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I. INTRODUCTION

The 2017 Tax Act changed both income and estate tax rules, further expanding the range of cases in which taxpayers, particularly those residing in states with high income taxes and modest or no estate taxes, may have a higher income tax rate imposed on ordinary income than the estate tax rate imposed on their estate. This is particularly true with respect to ordinary income that is subject to the 3.8% surtax on net investment income.

Practitioners must, therefore, consider both the estate taxes that may be imposed on larger estates, and the income taxes that may be imposed when a decedent's assets are sold or exchanged. This, in turn, requires serious consideration of the question of basis.

One cannot begin to determine the tax on a sale or exchange without knowledge of the taxpayer's "basis" in the assets in question. Basis is a measure of the taxpayer's economic investment in the property. As such, it serves two very important functions. First, a taxpayer's basis in the property determines whether there is a gain or loss upon a taxable disposition of the property, since the measurement of gain or loss is the difference between the amount realized and the taxpayer's basis in the asset. Second, basis determines the amount of any depreciation or cost recovery deductions allowable.

As important as it is to determine the quantity of gain, it is important to determine the quality of the gain (i.e., long-term or short-term); thus, one must not only understand basis, but one must have a good grasp of the holding period rules.

This paper first explores "basis" and "holding period" as it applies generally to the Federal income tax system, then it delves into basis as it applies to lifetime gifts and testamentary dispositions. Finally, there are a number of specific topics that are common in estate planning, where basis and holding period are explained in depth.
II. KEY BASIS CONCEPTS: WHAT IS BASIS?

A. Brief History of Basis

Three years after the ratification of the 16th Amendment to the U.S. Constitution, the Revenue Act of 1916 introduced the concept of basis to the tax laws, providing that to compute gain from the sale of property acquired before March 1, 1913, basis was equal to the fair market value as of that date. Regulations that were later issued filled in the gaps providing that property acquired after March 1, 1913, would use the seller’s cost as the basis. This later became law as a result of the Revenue Act of 1918.

The Revenue Act of 1921 provided new rules for determining basis for lifetime gifts and testamentary transfers. The transferred basis rule for gift tax is more or less the same rule that exists today. However, with respect to the testamentary transfers, inherited basis would be the basis in the hands of the decedent. A few years later, the Revenue Act of 1928 changed the rule providing basis would be the date of death value. This rule was bantered back and forth for a few years (i.e., from 1928 to 1934), finally settling more or less with the rule that we have today (i.e., date of death value).

The concept of adjusting basis has its origins in the Revenue Act of 1924, which would allow both additions to and reductions (e.g., depreciation) of basis. The concept of substituted basis introduced in 1932, was bifurcated and became later known as transferred basis and exchanged basis in 1984. Changes to the Internal Revenue Code of 1954 and 1986 had slight modifications to the concepts of and rules regarding basis.

As it applies to estate planning and administration, within the last decade, the only major modification to the basis rules was the enactment of IRC § 1022 for those decedents dying in 2010, where the executors of their estates could elect out of the estate tax regime and utilize the income tax regime.

B. Generally

1. What is Basis?

Basis represents a taxpayer’s investment in property. This is a unique income tax concept. The income tax basis tracking rules are detailed below. Though the basis tracking rules for accounting purposes are similar, they not the same and often times don’t correlate.

2. Basis’ Significance

Basis is important because it keeps track of one’s investment in property, as such property may be depreciated or as capital improvements are made thereto. Basis measures the accretion of wealth and recognition of income when assets are bought, sold, exchanged and otherwise disposed.

Basis creates an ascertainable measure by which a taxpayer’s gain or loss is calculated. Without basis, gains and losses could not be readily ascertained.

There are many terms associated with basis, such as:

* cost basis
* adjusted basis
* unadjusted basis
* depreciable basis
* transferred basis
* exchanged basis  
* carryover basis  
* stepped-up basis  
* stepped-down basis  
* gain basis  
* loss basis  
* outside basis  
* inside basis

These terms are discussed throughout this paper.

C. Cost Basis

In general, the basis of property is initially determined by its cost. IRC § 1012(a); Reg. § 1.1012-1(a). Thus, it is generally thought that an asset’s “initial basis” or “original basis” is its “cost basis.” There are many adjustments that can be made to a property’s basis, which is discussed below. IRC § 1012(a); Reg. § 1.1012-1(a).

1. Property Purchased

Since its inception in tax law in 1918, the term “cost” has not been defined statutorily. Although the term is used in IRC § 1012, where the statute provides that “[t]he basis of property shall be the cost of such property”, it remains undefined, and when the term needs some refinement or definition, the regulations and case law have filled in the gaps over the years. Generally, cost is the amount paid for an item, and that is true regardless of whether the cost is the asset’s true fair market value. However, if there is great disparity between the amount paid and the fair market value, the taxpayer will generally have the burden to show that the amount paid was at an arm’s length. See, e.g., Majestic Sec. Corp. v. Comm’r, 12 F.2d 12 (8th Cir. 1941) and Comm’r v. Matheson, 82 F.2d 380 (5th Cir. 1936). If payment is made by debt, whether recourse or non-recourse, the debt is considered payment (and thus the “cost”). Provided however that the debt is only the principal part of the debt and that there is no unstated or disguised interest in the debt obligation. Reg. § 1.1012-1(g).

2. Property Received from Compensation

Reg. § 1.61-2(d)(2)(i) provides that property received as compensation for services takes a basis equal to the fair market value of those services. The rationale behind this is that the taxpayer would have received the compensation as cash and reported it as gross income, and then reinvested those proceeds to purchase the property.

D. Adjusted Basis

1. Generally

The taxpayer’s initial basis is adjusted by various additions to and deletions from to the capital value of the asset. IRC § 1011(a); Reg. § 1011-1.
2. **Common Basis Adjustments**

Among the most common basis adjustments are:

a) **Capital Improvements**

Basis is increased by expenditures to improve or add to the property, to the extent they are properly added to the taxpayer’s capital account for the asset. IRC § 1016(a)(1); Reg. §§ 1.1016-2(a), 1.1016-2(b). The real problems in this area arise in distinguishing between capital improvements (which are added to basis and depreciable over the life of the asset) and maintenance costs (which are immediately deductible, if the property is business related or held for investment, or not deductible at all if the property is not business related and not held for investment, such as a personal residence). Capital improvements must, in general, improve the value of the asset and prolong its life. Maintenance expenses keep the asset at its present or normal condition, and do not add to its value or prolong its useful life. The latter are not an addition to the owner's basis and, unless the property is a business or investment asset, not deductible. Maintenance costs are deductible if they are related to a trade or business activity. Reg. § 1.162-4.

Example II-1

A puts a new roof on his house at a cost of $50,000. He also paints the exterior and interior of the house at a cost of $2,500. A may increase his basis by the $50,000 cost of a new roof, which is a capital improvement, but not by the cost of painting the house, which is considered routine maintenance.

b) **Carrying Charges**

(1) **Right to Capitalize**

A taxpayer may elect to capitalize carrying charges for property, such as real estate taxes or mortgage interest, rather than to deduct them. IRC § 266. Most taxpayers prefer to have the current deduction for such expenditures, but a taxpayer may have low taxable income in a given year, and may prefer to capitalize these costs as opposed to wasting the deductions.

Example II-2

A pays $50,000 in mortgage interest and $20,000 in real estate taxes on undeveloped real estate in 2014. In that year, A's taxable income will already be reduced to nearly zero by other deductions and exemptions. A may elect to add these costs to A’s basis in the property and thereby reduce his gains on the eventual sale of the property.

(2) **“Carrying Charges” Defined**

The regulations do not actually define “carrying charges,” but they state that the following items are carrying charges:

- In the case of unimproved and unproductive real property: Annual taxes, interest on a mortgage, and other carrying charges. Reg. § 1.266-1(b)(1)(i);

- In the case of real property, whether improved or unimproved and whether productive or unproductive, (a) interest on a loan (but not theoretical interest of a taxpayer using his own funds), (b) taxes of the owner of such real property measured by compensation paid to his employees,
(c) taxes of the owner of such property imposed on the purchase of materials, or on the storage, use, or other consumption of materials, and (d) other necessary expenditures paid or incurred for the development of the real property or for the construction of an improvement or additional improvement to such real property, up to the time the development or construction work has been completed. Reg. § 1.266-1(b)(ii);

- In the case of personal property: (a) taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to the plant or installing them therein; (b) interest on a loan to buy the property or to pay for transporting or installing the same; (c) taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property, paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later; and (d) any other taxes and carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account. Reg. § 1.266-1(b)(1)(iii).

