legal Issues

Historically, under common law, a trust could be terminated by consent of the beneficiaries provided that no material purpose for the trust remains unfulfilled. This and other common law principles are now incorporated into Colorado statutes. Under statutory law, a trust may be terminated by consent or because of unanticipated circumstances that render the trust impracticable to administer.

Termination Under Common Law

The doctrine of merger provides that "when the right to the income from the estate and the right to the estate itself unite in the same person, the two merge and the estate is free of the trust."[12] Merger occurs when the trustee conveys the trust property's legal title to the beneficiary, who then has all the trust's beneficial interests.[13]

Early American common law tended to follow English common law, which liberally allowed a trust to be terminated early by unanimous consent of the beneficiaries.[14] But the seminal case *Claflin v. Claflin*, 20 N.E. 454 (Mass. 1889), introduced a new "material purpose" analysis that other American courts eventually followed.[15] Under the so-called *Claflin* rule, a trust may not be terminated by consent of the beneficiaries if continuation of the trust is necessary to achieve a "material purpose" of the trust.[16] The *Claflin* rule was incorporated into the *Restatement (Third) of Trusts*[17] and codified in the Colorado Uniform Trust Code (CUTC) (as well as prior Colorado statutory law).[18] The material purpose requirement is discussed in more detail below.

The common law doctrines of equitable deviation and cy pres permit a trustee of a charitable trust to deviate from a trust's express terms, including terms requiring the trustee to make a final distribution. These two doctrines are similar but distinct theories generally designed to remedy administrative problems in charitable trusts.[19] Both doctrines are concerned with fulfilling the intent of the settlor despite changed circumstances that render the settlor's (charitable) intent impossible or impracticable to achieve. Courts apply equitable deviation to make changes in the manner a charitable trust is carried out, whereas courts apply cy pres in situations where the trustee seeks to modify or redefine the settlor's specific charitable purpose.[20]

The application of the common law doctrine of equitable deviation has been extended in two significant respects under the CUTC. First, the doctrine now applies to both charitable and noncharitable trusts.[21] Second, equitable deviation can now be used to terminate or modify a trust, provided that the termination or modification will "further the purposes of the trust."[22]

Termination Under the Colorado Uniform Trust Code

The CUTC contains three statutory methods by which interested persons can terminate an irrevocable trust: (1) termination by consent of the beneficiaries;[23] (2) termination because of circumstances unanticipated by the settlor or inability to administer the trust effectively;[24] and (3) termination of an uneconomical trust (for trusts holding less than $100,000 of assets).[25] This article discusses the first two methods only, although it is worth noting that the third method is often allowed by the express terms of the trust agreement.

The first two methods for termination under the CUTC require court action. Accordingly, an early termination and distribution of a trust pursuant to a nonjudicial settlement agreement that is not approved by a court involves the risk that nonparties to the agreement (i.e., contingent, minor, or unborn beneficiaries) would later be able to challenge the agreement as to its impact on them. If such beneficiaries are the heirs or devisees of the signing parties, one option for protecting against this scenario is to include reciprocal indemnification provisions in the agreement. As discussed further below, when a trust is terminated by consent, these contingent, minor, or unborn beneficiaries must be adequately represented before a court may approve the trust's termination.

Termination by consent. The termination of an irrevocable trust by consent of the beneficiaries requires that all beneficiaries, not just the income beneficiaries, consent to the termination.[26] In cases where the settlor is still alive, if the settlor consents to the termination, "the court shall approve the . . . termination even if [it is] inconsistent with a material purpose of the trust."[27]

Because trusts are frequently held for the benefit of unborn, minor, or incompetent persons, many termination proceedings involve at least one beneficiary who is incapable of consenting on their own. In these situations, a representative may be allowed to act on behalf of the beneficiary, a process known as "virtual representation."[28] For instance, a parent might "virtually" represent their child with respect to the child's interest in a trust.[29]

However, under CRS § 15-5-303(1), consent given by a representative is invalid if there is a conflict of interest between the representative and the person represented. A conflict of interest could arise, for example, if a parent and their child have different types of beneficial interests in a trust. If the parent has an income interest only and the child has a remainder interest only, a conflict arises because distribution of income to the parent will be at the expense of accumulating the income for the remainder beneficiary. And conversely, accumulating income comes at the expense of distributing it to the income beneficiary.