3. Capitalized Expenditures

a) Generally

A capital expenditure is a cost that will yield benefits in future years for the taxpayer's business or income-producing activities. The most obvious examples of capital expenditures are the costs of acquiring or improving an asset, but there are other expenditures that must also be capitalized. Generally, capitalized expenditures are added to the basis of the asset to which they relate. IRC § 1016(a)(1); Reg. §§ 1.263(a)-5(g)(2)(i) (In the case of a taxable acquisition, merger, or consolidation “an amount required to be capitalized under this section by the acquirer is added to the basis of the acquired assets . . . or the acquired stock . . . .”); Reg. § 1.1016-2(a) (“The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property”). See, however, discussion of selling expenses, below.

b) Presumption of Capitalization

In Indocpo, Inc. v. Comm’r, 503 U.S. 79 (1992), the Supreme Court held that “deductions are exceptions to the norm of capitalization” and “are strictly construed and allowed only ‘as there is a clear provision therefor.’” 503 U.S. at 84. Thus, all costs are required to be capitalized, unless the taxpayer can show that they are expressly made deductible by some provision of law. See Conjura, Zuber & Beale, To Capitalize or Not? The INDOPCO Era Ends with Final Regulations Under Section 263(a), 100 J. Tax’n 215 (April 2004); Elliot, Capitalization of Operating Expenses After INDOPCO: IRS Strikes Again, 5 S.C. Law. 29 (1993); Seago & Crumbley, INDOPCO: A Tiger, a Pussycat, or a Creature Somewhere in Between? 94 J. Tax’n 14 (Jan. 2001); Sheppard, The INDOPCO Case and Hostile Defense Expenses, 54 Tax Notes 1458 (1992); Yale, When are Capitalization Exceptions Justified? 57 Tax L. Rev. 549 ’summer 2004).

c) Distinguishing Deductions from Capital Expenditures

The fundamental distinction between deductible expenses and nondeductible capital expenditures is inherent in the concept of an expense as a cost of current operations. In Comm’r v. Tellier, 383 U.S. 687 (1966), the Supreme Court observed that the principal function of the word “ordinary” in IRC § 162(a) was “to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature
of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset.”

d) **Selling Expenses**

Among the most common capital expenditures is the cost incurred in selling an asset. See *Woodward v. Comm’r*, 397 U.S. 572, 576 (1970) (“legal, brokerage, accounting, and similar costs incurred in the acquisition or disposition of . . . property are capital expenditures” and that “such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it.”); *Alphaco, Inc. v. Nelson*, 385 F.2d 244 (7th Cir., 1967) (broker's commissions, accounting, and attorney's fees incurred in effecting a sale of the taxpayer's capital assets must be capitalized).

(1) **Selling Tangible Property**

Regulations relating to tangible property state that “[c]ommissions and other transaction costs paid to facilitate the sale of property generally must be capitalized.” Reg. § 1.263(a)-1T(d)(1).

(2) **Selling Securities**

The regulations relating to the sale of securities state that “[c]ommissions paid in selling securities are an offset against the selling price.” Reg. § 1.263(a)-2(e).

(3) **Additions to Basis or Reductions in Amount Realized?**

Selling expenses are not added to basis but are instead deducted from the amount realized on the sale. Reg. §§ 1.263(a)-1(e) (“[c]ommissions paid in selling securities are an offset against the selling price”); 1.263(a)-5(g)(2)(ii) (in a taxable acquisition, merger, or consolidation that is treated as an asset acquisition for federal income tax purposes, “an amount required to be capitalized under this section by the target is treated as a reduction of the target's amount realized on the disposition of its assets”); see also *Spreckels v. Helvering*, 315 U.S. 626 (1942) ‘sales expenses incurred by trader in securities must be used to reduce sales price, rather than be currently deducted, under predecessor statute); *Comm’r v. Covington*, 120 F.2d 768 (5th Cir. 1941), cert. denied, 315 U.S. 822 (1942) ‘same for dealer in commodities futures); *Ward v. Comm’r*, 224 F.2d 547 (9th Cir. 1955), aff’d 20 T.C. 332 (1953), acq. 1956-2 C.B. 4 (attorney’s and appraisal fees that enabled taxpayer to sell partnership interest at a greater profit were not deductible as expenses incurred in production of income, but were capital expenditures properly offset against sale price); *United States v. General Bancshares Corp.*, 388 F.2d 184 (8th Cir. 1968) (expenses in selling nonbanking assets must be used to reduce amount realized); *Jasko v. Comm’r*, 107 T.C. 30 (1996) (legal fees incurred in recovering insurance proceeds after principal residence was destroyed by fire were not deductible as expenses incurred in production of income, but were capital expenditures properly offset against sale price); *Washington Mkt. Co. v. Comm’r*, 25 B.T.A. 576 (1932) (engineering fees, counsel fees, and expenses of expert witnesses deductible from condemnation award).

e) **Restructuring and Reorganization Expenses**

Regulations expressly require capitalization of amounts expended to facilitate “[a] restructuring, recapitalization, or reorganization of the capital structure of a business entity,” a
transfer of property to a corporation or partnership in exchange for interests in that entity, an “acquisition of capital,” or “[a] stock issuance.” Reg. §§ 1.263(a)-5(a)(4), 1.263(a)-5(a)(5), 1.263(a)-5(a)(7), and 1.263(a)-5(a)(8). The term “restructuring, recapitalization, or reorganization of the capital structure of a business entity” in the regulations thus appears to encompass all forms of changes in the structure of a business entity, including the combination of partnerships or corporations into a single entity, and the division of partnerships or corporations into separate entities.

(1) Facilitation

Costs must be capitalized if they are incurred to facilitate these activities. The regulations explain that amounts paid “to facilitate a transaction” include amounts paid in the process of investigating or otherwise pursuing the transaction. The fact that the amount would (or would not) have been paid but for the transaction is relevant, but not determinative. Reg. § 1.263-5(b).

(2) Amounts Treated as Employee Compensation

The regulations create an exception to the usual rule of capitalization for amounts treated as employee compensation, even if the employees are facilitating transactions that would normally require capitalization. Reg. § 1.263-5(d)(2)(ii). The regulations state, however, that whether an individual is employed for these purposes depends on the characterization of that individual under the rules for income tax withholding. Reg. § 1.263-5(d)(2)(i).

(3) Elective Capitalization

A taxpayer who is unsure whether or not income tax withholding was required (or who otherwise wishes to do so) can elect to capitalize costs which the regulations would not otherwise require be capitalized. Reg. § 1.263-5(d)(4). This election is made by treating the amounts as capital on a timely-filed federal income tax return for the year in which the amounts are paid. Id.

(4) Cost Recovery

Basis is reduced by appropriate deductions for depreciation (IRC § 167), accelerated cost recovery (IRC § 168), amortization (IRC § 167), and cost depletion (IRC § 611).

(a) Generally

Depreciation, in general, is a current deduction for the exhaustion, or wear and tear on property. When a taxpayer takes or could take a deduction for depreciation, whether or not actually taken, the basis in the depreciated asset must be reduced by the allowed or allowable deduction. Comm'r v. Superior Yarn Mills, 228 F.2d 736 (4th Cir. 1955) (reduction in the allocation of the purchase price of land and building to the building because of depreciation deductions passed over by the taxpayer); Schrader v. United States, 582 F.2d 1374 (6th Cir. 1978), (basis of air conditioner owned by coin laundry not actually claimed).

(b) Types of Cost Recovery

This annual deduction for depreciation goes by different names, depending upon when the asset was placed in service:
(i) **MACRS**

The system of deductions for writing off the basis of assets is called Modified Accelerated Cost Recovery System (MACRS), if it applies to recovery property that's placed in service after 1986. IRC § 168. See Tax Reform Act of 1986 § 203, 100 Stat. 2143 (1986). Property placed in service after July 31, 1986, and before 1987 is also subject to MACRS if the taxpayer elected to apply MACRS.

(ii) **ACRS**

The system of deductions for writing off the basis of assets is called Accelerated Cost Recovery System (ACRS), if it applies to recovery property that's placed in service after 1980 and before 1987. IRC § 168, before Pub. L. 99-514 § 201(a), 99th Cong., 2d Sess. (1986).

(5) **Depreciation**

The system of deductions for writing off the basis of assets is called depreciation if it applies to property placed in service before 1981, or to property placed in service after 1980, if it does not qualify for either MACRS or ACRS. IRC § 167(a), before the Technical and Miscellaneous Revenue Act of 1988 § 1002(a)(24), 102 Stat. 3401 (1988).

(6) **Amortization**

The system of deductions for writing off the basis of assets is called amortization, if the asset is intangible or under certain special provisions for tangible property. See IRC § 167(g)(8).

(7) **Depletion**

The system of deductions for writing off the basis of assets is called depletion, if the assets are exhaustible natural deposits, such as oil, gas, or timber. (e.g., oil and gas) or timber. See IRC § 611.
III. KEY BASIS CONCEPTS: BASIS OF PROPERTY ACQUIRED BY GIFT -- IRC § 1015

A. Brief History

1. 1913-1921

Until 1921, there was no statutory rule on the basis of property acquired by gift. Treasury allowed donees to take a basis equal to the fair market value of the property on the date of the gift. See S. Rep. No. 275, 67th Cong., 1st Sess. (1921); Taft v. Bowers, 278 U.S. 470 (1929).

2. Revenue Act of 1921

The Revenue Act of 1921 first provided that the donee must take a “carryover basis” from the donor and use that basis computing gain on selling or otherwise disposing of the property. 42 Stat. 227 (1921); S. Rep. No. 275, 67th Cong., 1st Sess. (1921). As a relatively useless aside, a donee who holds property that he or she received as a gift before 1921 still takes a basis equal to the fair market value of the property on the date of the gift. IRC § 1015(c).

3. Revenue Act of 1934

The Revenue Act of 1934 provided that the carryover basis could not be used to give losses to the donee; the carryover basis would be used only in calculating gain on a later sale. 48 Stat. 680 (1934); S. Rep. No. 558, 73d Cong., 2d Sess. (1934); Keller, At a Loss: A Half Century of Confusion in the Tax Treatment of Transfers of Depreciated Property Between Related Taxpayers, 44 Tax Law. 445 (1991).


6. Deficit Reduction Act of 1984

The Deficit Reduction Act of 1984§ 421(b)(5), provided the special rule of IRC § 1041 for treating interspousal transfers as gifts and for determining the basis of property received in such transfers, and modified IRC § 1015 to defer to IRC § 1041 in determining such bases. 98 Stat. 794 (1984).

B. General Rule – Transferred Basis

Transferred basis transactions generally occur when there is no sale or exchange, but property is transferred from the old owner (i.e., sometimes called the “transferor” or “donor”) to the new owner (sometimes called the “transferee” or “donee”). See, IRC § 7701(a)(43).

In estate planning this happens whenever there has been a completed gift. There are different rules that apply for gifts of appreciated property (i.e., where, at the time of the gift, the fair market value of the gifted property is greater than its adjusted basis), and gifts of depreciated property (i.e., where, at the time of the gift, the fair market value of the gifted asset is less than its adjusted basis), which we discuss below.
C. When Does the Basis Transfer?

The date that a donee acquires an interest in property by gift is the date on which the donor relinquishes dominion and control over the property, and not necessarily the date on which title passes to the donee. Reg. § 25.2511-2(b). The date on which a remainder beneficiary or other successive interest holder receives the interest by gift is the date on which the interest is created, rather than the date on which it becomes possessory. Reg. § 1.1015-1(c).

D. Gifts of Appreciated Property

Appreciated property is defined as property whose fair market value exceeds its adjusted tax basis. For gifts of appreciated property, the general rule is that the donee’s basis is equal to the donor’s basis in the asset at the time of the gift, increased by any gift tax paid on the net appreciation in the property’s value (but not to exceed the asset’s fair market value) at the time of the gift. IRC § 1015(a) and (d)(6).

Example III-1

On January 1, 2014, P purchased 20,000 shares of Dapple stock for $1 per share (totaling $20,000). On February 1, 2014, when Dapple’s value was $1.50 per share, P gifted his 20,000 shares of Dapple to Q. Under IRC § 1015(a) P’s basis of $20,000 would become Q’s basis.

Example III-2

Same facts as Example III-1, except assume further that this was P’s only gift and that the gift triggered a gift tax of $2,400 attributable to the net appreciation. In this case, under IRC § 1015(d)(6), Q’s basis would be P’s basis of $20,000 increased by the $2,400 of gift taxes paid (or $22,400). For a more detailed example and refinement of the rule, see section III.K below.

E. Gifts of Depreciated Property

1. General Rule aboutGifted Depreciated Property

A different rule applies for gifts of “depreciated property”. This rule is intended to prevent the transfer, through gifts of property, of deductible losses by lower-bracket donors to higher-bracket donees.

2. “Depreciated Property” Defined

“Depreciated property” is property where the fair market value is less than its adjusted basis. Thus, a gift of depreciated property arises when, at the time of the gift, the fair market value of such property is less than its adjusted basis. IRC § 1015(a) provides that in the case of gifts of depreciated property, when such property is later sold or exchanged by the donee, there is one basis to be used if the sale or exchange generates a gain, and a different basis to be used if the property generates a loss.

There are three different scenarios that could arise when the gifted, depreciated property is sold or exchanged.

Scenario 1: The selling price is greater than the adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee).

Scenario 2: The selling price is less than adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee), but greater than the fair market value at the date of the gift.
Scenario 3: The selling price is less than the adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee) and it is also less than the fair market value of the property at the date of the gift.

Each of these scenarios generates a different result.

a) **Scenario 1 – Gain Recognized**

In Scenario 1, the fair market value of the property on the date of the later sale is greater than the adjusted basis of the donor (as it may have been adjusted subsequent to the gift) at the time of sale; thus, a gain will be recognized. Specifically, IRC § 1015(a) requires that the adjusted basis shall be the transferred basis (as it may have been required to be adjusted in the hands of the donor).

**Example III-3**

Donor buys a share of Acme stock for $100 on January 1, 2013. Donor gives the stock to Donee on March 1, 2014, when the fair market value of the stock is $80. On October 1, 2014, Donee sells the stock for $125.

In this case since Donee sold the stock for more than the basis in Donor’s hands, Donee’s basis is the Donor’s basis of $100; thus, gain recognized will be $25 (i.e., the fair market value on date of sale of $125 minus the donor’s $100 basis).

b) **Scenario 2: No Gain – No Loss**

In Scenario 2, the fair market value of the property on the date of the later sale is between the donor’s adjusted basis and the fair market value on the date of gift. In this case there is no gain or no loss recognized.

**Example III-4**

Same facts as Example III-3, however, on the date of the sale, the fair market value of the stock is $90. In this case, there is no gain and no loss, since the fair market value on the date of the sale is greater than the fair market value on date of the gift, but less than the adjusted basis was in Donor’s hands. Reg. § 1.1015-1(a)(2).

c) **Scenario 3: Loss Recognized**

In Scenario 3, the fair market value of the property on the date of the later sale is below both (1) the donor’s adjusted basis and (2) the fair market value on the date of gift.

IRC § 1015(a) requires that for purposes of determining the loss, the donee/seller would use the fair market value on the date of the gift to determine the basis.

**Example III-5**

Same facts as Example III-3, however, on the date of the sale, the fair market value of the stock was $62. In this case, the basis to be used is the fair market value on the date of the gift (i.e., $80). Thus, Donee recognizes a loss of $18 (i.e., the difference between $80 and $62).

d) **Holding Period**
The donee’s holding period will be affected depending on whether the stock is sold for a gain or a loss. See the discussion below in section V.B.3.b)(1)(c)(iii), where these same examples are used to explain the holding period.

F. Part Gift – Part Sale

1. Generally

Situations arise where a transaction is considered partially a gift and partially a sale (i.e., the “part gift-part sale transaction”). For instance, when a donor ‘sells’ property to a donee at price that is below the asset’s fair market value, where the donee takes property subject to a debt, or where the donor makes a gift, and the donee agrees to pay the gift tax associated with the gift (i.e., the net gift concept).

For income tax purposes, the transaction is deemed to be two separate transactions: (1) a sale for the amount of the proceeds received (relative to the entire fair market value) of the property given up; and (2) a gift for the balance.

Example III-6

Donor buys a widget for $50 many years ago, and later ‘sells’ it to Donee (Donor’ son) for $80, when the widget’s true fair market value is $100.

There is a sale of 80% (i.e., $80 ÷ $100) of the asset, and a gift of 20% (i.e., {100% - 80%} or {[$100 – $80] ÷ $100}) of the asset.

In this example, the basis would be bifurcated; therefore, for sales purposes, the basis is $40 (i.e., 80% of $50) and for gift purposes, the basis is $10 (i.e., 20% of $50).

2. Planning Strategy

When a donor plans to make gifts of depreciated business or investment property, it is usually a better idea for the donor first to sell the property, generating a loss, and then to give the donee the cash sales proceeds. This arrangement preserves any loss deduction for the donor, rather than forfeiting it entirely.

G. Sequential Gifts

The regulations state that the donee takes the basis of the donor or, if the donor acquired the property by gift, of “the last preceding owner by whom it was not acquired by gift.” Reg. § 1.1015-1(a)(1). The basis of a donee in property, therefore, looks not necessarily at the basis of the immediate donor, if the immediate donor also acquired the property by gift. Of course, if the immediate donor acquired the property by gift, he or she would have a transferred basis from that of the prior donor, and this process would continue as far back as it takes to get to a donor who did not also acquire the property by gift. Thus, this statement in the regulations is rather irrelevant.

H. Recordkeeping

Donors and donees should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value on the date of the gift. Reg. § 1.1015-1(g).
I. Proving Basis

See section VII below, regarding how to prove basis, if there are insufficient records.

J. Fiduciary Reinvestments

A fiduciary takes a cost basis in property that the fiduciary purchases or otherwise acquires by reinvesting property given to the fiduciary. The gift basis rules do not continue to apply to property so acquired. Reg. §§ 1.1015-1(f), 1.1015-2(b).

K. Increase for Gift Tax Paid on Net Appreciation

1. Generally

The donee’s adjusted basis in property received by gift is increased for any gift tax paid on the transfer, to the extent attributable to the net appreciation in the value of the gift.

a) Net Appreciation

The donee’s basis is increased by that portion of the gift tax paid on the transfer that bears the same ratio to the total gift tax paid as the net appreciation in the value of the gift bears to the amount of the gift. IRC § 1015(d)(6)(A); Reg. § 1.1015(c)(1). For this purpose, the net appreciation in the value of the gift is the amount by which the fair market value of the gift exceeds the donor’s adjusted basis immediately before the gift.

b) Amount of the Gift

The amount of the gift, for this purpose, is determined after subtracting the available gift tax annual exclusion and any available marital and charitable deductions. If there is more than one gift of a present interest in property made to the same donee during a calendar year, the annual exclusion applies to the earliest of such gifts in point of time. Reg. §§ 1.1015-5(c)(1) and 1.1015-5(c)(2).

c) Amount of Gift Tax Paid

(1) Only One Gift That Year

If only one gift was made during a calendar year, the entire amount of the gift tax paid for that year is the amount of the gift tax paid with respect to the gift. Reg. §§ 1.1015-5(b)(1)(i), 1.1015-5(c)(2).

(2) Multiple Gifts That Year

(a) Generally

Where more than one gift is made by the donor in a calendar year, the amount of gift tax paid with respect to any specific gift made during that period is the amount which bears the same ratio to the total gift tax paid for that period (determined after reduction for any available unified credit) as the amount of the gift bears to the total taxable gifts for the period. Reg. § 1.1015-5(c)(3).

(b) Say It with Formulae

Algebraically, the amount of the gift tax paid with respect to a gift equals:
For this purpose, the "amount of the gift" is the value of the gift reduced by any portion excluded or deducted by virtue of the annual exclusion, the charitable deduction, or the marital deduction. The values are those finally determined for gift tax purposes. Reg. § 1.1015-5(b)(1)(ii).