Therefore, in some multigenerational trust termination proceedings, a court-appointed representative can and should be appointed to represent the trust's minor beneficiaries. Furthermore, in dynasty trusts, an additional representative may need to be appointed to represent unborn children and other unascertained beneficiaries. A court-appointed attorney or guardian ad litem might be used for these purposes.

Even if a beneficiary (or the beneficiary's representative) objects to the termination of the trust, the CUTC authorizes a court to approve the trust's termination if the court is satisfied that the nonconsenting beneficiaries' interests are adequately protected.[30] According to Uniform Trust Code (UTC) comments, a court can protect the interests of nonconsenting beneficiaries by:[31]

- ordering a partial continuation of the trust,
- ordering the purchase of an annuity, or
- ordering a valuation and cashing out of a specific interest in the trust.

In the case of a termination by consent, a court must conclude not only that all interests are adequately represented and protected, but also that continuation of the trust is not necessary to achieve a material purpose of the trust (unless the settlor consents to the termination).[32] To protect against appeal or other future challenges, the court's order terminating the trust should contain findings that these conditions are satisfied.

> "Historically, courts often found that a spendthrift provision constituted the trust's material purpose. This type of 'boilerplate' provision is so frequently drafted into trusts that the comments to the UTC note that 'spendthrift provisions are often added to instruments with little thought.'"

Whether terminating under the CUTC or common law, the *Restatement (Third) of Trusts* § 65, comment d, still applies in Colorado and offers useful guidance on interpreting material purposes:

> Material purposes are not to be readily inferred. A finding of a such a purpose generally requires some showing of a particular concern or objective on the part of the settlor, such as concern with regard to the beneficiary's management skills, judgment, or level of maturity. Thus, a court may look for some circumstantial or other evidence indicating that the trust arrangement represented to the settlor more than a method of allocating the benefits of property among multiple beneficiaries, or a means of offering to the beneficiaries (but not imposing on them) a particular advantage. Sometimes, of course, the very nature or design of a trust suggests its protective nature or some other material purpose.

Historically, courts often found that a spendthrift provision constituted the trust's material purpose.[33] This type of "boilerplate" provision is so frequently drafted into trusts that the comments to the UTC note that "spendthrift provisions are often added to instruments with little thought."[34] Perhaps for this reason, the UTC and the CUTC both provide that the operation of a spendthrift provision is not presumed to be a material purpose of the trust.[35] The absence of this presumption permits a court, based on the facts and circumstances, to determine whether a particular trust's material purpose includes a spendthrift provision.

Courts frequently deny termination when they determine that a trust's material purpose is to:[36]

- delay ownership until a beneficiary's attained age or education level,
- give a trustee unlimited discretion to make distributions,
- preserve trust property for successive generations,
- periodically pay a sum certain, or
- periodically pay a fixed fraction of trust income.

For example, trusts may provide for gradual mandatory distributions of principal to younger adult beneficiaries upon attaining certain ages or other circumstances, such as completing specific stages of education. Additionally, annuity trusts and unitrusts by definition provide for distributions of a sum certain or a fixed fraction of trust assets. Trusts that are designed to qualify for the marital deduction generally must have mandatory distributions of income.[37] The presence of one or more of these provisions creates a risk that a court will find that a material purpose remains unfulfilled. Overcoming this hurdle may ultimately depend on whether the particular court disfavors long-term, unpractical or unnecessary, or expensive trust administrations.

Under the CUTC, when a trust is terminated by consent of the beneficiaries, the trustee must distribute the trust property as the beneficiaries agree. The beneficiaries must be cautious, however, because if the trust's final distribution is not in accordance with the actuarial value of the beneficiaries' interests, the final distribution may give rise to unintended gift tax consequences.[38]

Termination because of unanticipated circumstances or inability to administer trust effectively. CRS § 15-5-412 provides another basis for the termination of an irrevocable trust. Under that section, the termination "must further the purposes of the trust" because of a circumstance not anticipated by the settlor.

The seemingly inconsistent act of terminating a trust to further its purposes requires an analysis of the trust's purpose. As with termination by consent, the *Claflin* rule applies to termination due to unforeseen circumstances or inability to administer trust effectively. For example, a settlor may have created an irrevocable trust for the purpose of estate tax savings. If estate tax savings are no longer a concern because the irrevocable trust assets are includable in the settlor's taxable estate, termination of the trust and distribution to the settlor will permit a stepped-up basis for income tax purposes.[39] Another example might be terminating a trust embroiled in litigation. And as the birth rate in the United States declines to historic lows, a trust designed to continue for multiple generations may have beneficiaries without children and whom the settlor wants to benefit by an early termination and distribution.[40]

When terminating a trust because of changed circumstances, the comments to the UTC state that although circumstances must exist that justify the trust's termination, the circumstances need not arise after the trust's creation. In other words, the circumstances may exist at the time the trust was created, so long as they were unanticipated by the settlor. Upon termination of a trust because of unanticipated circumstances, the trust must be distributed in a manner consistent with the purposes of the trust. This stands in contrast to termination by consent, which permits the trust property to be distributed based solely on the agreement of the beneficiaries.

Terminating an Irrevocable Trust: Tax Issues

When analyzing the tax consequences of a trust's termination, advisers should consider income, estate, gift, and generation-skipping transfer taxes.

Income Taxes

When a trust terminates by its terms, the remainder (residuary) beneficiary receives a final distribution from the trust that includes all of the trust's principal and accrued income. The remainder beneficiary reports trust income in the year of distribution as the same character of income earned by the trust. Upon termination of the trust and distribution to the remainder beneficiary, excess income, deductions, and other tax items of the trust are passed through to the remainder beneficiary on a K-1 filed with the trust's final fiduciary income tax return Form 1041. The principal distribution to a remainder beneficiary pursuant to the terms of the trust is generally not taxable to the recipient, and the remainder beneficiary takes the trust's basis in the assets distributed. If a distribution is in-kind, the trustee can elect to treat the distribution as a sale of trust assets under § 653(e)(3).

However, when an irrevocable trust terminates and is distributed other than pursuant to the terms of the trust, the IRS has a history of issuing private letter rulings that treat these trust terminations as taxable transactions in which the income beneficiary is deemed to have sold their income interest to the remainder beneficiary.[41] Under these circumstances, the basis attributable to the income interest is deemed to be zero, resulting in the income beneficiary recognizing capital gain on the full amount of the distribution.[42]

Sale or other disposition. On the surface, there seems little logic to different tax treatment for a final distribution pursuant to the trust's stated terms compared to a premature final distribution as a result of court order based on beneficiary consent or an inability to administer the trust effectively, or due to a nonjudicial settlement agreement. This tax disparity is particularly puzzling in a case where the trustee makes the final distribution in-kind as opposed to in cash. In an in-kind distribution, the income beneficiary will receive property but no cash to pay the tax that results from the deemed sale. What would the tax consequences be if the income beneficiary actually sold the property to pay the tax resulting from the deemed sale? Would income tax be triggered on both the deemed sale and the actual sale?

Some commentators have suggested that *Cottage Savings v. Commissioner* supports treating trust commutations as a taxable transaction. In that case, the US Supreme Court held that a taxable exchange occurs when a taxpayer receives property interests that differ in kind or extent from the property interests relinquished in the transaction.[43] It could be argued that an income beneficiary holds only equitable title prior to the trust's distribution, whereas after the trust's distribution, the income beneficiary holds both equitable and legal title, and that these two property interests differ in kind or extent, resulting in a taxable transaction. But if the merger of legal and equitable title results in a taxable transaction, all trust distributions would be treated as taxable transactions, not just those resulting from an early termination.

Another explanation for taxing trust distributions differently may be this: when a trust terminates pursuant to its terms, the income beneficiary does not receive any distribution because that beneficial interest in the trust has expired due to the income beneficiary's death, the lapse of a term of years, or some other triggering event. When the income beneficiary's interest expires, only the remainder beneficiaries receive the trust's final distribution. But in an early termination pursuant to the beneficiaries' agreement, court order, or unanticipated circumstances, the income beneficiary receives a portion of the trust equal to the income beneficiary's actuarial value of their interest. Since the income beneficiary would have owed tax on the trust's distributions of distributable net income (DNI) if the trust had continued, the early termination effectively accelerates the

DNI that the income beneficiary would have received over time had the trust terminated pursuant to its terms.