**Example III-7**

Donor has previously used up all available unified credit. In 2014, Donor gives Donee-1 a parcel of real estate worth $100,000. Donor’s adjusted basis in the property immediately before the gift was $70,000. Also in 2014, Donor gives Donee-2 a painting with a fair market value of $70,000. Donor files a timely gift tax return paying $56,800 in gift tax, computed as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of real estate transferred to Donee-1</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less: Annual Exclusion</td>
<td>(14,000)</td>
</tr>
<tr>
<td>Included amount of gift to Donee-1</td>
<td>$86,000</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of painting transferred to Donee-2</td>
<td>$70,000</td>
</tr>
<tr>
<td>Less: Annual Exclusion</td>
<td>(14,000)</td>
</tr>
<tr>
<td>Included amount of gift to Donee-2</td>
<td>$56,000</td>
</tr>
</tbody>
</table>

Total Included gifts (to Donee-1 and -2) $142,000

Total gift tax liability for 2014 gifts (i.e., 40% of $142,000) $56,800

The gift tax paid with respect to the real estate transferred to Donee-1, is determined as follows:

\[
\frac{86,000}{142,000} \times 56,800 = 34,400
\]

The amount by which Donee-1’s basis in the real property is increased is determined as follows:

\[
\frac{30,000 \text{ (net appreciation)}}{86,000 \text{ (fair market value – Annual Exclusion)}} \times 34,400 = 12,000
\]

Donee-1’s basis in the real property is $70,000 plus $12,000, or $82,000. If Donor had not exhausted any of Donor’s unified credit, no gift tax would have been paid and, as a result, Donee-1’s basis would not be increased at all above Donor’s carryover basis of $70,000. Reg. § 1.1015-5(c)(5), Ex. 1.
Planning Pointer: Gifts of Cash and Property

A donor who plans to give away both cash and appreciated property in an amount that will cause a gift tax to be imposed, should first make the cash gifts, absorbing as much of the annual exclusion and unified credit as possible. In the next year, the donor should give away the appreciated property. This strategy maximizes the increase in the donee’s adjusted basis for the gift tax paid by the donor, without increasing the amount of gift tax paid by the donor.

Example III-8

Donor plans to give Donee gifts of cash and stock in December 2014 and January 2015. Prior gifts have exhausted all but $100,000 of Donor’s applicable exclusion amount. Donor’s 2014 gifts to Donee consist of $114,000 in cash and an equal amount in marketable securities. Donor’s adjusted basis in the securities is $20,000. Donor gives Donee the securities in 2014, and pays $40,000 of gift tax ($114,000 - $14,000 annual exclusion = $100,000 taxable gift; 40% gift tax x $100,000 = $40,000).

In 2015, Donor gives $114,000 of cash to Donee, which generates another $40,000 in gift tax. Donee obtains no basis in the cash.

If Donor makes the gift of cash in 2014 and the gift of securities in 2015, there will be no change in Donor’s gift tax liability, but Donee’s adjusted basis in the securities will increase by $32,000 (($40,000 gift tax paid by Donor on the appreciation in the value of the securities x $80,000 appreciation / $100,000 value of gift)).

Annual Exclusion

Where more than one gift of a present interest in property is made to the same donee during a calendar year, the annual exclusion applies to the earliest gifts. Reg. §§ 1.1015-5(b)(2) and 1.1015-5(c)(3).

Gift Splitting

If the donor and the donor’s spouse elect to gift split under IRC § 2513, the amount of gift tax paid is the sum of the amounts of tax paid with respect to each half of the gifts, computed separately. Reg. § 1.1015-5(b)(3).

One Gift, Multiple Items of Property

If a gift consists of more than one item of property, the gift tax paid with respect to each item is computed by allocating to each item a proportionate part of the gift tax paid. Reg. § 1.1015-5(b)(1)(iii).

d) When is the Basis Adjustment Made?

General

The Code and regulations state that the donee’s basis is increased for the “gift tax paid” with respect to the transfer. This suggests that the donee’s basis cannot be increased until those taxes are paid and raises the question about how the donee determines basis before the donor has paid the gift tax.

Example III-9

It is not clear how Donee calculates the tax on a sale of the shares before April 15, 2015.

(2) Regulations for Pre-1977 Gifts

Regulations applicable to gifts made before January 1, 1977, however, state:

“If section 1015(d)(1)(A) applies, the basis of the property is increased as of the date of the gift regardless of the date of payment of the gift tax.”

Example III-10

Assume that property was acquired by gift on September 8, 1958, and sold by the donee on October 15, 1958, the basis of the property would be increased ‘subject to the limitation of IRC § 1015(d)) as of September 8, 1958 (the date of the gift), by the amount of gift tax applicable to such gift even though such tax was not paid until March 1, 1959. Reg. § 1.1015-5(a)(1)(i).

Unfortunately, this portion of the regulation does not, by its own express language, apply to gifts made after December 31, 1976, although there is nothing in the regulations that suggests a different rule for later gifts.

(3) Recommendation

There is nothing contrary in the regulations, and no reason to believe that a rule similar to that applicable prior to 1977 would not apply to gifts made after 1976. It would make sense, therefore, for a donee to assume that the donor will pay the gift tax, and to adjust his or her basis immediately. Of course, if the donor then fails to pay the gift tax, the donee will need to make a corresponding adjustment in the basis.

2. Net Gift

The basis adjustment applies regardless of who pays the gift tax. Therefore, the gift tax paid by the donee on a net gift, to the extent allocable to appreciation, is added to the donee’s basis. Reg. § 1.1015-5(b)(2). See discussion of basis and net gifts below.

3. Qualified Domestic Trusts

A distribution from a qualified domestic trust (QDOT) during the noncitizen surviving spouse’s lifetime on which a tax is imposed under IRC § 2056A(b)(1)(A), is treated as a transfer by gift for this purpose, and the additional estate tax paid on the distribution is treated as a gift tax paid, for basis purposes. Reg. § 1.1015(c)(4).

Example III-11

Decedent dies in 2012. Spouse is not a United States citizen. In order to obtain the marital deduction for property passing to Spouse, Decedent established a testamentary QDOT. In 2014, the trustee of the QDOT makes a distribution of principal from the trust in the form of shares of stock having a fair market value of $70,000 on the date of distribution. The trustee's basis in the stock was $50,000. An estate tax is imposed on the distribution under IRC § 2056A(b)(1)(A) in the amount $28,000 and is paid. The basis of the stock in the hands of the distributee is increased by a portion of the IRC § 2056A estate tax paid determined as follows:

\[
\frac{20,000 \text{ (net appreciation)}}{70,000 \text{ (distribution)}} \times 28,000 \text{ ($2056A tax)} = 8,000
\]

The distributee’s basis in the stock is $50,000 (trust’s basis) plus $8,000, or $58,000. Reg. § 1.1015-5(c)(5), Ex. 2.

4. Effective Date

This rule applies to gifts made after December 31, 1976. IRC § 1015(d)(6). For gifts made on or after September 2, 1958, and before January 1, 1977, the donee’s basis is increased by the entire gift tax paid on the transfer. IRC § 1015(d)(1).

L. Inter-spousal Lifetime Gifts

1. Generally

IRC § 1041(a) provides that inter vivos transfers between spouses are always treated as gifts, rather than sales or exchanges, even if there is reciprocal consideration.

IRC § 1015(e) states that the basis of a transferee spouse is determined under IRC § 1041(b)(2), rather than IRC § 1015. IRC § 1041(b)(2) states that the transferee-spouse takes the transferor-spouse’s adjusted basis immediately before the transfer. See also Godlewski v. Comm’r, 90 T.C. 200 (1988) (husband’s basis in share of marital home bought from wife not increased by purchase price).

2. Transferred Basis for Gain and Loss

The transferor-spouse’s adjusted basis transfers to the transferee-spouse under IRC § 1041. Unlike gifts to non-spouses, where there is a different treatment between “appreciated property” and “depreciated property”, there is no special rule for transfer between spouses. Thus, the transferee spouse always uses the transferor’s spouse’s basis, whether the transferee-spouse sells the property for a gain or a loss. Reg. §1.1041-1T(d), Q & A-11.

3. Liabilities and Basis

a) Generally

IRC § 1041 requires that the transferee-spouse receive the transferor-spouse’s adjusted basis, even if the transferred asset is subject to liabilities exceeding the transferor-spouse’s basis. Reg. § 1.1041-1T(d), Q & A-12. See also PLR 9250031 (IRC § 1041(b) determines the basis on a transfer of a partnership interest in which the transferor-spouse's share of
partnership liabilities exceeded the outside basis for the transferor-spouse’s partnership interest).

b) Debt In Excess of Basis

IRC § 1041(e) provides, however, for recognition of gain on transfers that would otherwise be nontaxable under IRC § 1041(a), if the transfer is in trust and liabilities assumed or encumbering the property exceed its adjusted basis. Gain recognized under IRC § 1041(e) is added to the transferee’s transferred basis in the transferred asset.

4. No Gift Tax Adjustment

a) U.S. Citizen Resident Spouse

No provision is made for increasing this basis by gift taxes, presumably because the gift tax marital deduction will most often render it immaterial.

b) Non-Citizen Spouse

IRC § 1041(d) states that this section does not apply if either spouse is a nonresident alien, but IRC § 2523(i) does not allow the unlimited gift marital deduction unless the donee spouse is a U.S. citizen. The application of IRC § 1041, therefore, should preclude the increase in the transferee-spouse’s adjusted basis for the gift taxes paid on the net appreciation, if the transferee-spouse is a resident alien.

M. Planning Strategies to Maximize Basis on Gifts

1. Expiring Loss Carryovers

Shifting a taxable gain to a donee by giving appreciated assets is particularly useful if the donee has an expiring capital loss carryover. IRC § 1212. The donee can then sell the asset and use the loss carryover to reduce or eliminate the tax on the gain.

2. Balancing Income and Wealth Transfer Taxes

A donor should compare the income tax effects of a gift with the estate, gift, and GST tax savings. The carryover basis rules for gifts create a risk that a significant taxable gain will be recognized on a later gift of appreciated property. A bequest or devise of that same property at death, or a gift of that same property with a retention of sufficient controls or beneficial interests in the property to cause it to be included in the donor’s gross estate for estate tax purposes, gives the donee an income tax basis in the property equal to its value on either the date of death or, if the executor so elects, the alternate valuation date, which is generally six months after the date of death. IRC §§ 1014(a), 2032. This generally eliminates from the donee’s income tax all appreciation up to the date of the donor’s death or, if applicable, the alternate valuation date.

3. 2017 Tax Act Implications

This is especially true in the case when the unified gift or estate tax exclusion and GST exemption is now $11.18 million (2018). There is a greater incentive not to make gifts, for those whose estate will be less than the exclusion and exemption.
A Short History

The Revenue Act of 1921 § 202(a)(3), first codified the Treasury practice of giving date-of-death value basis for property received from a decedent. 42 Stat. 227 (1921) (property acquired by bequest, devise, or inheritance; by certain transfers in contemplation of, or intended to take effect at or after, death; or pursuant to a general power of appointment exercised by will); Treas. Reg. 45, art. 1562 (under Revenue Act of 1918).

A number of years later, in Brewster v. Gage, 280 U.S. 327 (1930), the Supreme Court clarified that the basis of property received from a decedent is determined from the value of the property on the date of death, rather than the date on which the personal representative distributes property to the legatee. This was codified by the Revenue Act of 1934 § 113(a)(5), 48 Stat. 680; see also S. Rep. No. 558, 73d Cong., 2d Sess. (1934).

The Tax Reform Act of 1976 §§ 1901(c)(8) and 2005(a)(1), repealed the estate tax value basis rules and substituted a form of carryover basis, effective for estates of decedents dying after December 31, 1976. 90 Stat. 1803, 1872. Fear about complexity lead to the suspension of the effective date by the Revenue Act of 1978 § 515(1), 92 Stat. 2884, 2926, and then it was repealed retroactively by the Crude Oil Windfall Profits Tax Act of 1980 § 401(a), 94 Stat. 299.

Enactment of the unlimited marital deduction resulted in the adoption of the reverse gift in contemplation of death rule of IRC § 1014(e), as part of the Economic Recovery Tax Act of 1981 § 425(a), 95 Stat. 318.


Generally

The basis of property in the hands of a person acquiring it from a decedent or to whom the property passed from a decedent is the fair market value of the property at the date of the decedent's death or the alternate valuation date, if validly elected. IRC § 1014(a). See also Helvering v. Reynolds, 313 U.S. 428 (1941) (taxpayer received contingent remainder in testamentary trust the assets of which included securities; basis was the fair market value of those assets on the date of death, rather than the date on which the remainder interest became possessory); and Haywood v. Gill, 313 F.2d 454 (4th Cir. 1963) (same).

C. Property “Acquired From” or “Passed From” the Decedent

Many different situations will cause property to be considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. Some are obvious, but others are subtler.

1. Caveat

Reg. § 1.1014-1(a) states that “[t]he purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax.” However, neither IRC § 1014 nor the regulations actually makes a consistent effort to do that, and even the IRS has acknowledged that there are situations in which a basis adjustment is available without a concomitant inclusion of the property in a U.S. gross estate.

2. Assets Passing Under Will or By Intestacy

a) Generally
Property acquired by bequest, devise, or inheritance, or by the decedent’s estate from the
decedent (whether under the decedent’s will or under the laws of descent and distribution
(i.e., intestacy)) is considered to have been acquired from or to have passed from the decedent
for purposes of the basis rules of IRC § 1014. IRC § 1014(b)(1); Reg. § 1.1014-
2(a)(1).

b) **Property Need Not be Includible in Gross Estate**

Property need not be includible in a decedent’s gross estate to be deemed to have been
inherited from the decedent.

This occurs most often with nonresident alien decedents. Rev. Rul. 84-139, 1984-2 C.B.
168 (real property owned by nonresident alien and not subject to U.S. estate tax takes a
basis equal to its fair market value on the date of death); PLR 201245006 (cash and stock
in a foreign trust is includible in nonresident alien decedent’s gross estate).

See also discussion of effect of the death of a grantor on basis of assets in grantor trust, in
section XIII.B. below.

3. **Assets Includible in the Decedent’s Gross Estate**

a) **Generally**

For decedents dying after 1953, property acquired from the decedent by reason of death,
form of ownership, or other conditions (including property acquired through the exercise
or non-exercise of a power of appointment), that is included in the decedent’s gross estate,
is considered to have been acquired from or to have passed from the decedent for purposes
of the basis rules of IRC § 1014. IRC § 1014(b)(9); Reg. § 1.1014-2(b)(1); Rev. Rul. 56-
215, 1956-1 C.B. 324 (portion of joint property included in gross estate eligible for basis
adjustment).

b) **No Return is Required**

The basis adjustment under IRC § 1014 is available whether or not an estate tax return is

c) **Cost Recovery Adjustment**

The basis of property includible in the decedent’s gross estate that was acquired before the
decedent’s death, is reduced by the amount allowed to the taxpayer as deductions in com-
puting taxable income for exhaustion, wear and tear, obsolescence, amortization, and de-
pletion on such property before the decedent’s death. Such basis shall be applicable to the
property commencing on the death of the decedent. IRC § 1014(b)(9); Reg. § 1.1014-
6(a)(1).

4. **QTIP**

Property includible in the gross estate of the decedent under IRC § 2044 (QTIP assets), is considered
to have been acquired from or to have passed from the decedent for purposes of the basis rules of
IRC § 1014. The same cost recovery adjustment described above applies to IRC § 2044 assets. IRC
§ 1014(b)(10).
5. Surviving Spouse’s One-Half Share of Community Property

a) Generally

For decedents dying after December 31, 1947, the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, U.S. possession, or foreign country, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014, even though that property is not included in the decedent’s gross estate for federal estate tax purposes. This rule applies if at least one-half of the whole of the community interest in such property is includible in the decedent's gross estate. IRC § 1014(b)(6); Reg. § 1.1014-2(a)(5); see also Rev. Rul. 87-98, 1987-2 C.B. 206, 1987-39 I.R.B. 15; Rev. Rul. 66-283, 1966-2 C.B. 297; Rev. Rul. 59-220, 1959-1 C.B. 210; Rev. Rul. 55-605, 1955-2 C.B. 382.

b) What and Where is Community Property

(1) Background

Community property is a form of concurrent ownership between a husband and wife derived from the Napoleonic Code. It came to the United States through Spanish law in several states, and through a special statutory adoption in a few more. Under community property laws, property acquired by a married couple during marriage is owned in equal shares by each spouse. Management of the property may be shared by the spouses or exercisable by one spouse only, depending upon the specific law in question. Income from community property may or may not be community property, depending upon the state in question.

(2) Where

(a) Generally


(b) Spanish Origins

Eight of these states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington), trace their community property laws to their Spanish origins, as community property originated under the French laws of Napoleon, which pervaded Europe during his conquests.

(c) Wisconsin

Wisconsin created a form of community property in 1986, when it became the only state to adopt the Uniform Marital Property Act. One may reasonably question the use of the term “Uniform” on an act adopted by
c) Alaska, South Dakota, and Tennessee - Opt-In Community Property

Alaska, South Dakota, and Tennessee enacted elect-in community property regimes, in which a married couple may elect to have some or all of the property acquired during their marriage become community property. The IRS has not yet expressly opined whether it views these laws as creating community property for basis purposes. See, e.g., IRS Pub. 555, Community Property, p. 2 (Rev. Feb. 2016), stating that “Note. This publication does not address the federal tax treatment of income or property subject to the “community property” election under Alaska state laws.” See also discussion of the elect-in regime and its utility in XVI. below.

(1) Foreign Countries

Most of Western Europe has community property, because of its history of being under the control of Napoleon. The United Kingdom, because of its contrary history, does not have community property.

(2) Community Property in Common Law States

Community property acquired while residing in a community property state or country remains community property after it is transported to a common law state, unless steps are taken to convert it to separate property or it is commingled with separate property. See, e.g., Restatement (second) of Conflict of Laws § 222 (1971). See also Section 3 of The Uniform Disposition of Community Property Rights at Death Act (1971) (“UDOCRADA”), adopted in 16 states, which states that:

“Upon death of a married person, one-half of the property to which this Act applies is the property of the surviving spouse and is not subject to testamentary disposition by the decedent or distribution under the laws of succession of this State. One-half of that property is the property of the decedent and is subject to testamentary disposition or distribution under the laws of succession of this State. With respect to property to which
It may be noteworthy that this does not actually state that the property originally acquired as community property under the laws of another state retains its status as community property when moved to a non-community property state. It merely provides for the testamentary disposition of the property in a manner that resembles what would have occurred had the property been community property. The drafters of UDOCPRADA were very careful in their comments to clarify that they were only addressing the “rights” of the surviving spouse, and not addressing the nature of the property. On the other hand, the IRS has stated at least once that community property brought to a state that has the Uniform Disposition of Community Property Rights at Death Act is, by virtue of this act, community property.


6. Largely Superfluous Rules

Retained Income Interests and Retained Right to Revoke

a) Generally

Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, or with the right reserved to the decedent at all times before his death to revoke the trust, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. IRC § 1014(b)(2); Reg. § 1.1014-2(a)(2). See also Hazel B. Beckman Trust v. Comm’r, 26 T.C. 1172 (1956); Bankers Trust Co. v. United States, 156 F. Supp. 930 (Ct. Cl. 1957); Rev. Rul. 57-287, 1957-1 C.B. 517, modifying Rev. Rul. 55-502, 1955-2 C.B. 560. This is superfluous because these assets would be includible in the decedent’s gross estate under IRC § 2036, merely on account of the income interest, or IRC § 2038, merely on account of the right to revoke. The combination of them seems to be overkill in this context.

b) Decedents Dying After 1951

For decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. IRC § 1014(b)(3). This is superfluous because these assets would be includible in the decedent’s gross estate under IRC § 2038.

c) Property Subject to an Exercised General Testamentary Power of Appointment

Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. IRC § 1014(b)(4); Reg. § 1.1014-2(a)(4). This rule is superfluous because such property would also be includible in the decedent’s gross estate under IRC § 2041, whether or not the power was actually exercised.