IRC § 1015(b)—uniform basis. Just as a taxpayer can have a tax basis in property owned outright, a beneficiary of a trust can have a tax basis in their beneficial interest in the trust.[44] A beneficiary's basis in the trust is determined by the uniform basis rules prescribed under the Treasury Regulations.[45] The uniform basis rules allocate the trust corpus's basis and fair market value between the income beneficiary and remainder beneficiary based on the actuarial values of their respective interests. The actuarial values of the income interest and remainder interest adjust over time to reflect the decreasing value of the income interest as the income beneficiary's life expectancy decreases. Correspondingly, the value of the remainder interest increases as the amount of time before distribution decreases.

When a trust is terminated before the time designated by its terms, a determination must be made of the actuarial values of the remainder interest and income interest. At that point in time, all trust property is divided between the life tenant and remainder beneficiaries in amounts that reflect the fair market values of each beneficiary's respective interest. The terminating distribution may be made in cash or in-kind unless the trust agreement specifies otherwise.

In Revenue Ruling 72-243, the IRS ruled that in an actual sale of an income beneficiary's entire life estate to the remainder beneficiary, the transaction is treated as a taxable exchange under IRC § 1222. Revenue Ruling 72-243 further concluded that the income beneficiary's basis in the life estate is disregarded pursuant to IRC § 1001(e), resulting in the income beneficiary recognizing the entire amount realized as taxable income.

IRC § 1001(e). IRC § 1001(e) generally provides that when a term interest in property is sold or disposed, the portion of adjusted basis that is determined pursuant to § 1015 is disregarded. IRC § 1015 governs the determination of tax basis in property transferred to a trust. For purposes of § 1001(e), a term interest in property includes an income interest in a trust, a life interest in property, and an interest in property for a term of years.[46] There is an exception to the no-basis rule if the life tenant and remainder beneficiary sell or dispose of all of the trust's interests to a third party.[47] However, third parties will rarely be involved in a trust commutation.

Gift Taxes

An income beneficiary may be willing to structure the termination so that all trust property is distributed to the remainder beneficiaries, thus avoiding the income beneficiary's receipt of any taxable income. However, if the beneficiaries' interests are not distributed in accordance with their actuarial values, the distributions are considered gifts. Such gifts may be subject to gift or estate tax consequences, depending on the actuarial values of the beneficiaries' interests.

In *McDougall v. Commissioner*, the remainder beneficiaries of a QTIP trust entered into a nonjudicial settlement agreement with the sole income beneficiary under which the entire QTIP trust was vested outright and free of trust in the income beneficiary.[48] The US Tax Court held that as a result, the remainder beneficiaries made taxable gifts to the income beneficiary. The tax court held:

> Before the implementation of the Nonjudicial Agreement, [the remainder beneficiaries] held valuable rights, i.e., the remainder interests in the QTIP. After the implementation of that agreement, which required their consent, [the remainder beneficiaries] had given up those valuable rights by agreeing that all of the [trust] assets would be transferred to [the income beneficiary]. And they received nothing in return.[49]

Interestingly, under the terms of the *McDougall* trust, the income beneficiary held a testamentary general power of appointment, which the tax court observed could be exercised to substantially reduce one of the remainder beneficiary's interests in the trust.[50] Because the remainder interests were subject to divestment, the tax court declined to address the value of the remainder interests and therefore the amount of the deemed gift has not been decided as of the writing of this article.[51]

Estate Taxes

When terminating an irrevocable trust, the beneficiaries' receipt of outright ownership of the trust property will cause it to be includable in the beneficiary's taxable estate.[52] If the trust was includable in the beneficiary's estate before the termination (for example, because the beneficiary had a general power of appointment), the termination of the trust will not make a difference for estate tax purposes. But if the trust was not includable in the beneficiary's estate before the termination, the beneficiary should be advised that terminating the trust will cause the trust principal to be included in their taxable estate. With current exemption levels, this issue will likely affect only a small fraction of cases. But unpredictable policy changes with respect to estate tax exemption amounts make it difficult to know whether current exemption levels will apply to a particular client, especially younger clients.

Generation-Skipping Transfer Taxes

Multigenerational trusts, by their nature, involve GST tax. Generally, the termination and final distribution of a trust to a skip person will trigger GST taxes as either a taxable termination or a taxable distribution unless the trust is exempt.[53] To determine whether a trust is exempt, the trust's prior Forms 709 and 706 tax returns should be carefully reviewed by experienced counsel.