7. Somewhat Dated Rules

a) Pre-2005 Foreign Personal Holding Companies
For decedents dying after August 26, 1937, and before January 1, 2005, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, consisting of stock or securities of a foreign personal holding company (determined with respect to its taxable year next preceding the date of the decedent's death), is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. The basis of such property is its fair market value on the date of the decedent's death or, if lower, its basis in the hands of the decedent. IRC § 1014(b)(5); Reg. § 1.1014-2(c)(1).

b) Community Property Between 1942 and 1947

For decedents dying after October 21, 1942, and before January 1, 1948, the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, U.S. possession, or foreign country, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014, if it was included in the decedent’s gross estate under the Internal Revenue Code of 1939. IRC § 1014(b)(7); Reg. § 1014-2(c)(2).

c) Joint and Survivor Annuities for 1951-1953 Decedents

For decedents dying after December 31, 1950, and before January 1, 1954, the survivor's interest in a joint and survivor's annuity any part of which was includible in the decedent’s gross estate under the Internal Revenue Code of 1939, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. IRC § 1014(b)(7); Reg. § 1.1014-2(a)(6).

d) Domestic International Sales Corporation Stock

The estate tax value basis of stock of a domestic international sales corporation (DISC) or former DISC (as defined in IRC § 992(a)) owned by a decedent, is reduced by the amount (if any) that would have been included in gross income under IRC § 995(c) as a deemed dividend, had the decedent lived and sold the stock at its fair market value on the estate tax valuation date. In computing the gain the decedent would have had if he or she had lived and sold the stock, the decedent’s basis is determined without regard to the last sentence of IRC § 996(e)(2) (relating to reductions of basis of DISC stock). IRC § 1014(d). The DISC rules were repealed in 1984, but the basis rules do apply to former DISCs, so the may not be entirely irrelevant. It will, however, be a rare occasion in which former DISC stock will appear in the typical estate planning practice. See Reg. § 1.1014–9.

e) Restricted Stock Options

The estate tax value basis is not available for restricted stock options described in IRC § 421 which the employee has not exercised at death, if the employee died before January 1, 1957. Reg. § 1.1014(c)(2).

D. Income in Respect of a Decedent

1. Generally

The basis adjustment rules of IRC § 1014 do not apply to property that constitutes a right to receive an item of income in respect of a decedent (IRD) under IRC § 691. IRC § 1014(c); Reg. § 1.1014-1(c)(1). See also Stanley v. Comm’r, 338 F.2d 434 (9th Cir. 1964), aff’d 40 T.C. 851 (1963) (right to installment payments was both IRD and community property, and basis provisions relating to community property did not prevent excluding asset from any basis adjustment because it was also IRD); Collins v. United States, 318 F. Supp. 382 (C.D. Cal. 1970), aff’d per curiam, 448 F.2d 787
(9th Cir. 1971) (payments made to surviving spouse by her late husband’s employers under contracts negotiated by husband were IRD and ineligible for basis adjustment at husband’s death).

Although not explicitly stated in the statute, the basis of the estate (or other successor in interest) is a transferred basis. So, if the basis was zero in the hands of the decedent (e.g., earned but not yet received compensation) or something other than zero (e.g., installment note owned by the decedent), that basis will be transferred to the successor in interest in the IRD property (and not adjusted to its fair market value). See IRC § 1014(c) and IRC § 691(c)(4).

2. **“IRD” Defined**

   a) **Code**

      The Code does not actually define “income in respect of a decedent.” It only says how and when it is taxed. Specifically, IRC § 691(a)(1) provides that “when received”, the appropriate person (generally the person who is deemed to be the owner of the IRD at the time of receipt) will include the received amount into his or her gross income. Effectively, the recipient of IRD is put on a cash basis method of accounting with respect to the IRD payments.

   b) **Regulations**

      The Regulations provide a misleadingly narrow definition of IRD as, “in general,” “those amounts to which a decedent was entitled as gross income but which were not properly includable in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent.” Reg. § 1.691-1(b). Thus, the term includes all accrued income of a decedent who reported his or her income by use of the cash receipts and disbursements method, all income accrued solely by reason of the decedent's death in the case of a decedent who reports his or her income by use of any accrual method of accounting, and income to which the decedent had a contingent claim at the time of his or her death. Reg. §§ 1.691(a)-1(b)(1), 1.691(a)-1(b)(3). The regulations define neither “accrued solely by reason of decedent's death” nor “contingent claims.”

   c) **Cases and Rulings**

      Cases and rulings have provided a more workable definition of IRD as those items of income substantially earned by a decedent on the date of death, that are not properly includable in the decedent's gross income prior to death under the decedent's method of accounting. For more than you really wanted to know about IRD, see also R. Danforth, N. Lane, & H. Zaritsky, Federal Income Taxation of Estates and Trusts, ch. 15 (Thomson-Reuters/WG&L, 3rd ed. 2001). Also see Crowell, Income in Respect of a Decedent Affects Both Income and Estate Taxes, 16 Est. Plan. 288 (1989); Maloney, Income and Estate Tax Impact of Income in Respect of a Decedent, 23 Est. Plan. 165 (May 1996); Maydew, How the Courts Interpret Income in Respect of a Decedent, 92 J. Tax’n 41 (Jan. 2000); Steinkamp, Identification of Income in Respect of a Decedent: The Case for Using Assignment of Income Precedents, 46 DePaul L. Rev. 367 (Winter 1997).

   d) **Common Forms of IRD**

      The most common forms of IRD are probably unpaid current compensation, deferred compensation, and company death benefits payable to beneficiaries of deceased employees, accrued interest and rents as of the time of a property owner's death, and the gain realized on a sale of property that occurs before death if the decedent reported the gain on the installment method. Certain executory sales contracts entered into by the decedent at death may also produce IRD, only if no material conditions remained to be satisfied by the decedent at the time of death.
E. Reverse Transfers in Contemplation of Death

1. Generally

Appreciated property acquired by a decedent who dies after 1981 takes a basis equal to the decedent’s basis immediately before death, if: (a) the property was acquired by the decedent by gift during the one-year period ending on the date of death, and (b) the property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the donor’s spouse). IRC § 1014(e). There are no regulations under IRC § 1014(e), and the IRS closed its regulations project on IRC § 1014(e) in 1986. I.R. 86-167 (Dec. 9, 1986). See also Siegel, I.R.C. Section 1014(e) and Gifted Property Reconveyed in Trust, 27 Akron Tax J. 33 (2011-2012).

a) Appreciated Property

"Appreciated property" means any property the fair market value of which on the day it was transferred to the decedent by gift exceeds its adjusted basis. IRC § 1014(e)(2)(A).

b) Property Sold by Estate

The basis of the proceeds of appreciated property acquired within one-year of the date of death and sold by the decedent’s estate or by a trust of which the decedent was the grantor is determined under “rules similar to the rules of paragraph (1).” IRC § 1014(e)(2)(B).

2. Timing

IRC § 1014(e) does not apply to property received from a decedent to whom it was given more than a year prior to death. One may, therefore, obtain a basis increase by transferring highly appreciated assets to a spouse whose health is seriously impaired. The gift can be returned to the donor through a bequest or device without additional estate or GST taxes but with a basis equal to the estate tax value of the property, provided that the donee spouse lives for more than one year. If the donee spouse does not live one year, the return of the gift will not yield a basis increase, but also will not produce any additional estate or GST tax.

a) Actual Date of Death is Crucial

The only timing issue under IRC § 1014(e) is whether the time between the gift to the decedent and the date of death exceeds one year. The chances that it would do so on the date of the gift are immaterial, unlike many other estate planning situations in which the health of an individual becomes important. A gift made to a decedent when he or she is in great health and almost certain to live decades, will still be subject to IRC § 1014(e) if the donee/decedent dies within one year of the gift.

b) Natural Death Declaration

One may question whether a spouse to whom a reverse gift in contemplation of death is made should have a natural death declaration (i.e., a living will). Such a document precludes the use of extraordinary measures to keep the client alive. If only a few additional days are needed to satisfy the one-year rule of IRC § 1014(e), the termination of extraordinary life prolonging measures may be inappropriate. A medical power of attorney, giving the agent the right to decide whether or not to use extraordinary measures to keep the decedent-to-be alive, might be more appropriate where time-sensitive estate planning has been undertaken.

3. Gifts That Do Not Return to the Donor Spouse
a) Generally

Property received from a decedent within one year of the gift of that property to the decedent is not subject to the transferred basis rule of IRC § 1014(e) if the recipient of the property is someone other than its donor or the donor’s spouse.

It is, therefore, important to evaluate how a donee spouse plans to utilize his or her applicable exclusion amount. An individual who wishes to make gifts to other family members and whose spouse is terminally ill and has an unused applicable exclusion amount should give appreciated assets to the terminally ill spouse, who then can make a specific bequest of those assets to the intended donees. This will result in a lower total tax burden than would have occurred had the healthy spouse made a gift of the appreciated asset to the donee because the donee will receive the asset free of any built-in taxable appreciation. This also can reduce estate taxes of the donor spouse because it leaves the donor spouse’s applicable exclusion amount available for other transfers, because the donor spouse’s transfer to the donee spouse is sheltered by the gift tax marital deduction.

This planning is especially true in light of the substantial increase in the unified gift and estate tax exclusion amount as a result of the 2017 Tax Act.

b) Leaving the Property to Others

A specific bequest or devise to someone other than the donor spouse is the easiest way to assure that the appreciated property does not pass back to the donor spouse, but the same result can be achieved if the donee spouse makes someone other than his or her spouse the joint owner with right of survivorship in the property.

c) Formula Gifts

The legislative history of IRC § 1014(e) states:

“The denial of a stepped-up basis applies where the donor receives the benefit of the appreciated property regardless of whether the bequest by the decedent to the donor is a specific bequest, a general bequest, a pecuniary bequest, or a residuary bequest. However, in the case of a pecuniary bequest, the donor will receive the benefit of the appreciated property only if the inclusion of the appreciated property in the estate of the decedent affected the amount that the donor receives under the pecuniary bequest.”


IRC § 1014(e) thereby denies a basis adjustment if, by increasing the decedent’s gross estate, the gift also increases the amount of the surviving spouse’s formula marital deduction bequest, even if the property given to the decedent is not itself used to satisfy that marital bequest. One noted commentator suggests that the result should be the same even if the bequest to the spouse assumes the form of a fractional share. Pennell, 843-3rd Tax Mgmt. Estate Tax Marital Deduction at ¶ III E and 2 Casner & Pennell, Estate Planning §10.7 (8th ed. 2012). To the extent that the donor’s gift increases the amount passing back to the donor, Prof. Pennell states that the surviving spouse should take a carryover basis in the property. This analysis seems reasonable, and if regulations are ever promulgated, a similar rule may be adopted.
d) Bequests in Trust

(1) “Directly or Indirectly”

The legislative history states that IRC § 1014(e) applies where property is transferred to the decedent and back to the donor “directly or indirectly.” H.R. Rep. No. 201, 97th Cong., 1st Sess. 188–189 (1981). The IRS has adopted this same language in its IRC § 1014(e) rulings. PLRs 9026036 and 9321050. A transfer to a trust of which the donor or the donor’s spouse is a beneficiary could be deemed an indirect transfer to the donor (or spouse).

(2) Portion Issues

The legislative history states that: “If the heir is only entitled to a portion of the property (e.g., because the property must be used to satisfy debts or administrative expenses), the rule applies on a pro-rata basis.” H.R. Rep. No. 201, 97th Cong., 1st Sess. 188–189 (1981).

(3) Property Left to the Donor Spouse in Trust

The right to the income from a trust or to receive principal for health, education, support, or maintenance, could be viewed as the right to a portion of the property. This leaves unanswered the computation of basis when the donor’s interest in the trust is not ascertainable by ordinary actuarial methods.

(a) Administrative Guidance

The only guidance is private rulings that are largely unhelpful.

(i) PLR 9026036

The first ruling to address this issue was PLR 9026036, in which W transferred property owned solely by her to two trusts, as tenants in common.

W’s Trust held its assets to pay income to W for life, then to H for life. W retained a power to dispose of the trust assets by her last will or by lifetime appointment, and in default thereof, the assets of W’s Trust would be distributed to W’s then-living issue.

H had a 30-day withdrawal right over H’s trust, after which he would become the income beneficiary, with a testamentary power to appoint the assets to the couple’s issue, and in default of appointment, the assets would be held in trust for W’s lifetime benefit, and then distributed to W’s then-living issue.

Among other things, the IRS stated that the assets of W’s trust would be includible in her gross estate, and their basis would, at her death, be their estate tax value under IRC §1014(a). With respect to H’s trust, the IRS first noted that H had a general power to appoint that trust to himself, which power lapsed, after which H retained an income interest, such that the trust assets should be included in his gross estate under IRC § 2041. The IRS stated:
“However, W reserved an interest for her life in the H’s Trust if she survives H and H does not exhaust the assets of the H’s Trust during the 30 day period described above. Because H is the donee of an income interest in the H’s Trust received from W, and she could receive back, upon H’s prior death, a similar income interest in the H’s Trust within one year of the creation of H’s Trust, section 1014(e) could be applicable to this case. If so, the basis of a portion of the assets of the H’s Trust would be the same as the adjusted basis of the assets at the time of H’s death. On the other hand, if H should survive longer than one year after the creation of the H’s Trust, and then die leaving W, as a survivor, section 1014(e) should not be applicable. In that case, basis to the extent of the income interest will be determined under section 1014(a).”

But ultimately it concluded:

“Because there exist two different possible answers that will be decided by future facts, the Service cannot rule on the basis issue with respect to the Husband’s Trust.”

Notwithstanding that ruling, the analysis provides that the disposition of an income interest in trust to the donor spouse is an indirect receipt of a retransfer of the original assets. The income interest is a clearly-ascertainable portion of a trust fund, so this result is somewhat less than amazing.

The IRS reconsidered part of PLR 9026036 three years later, in PLR 9321050 (May 28, 1993), but did not change its analysis with respect to IRC § 1014(e).

(ii) PLR 200101021

In PLR 200101021, H and W proposed to create a joint revocable trust and fund it with assets that they owned as tenants by the entirety. The trust also granted the first grantor to die a testamentary general power of appointment, exercisable alone and in all events, to appoint part or all of the assets of the trust to the deceased grantor’s estate or any other person. In default of the valid exercise of this power of appointment, the trust fund to which the power relates would be divided into a credit-shelter nonmarital trust and an outright marital share. The trustee would use the nonmarital trust for the surviving spouse’s support and maintenance, and for the maintenance, support, and education of the couple’s descendents.

The IRS ruled, in applicable part, that IRC § 1014(e) might apply. The IRS stated that, on the death of the first grantor to die, the surviving grantor would be treated as relinquishing his or her dominion and control over the surviving grantor’s one-half interest in the trust, and the surviving grantor would make a
completed gift for gift tax purposes of the surviving grantor’s entire interest in the trust, and this gift will qualify for the marital deduction under IRC § 2523. The IRS also stated that IRC § 1014(e) would apply to any trust property includible in the estate of the first grantor to die that is attributable to the surviving grantor’s contribution to the trust and that is acquired by the surviving grantor, either directly or indirectly, pursuant to the deceased grantor’s exercise, or failure to exercise, the general power of appointment. What the IRS did not do, however, is state whether and to what extent the passage of property to a trust for the benefit of the donor spouse and the couple’s descendants would be deemed to have passed to the donor spouse.

See also similar trusts and similar analysis in PLR 200210051.

(b) Best Analysis

The phrase “directly or indirectly” should be assumed to have some meaning in the context of a transfer in trust. As such, the most logical approach, though lacking primary authority of even the most non-precedential nature, is to treat a surviving donor spouse as having received indirectly any interest in a trust the value of which is ascertainable. Therefore, an income interest, remainder interest, or right to principal under an ascertainable standard should proportionately disallow the basis adjustment under IRC § 1014(e). Whether the trust is a QTIP or a non-marital trust ought not to be relevant for this determination. Again, however, this is just a logical approach to the issue, and there is no real authority that one can rely upon to support this interpretation. See, however, Siegel, I.R.C. Section 1014(e) and Gifted Property Reconveyed in Trust, 27 Akron Tax J. 33 (2011-2012).

(4) Disclaimers

In PLR 8628030, Husband had given stock to Wife before she died. Husband disclaimed his income interest and all other interests in the trust which Wife created and funded with the stock she had received from Husband and which was includible in her gross estate. The trust property, therefore, passed to the children, bearing the estate tax value as the basis. This appears to have been, among other things, a successful effort to defeat the operation of IRC § 1014(e).

4. Additional Planning Considerations

The benefits of a reverse gift in contemplation of death must be re-evaluated if: (1) state gift, estate, or inheritance tax laws do not include an unlimited marital deduction; (2) there is a serious risk that the donee spouse will divert the assets to someone else, intentionally (by gift) or unintentionally (by creditor claim); or (3) the donee spouse may need to qualify for state or federal programs for which the contributed assets may be a disqualifying or limiting factor in determining “financial need.”

F. Special Use Valuation

Property whose estate tax value is its special use as farm assets or closely-held business real estate, under IRC § 2032A, takes a basis equal to its estate tax value. IRC § 1014(a)(3).

G. Carryover Basis for Conservation Easement
Real property subject to a conservation easement that is excludible from a decedent’s gross estate under IRC § 2031(c) takes a basis equal to its basis in the hands of the decedent. IRC § 1014(a)(4).

H. Fiduciary Reinvestments

A fiduciary takes a cost basis in property that the fiduciary purchases or otherwise acquires by reinvesting property given to the fiduciary. The estate tax value basis rules do not continue to apply to property so acquired. Reg. § 1.1014-3(c).
V. KEY BASIS CONCEPTS: HOLDING PERIOD

A. Holding Period’s Importance

An asset’s “holding period” determines whether a gain or loss will be long-term or short-term. With respect to long-term gains, currently (and for the most part historically) the Federal income tax structure provides reduced (thus favorable) tax rates. By comparison, short-term gains are typically taxed at higher (thus unfavorable) rates. See, generally, IRC § 1(h) for the taxation of capital gains.

For more than thirty (30) years, the law has provided that capital assets held for one year or less generate short-term gains/losses, and assets held for more than one year (i.e., a year and a day) generate long-term gains/losses. IRC §§ 1222 (1) - (4)).

Historically, the Tax Reform Act of 1976 changed the holding period from a six-month to a one-year period. For a brief period of time (for property acquired from June 23, 1984 through December 31, 1987) there was a reversion to the six-month period. However, since 1988, taxpayers have been operating under the one-year period.

B. When Does the Holding Period Begin?

1. Generally

The holding period begins when the property is “held” or “acquired” by the taxpayer. In McFeely v. Comm’r, 296 U.S. 102 (1935), the Supreme Court ruled that, for holding period purposes, property is “held” by a taxpayer when he or she owns the property. To determine “ownership”, generally for tax purposes, one looks beyond “legal” ownership, and instead determines whether the purported owner has the “benefits and burdens” of ownership.

2. Acquisition Date is Disregarded; Sale Date is Included

For purposes of determining the holding period, the acquisition date is disregarded and the sale date is included. IRC §1223; Rev. Rul. 70-598, 1970-2 C.B. 168. Thus, the time clock begins running on the day after acquisition.

Example V-1

X purchased a capital asset, CA, on January 1, 2017. X sells CA on January 1, 2018. X has held the property for exactly one year (i.e., from January 2, 2017 to January 1, 2018; thus, gain or loss will be short-term.

Example V-2

Same facts as Example V-1, however, X sells CA on January 2, 2018. In this case, the gain or loss will be long-term, since X held the property for a year and a day.

In analyzing Example V-1, even though for state law purposes X has legal title to the property for a year and a day, for Federal income tax purposes, X’s holding period is only one year (i.e., because the date of acquisition is ignored).