When property is transferred to a trust either as an inter vivos gift or a testamentary bequest, the transfer should be reported on IRS Form 709 (gift and GST tax return) or IRS Form 706 (estate and GST tax return), respectively. Part 2 of Schedule D on Form 709, and Schedule R on Form 706, each prescribe a box for reporting a trust's inclusion ratio. An inclusion ratio of 0 means that the trust is fully exempt from GST tax and therefore any distributions from the trust to a skip person are exempt from GST tax. However, if the inclusion ratio is greater than 0 (even if it is .0001), then distributions to a skip person from the trust—including distributions arising from trust's termination—will generally trigger GST tax.

> "If the trust's terms permit discretionary distributions of principal, consider winding down the trust through a series of discretionary distributions of principal to income and/or remainder beneficiaries."

If a trust is proposed to be terminated and the trust has an inclusion ratio greater than 0, advisers should consider a qualified severance of the trust prior to or as part of the termination of the trust.[54] The qualified severance will create two trusts from the original one trust. One of the two new trusts will have an inclusion ratio of 0, meaning that the trust is totally exempt for GST tax purposes and may make distributions to a skip person free of GST tax. The second new trust will have an inclusion ratio of 1, meaning that it is totally nonexempt for GST tax purposes and should be distributed to any non-skip beneficiary who is receiving the final distribution.

Despite this apparent simplicity, it may be very difficult to determine a trust's inclusion ratio simply by looking at prior tax returns. This is because prior tax returns will report the inclusion ratio only if GST tax exemption is affirmatively allocated by a knowledgeable tax return preparer. In a bid to assist taxpayers, Congress passed automatic allocation rules that *deem* GST tax exemption to be allocated to certain transfers so that the transfers do not trigger GST tax, regardless of whether the tax returns actually report the allocation of GST tax exemption.[55]

Unfortunately, the automatic allocation rules in concert with historically high GST tax exemption amounts have created an environment where tax return preparers can (and do) rely entirely on the automatic allocation rules assuming all transfers will be exempt from GST tax. Although this may work in the vast majority of cases, the result is that many Form 709 and Form 706 tax returns will not expressly state a trust's inclusion ratio. If there is uncertainty, experienced tax counsel should analyze the trust in question to determine whether GST tax could be assessed on the trust's termination and distribution to a skip person.

Potential planning opportunity. If the trust's terms permit discretionary distributions of principal, consider winding down the trust through a series of discretionary distributions of principal to income and/or remainder beneficiaries. This method of "termination over time" may avoid some of the income, gift, and GST tax traps that accompany a single termination event.

Charitable Remainder Trusts

The IRS has a long history of heavily scrutinizing the commutation of charitable remainder trusts and treating them as taxable transactions. This scrutiny culminated in Notice 2008-99, in which the IRS described the commutation of a charitable remainder trust as a "transaction of interest." The transaction in Notice 2008-99 involved a grantor who funded a charitable remainder trust with appreciated assets while retaining a noncharitable annuity or unitrust interest. The trustee sold the appreciated assets and reinvested the proceeds in a diversified portfolio. The grantor and charity then sold their trust interests to an unrelated third party for fair market value. The grantor claimed the following tax consequences: (1) an income tax deduction for the value of the CRT's remainder interest; (2) no recognized gain on the CRT's sale of appreciated assets; and (3) because the zero basis rule under IRC § 1001(e) does not apply to a sale of all trust interests to a third party, the amount realized on the grantor's sale of retained interest was sheltered by a substantial share of the grantor's uniform basis. The IRS stated in Notice 2008-99:

> The IRS and Treasury Department are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale of 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 Code § 1001(e) to avoid tax on gain from the sale of appreciated assets.

Conclusion

As the longevity of trusts increases, the termination of trusts earlier than provided under their express terms is likely to become a more frequent occurrence. When terminating a trust early, adequate representation of all interested persons, especially minor or unborn beneficiaries, is necessary. In addition, the material purpose test must be satisfied unless the settlor also consents to the trust's termination. Beneficiaries should be advised of all tax consequences, including income, estate, gift, and generation-skipping transfer taxes. Various tax elections can affect the trust's final distribution, including the election under § 643(e)(3) to treat an in-kind trust distribution as a sale of the trust's assets, thereby providing an income beneficiary with a greater tax basis in the distributed property, as well as GST tax exemption allocations and qualified severances.

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NOTES

1. Gary et al., *Contemporary Trusts and Estates* 190 (2d ed. Aspen Publishing 2014).
2. *Id.*
3. Haskins, "Extending the Grasp of the Dead Hand: Reflections on the Origins of the Rule Against Perpetuities," 126 *Pa. L. Rev.*, 19 (1977).
4. *See Restatement (Second) of Property* (Donative Transfers) § 1.3 (American Law Institute 1983).
5. Uniform Statutory Rule Against Perpetuities (Unif. L. Comm'n 1986/1990).
6. CRS § 15-11-1102.5(2).
7. *Id.*
8. Alaska Stat. § 34.27.050; Del. Code Ann. tit. 25, § 503; Idaho Code § 55-111; S.D. Codified Laws § 43-5-8; Wis. Stat. § 700.16(5).
9. IRC § 2631(c); IRC § 2010(c).
10. *In re Marriage of Balanson*, 25 P.3d 28, 41 (Colo. 2001).
11. IRC § 2010(c)(3).
12. *In re Nicholson's Est.*, 93 P.2d 880 (Colo. 1939).
13. *Denv. Found. v. Wells Fargo Bank, N.A.*, 140 P.3d 78, 86 (Colo.App. 2005) (citing *Restatement (Third) of Trusts* § 69).
14. *See generally* Fogel, "Terminating or Modifying Irrevocable Trusts by Consent of the Beneficiaries—A Proposal to Respect the Primacy of the Settlor's Intent," 50(3) *Real Prop., Tr. & Est. L.*, 338, 340 (Winter 2016).
15. *Id.*
16. *See, e.g.*, *In re Nicholson's Est.*, 93 P.2d 880 (Colo. 1939).
17. *Restatement (Third) of Trusts* § 65 (American Law Institute 2003).
18. CRS § 15-5-411.
19. *Niemann v. Vaughn Cmty. Church*, 113 P.3d 463 (Wash. 2005).
20. *Id.*
21. *See* UTC § 412 cmt. ("Just as a charitable trust may be modified if its particular charitable purpose becomes impracticable or wasteful, so can the administrative terms of any trust, charitable or noncharitable.").
22. CRS § 15-5-412(1).
23. CRS § 15-5-411.
24. CRS § 15-5-412.
25. CRS § 15-5-414(1) (providing for termination of a trust without a court order only if the trust holds less than $100,000 and the trustee determines that the value of trust property is insufficient to justify the costs of administration).
26. CRS § 15-5-411(1), (2)(a).
27. CRS § 15-5-411(1).
28. UTC Article 3 cmt.
29. CRS § 15-5-303(1)(f).
30. CRS § 15-5-411(5).
31. UTC § 411 cmt.
32. CRS § 15-5-411(2)(a).
33. Fogel, *supra* note 14 at 358.
34. UTC § 411 cmt.
35. CRS § 15-5-411(3).
36. Fogel, *supra* note 14 at 358.
37. IRC § 2056(a)(5), (7).
38. UTC § 411 cmt ("No gift tax consequences result from a termination as long as the beneficiaries agree to distribute the trust property in accordance with the value of their proportionate interests.").
39. IRC § 1014.
40. Minkin et al., "The Experiences of U.S. Adults Who Don't Have Children," Pew Research Center (July 25, 2024), https://www.pewresearch.org/social-trends/2024/07/25/the-experiences-of-u-s-adults-who-dont-have-children.
41. *See, e.g.*, IRS Priv. Ltr. Rul. 2019-32001 (Aug. 9, 2019).
42. *See, e.g.*, *id.*; Rev. Rul. 72-243.
43. *Cottage Savs. Ass'n v. Comm'r*, 499 U.S. 554 (1991).
44. Treas. Reg. § 1.1015-1(b).
45. Treas. Reg. § 1.1014-5.
46. IRC § 1001(e)(2).
47. IRC § 1001(e)(3).
48. *McDougall v. Comm'r*, 163 T.C. 5 (2024).
49. *Id.* at 68.
50. *Id.* at 70.
51. *Id.* at n.10.
52. IRC § 2033.
53. *See generally* IRC § 2612(a), (b).
54. IRC § 2642(a)(3).
55. IRC § 2632(c).