In Fogel v. Comm’r, 203 F.2d 347 (5th Cir. 1953), when the holding period was six months, property purchased on June 19th and sold on December 19th of the same year the court held that the property was not held for more than six months. In Frederick v. United States, USTC ¶ 9195 (E.D. Mich. 1968), Mr. Frederick exercised his option rights and purchased General Motors common stock at 10 am on April 10, 1963, and he sold the same GM stock at 11:20 am on October 10, 1963, the court held that the GM stock was not held for more than six months. Thus, the Frederick case stands for the proposition that parts of days do not count.
3. “Tacking” of Holding Period

An asset’s holding period generally begins when a new owner acquires the asset. However, when property is received in a tax-free or non-recognition transaction (e.g., a tax-free exchange or gift), the new owner’s holding period will generally include the holding period of a prior owner. IRC § 1223.

This concept is known as “tacking”, because it is said that the prior owner’s holding period is added or “tacked” onto the holding period of the new owner. In estate planning, there are two common transactions that cause tacking: (1) exchanged basis transactions, and (2) transferred basis transactions.

a) Exchanged Basis Transactions

Exchanged basis transactions generally occur when there has been a sale or exchange, but the sale or exchange is fully or partially non-taxable. See, IRC § 7701(a)(44).

In this case, the holding period of the asset in the hands of the new owner includes the holding period of the prior owner. IRC § 1223(1) provides, if (a) in determining gain or loss on the sale or exchange the same basis (in whole or in part) is to be used by the new owner, and (b) the asset exchanged is either a capital asset (as defined in IRC § 1221) or an IRC § 1231 asset, then the new owner could use the exchanged asset’s holding period.

A good example of exchanged basis is when a family creates a family limited partnership (LP) (or limited liability company (LLC)). Generally, the formation of a LP (or LLC) is structured to be tax free under IRC § 721(a); however, on occasion, gain may be recognized under IRC § 721(b). For simplicity, we assume gain was not recognized.

(1) Exchanged Basis to the Partner

Under IRC § 722, the contributing partner’s (i.e., the new owner’s) basis in the LP interest is the amount of money and adjusted basis of the contributed property, increased by gain (if any) that may have been recognized under IRC § 21(b). Under IRC § 1223(1), the contributing partner’s holding period for the LP interest would be that of the assets that were given up in exchange. Thus, the new owner’s holding period for the partnership interest is said to be that of the holding period of the contributed assets.

(2) Exchanged Basis to the Partnership

Correlatively, the partnership’s basis in the contributed property (from the partner) becomes the adjusted basis in the hands of the contributing partner at the time of contribution plus any gain that may have been recognized under § 721(b). IRC § 723. IRC § 1223(1) provides that the partnership’s holding period in the contributed assets would be that of the partner immediately before the contribution.

Example V-3

X owns 100 shares of ABC stock which X bought on January 1, 2012 for $100. Y also owns 100 shares of ABC stock which Y bought on February 1, 2010 for $80. On July 1, 2018, when the stock price per share is $2 (i.e., total value contributed is $400 (i.e. 200 shares at $2 per share), X and Y each contribute their 100 shares of ABC stock to XY, FLP, forming a 50/50 partnership, where X will be the general partner
(GP) and Y will be the limited partner (LP). The contribution would not trigger gain under IRC §721.

On July 1, 2018 (the date of contribution) the basis of the GP interest in X’s hands will be $100 (IRC § 722), and, X’s holding period will be January 1, 2012 (IRC § 1223(1)). The basis of the LP interest in Y’s hands would be $80 (IRC § 722) and Y’s holding period would be February 1, 2010.

For XY, FLP, the basis of the ABC stock would be $180 (i.e., $100 (for the 100 shares contributed by X) and $80 (for the 100 shares contributed by Y)) (IRC § 723) and XY, FLP’s holding period for the 100 shares contributed by X would be January 1, 2012 and for the 100 shares contributed by Y it would be February 1, 2010 (IRC § 1223(2)).

b) Transferred Basis Transactions

(1) Generally

Transferred basis transactions generally occur when there is no sale or exchange, but property is transferred from the old owner (i.e., sometimes called the “transferor” or “donor”) to the new owner (sometimes called the “transferee” or “donee”). See, IRC § 7701(a)(43).

In estate planning this happens whenever there is a gift. There are different rules that apply for gifts of appreciated property (i.e., where the fair market value of the gifted property is greater than its adjusted basis), and gifts of depreciated property (i.e., where the fair market value of the gifted asset is less than its adjusted basis).

(a) Gifts of Appreciated Property

As discussed above in section III.D above, IRC § 1015(a) provides that if appreciated property is gifted, the donor’s basis will become the donee’s basis. IRC § 1223(2) provides that if the donor’s basis becomes the donee’s basis, in whole or in part, the donor’s holding period is transferred to the donee. Thus, the donor’s holding period for gifts of appreciated property tacks to the donee.

Example V-4

On January 1, 2018, P purchased 20,000 shares of Dapple stock for $1 per share (totaling $20,000). On February 1, 2018, when Dapple’s value was $1.50 per share, P gifted 20,000 shares of Dapple to Q. Under IRC § 1015(a) P’s basis of $20,000 would become Q’s basis. Thus, under IRC § 1223(2), P’s holding period would be transferred to Q. Thus, Q’s holding period for the 100 shares of Dapple stock would begin on January 1, 2018.

(b) In Whole or in Part

The reference in IRC § 1223(2) to the term “in whole or in part” is designed to encompass situations where the transferor’s basis is increased for example by gift taxes paid under IRC § 1015(d).
(c) Gifts of Depreciated Property

Holding period follows the rules with basis for gifts of depreciated property. As set forth above in section III.E above, there are three different scenarios that could arise when the gifted, depreciated property is sold or exchanged.

● Scenario 1: The selling price could be greater than the adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee).

● Scenario 2: The selling price could be less than adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee), but greater than the fair market value at the date of the gift.

● Scenario 3: The selling price is less than the adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee) and it is also less than the fair market value of the property at the date of the gift.

Each of these scenarios generates a different result and accordingly a different holding period.

(i) Scenario 1 – Gain Recognized

In Scenario 1, the fair market value of the property on the date of the later sale is greater than the adjusted basis at the time of sale; thus, a gain will be recognized. IRC § 1015(a) requires that the adjusted basis shall be the transferred basis (as it may have been required to be adjusted in the hands of the donor). In this case, the holding period is determined under IRC § 1223(2) because basis in the hands of the donee was determined, in whole or in part, by basis in the hands of the donor.

Example V-5

Donor buys a share of Acme stock for $100 on January 1, 2018. Donor gives the stock to Donee on March 1, 2018, when the fair market value of the stock is $80. On October 1, 2018, Donee sells the stock for $125.

In this case since Donee sold the stock for more than the basis in Donor’s hands, Donee’s basis is the Donor’s basis, and Donee is allowed to tack Donor’s holding period from January 1, 2018. Thus, Donee would recognize a long-term capital gain.

(ii) Scenario 2: No Gain – No Loss

In Scenario 2, the fair market value of the property on the date of the later sale is between the adjusted basis and the fair market value on the date of gift. In this case there is no gain or no loss recognized. Since holding period is used to determine if a gain or loss is long-term or short-term, there is no need to determine the holding period, since there is no gain or loss. Thus, the determination of holding period is moot.
Example V-6

Same facts as Example V-5, however, on the date of the sale, the fair market value of the stock is $90. In this case, there is no gain and no loss, since the fair market value on the date of the sale is greater than the fair market value on date of the gift, but less than the adjusted basis was in Donor’s hands.

(iii) Scenario 3: Loss Recognized

In Scenario 3, the fair market value of the property on the date of the later sale is below both the adjusted basis and the fair market value on the date of gift. IRC § 1015(a) requires that for purposes of determining the loss, the donee/seller would use the fair market value on the date of the gift to determine the basis. If this is the case, then the basis in the hands of the donee is not determined “in whole or in part” by the donor’s basis. Thus, there is no tacking of the donor’s holding period under IRC § 1223(2); therefore, the holding period would begin to run on the date of the gift.

Example V-7

Same facts as Example V-5, however, on the date of the sale, the fair market value of the stock was $62. In this case, the basis to be used is the fair market value on the date of the gift (i.e., $80). Thus, Donee recognizes a loss of $18 (i.e., the difference between $80 and $62). Since the basis used by Donee is not determined “in whole or in part” by reference to Donor’s basis, Donor’s holding period is not tacked and Donee’s holding period starts on the date of the gift. In this case, the loss would be a short-term capital loss, since Donee has only held the stock for seven months (i.e., from March 1, 2018 to October 1, 2018).

(2) Exception – Given Property Included in the Donor’s Gross Estate

Where gifted property is later included in the donor’s estate, the holding period would be determined as if the property was inherited at death. See, discussion below titled, “Inherited Property – Deemed Holding Period”.

c) Part Gift – Part Sale

Situations arise where a transaction is considered partially a gift and partially a sale (i.e., the “part gift-part sale transaction”). For instance, when a donor ‘sells’ property to a donee at price that is below the asset’s fair market value, where the donee takes property subject to a debt, or where the donor makes a gift, and the donee agrees to pay the gift tax associated with the gift (i.e., the net gift concept).

For income tax purposes, the transaction is deemed to be two separate transactions: (1) a sale for the amount of the proceeds received (relative to the entire fair market value) of the property given up; and (2) a gift for the balance. For example, if Donor bought a widget for $50 many years ago, and later ‘sells’ it to Donee (Donor’ son) for $80, when the widget’s true fair market value is $100, then there is a sale of 80% (i.e., $80 / $100) of the
asset, and a gift of 20% (i.e., \(100\% - 80\%) \text{ or } \{([100 - 80] \div 100)\}) \text{ of the asset. In this example, since the basis is bifurcated, for sales purposes, the basis is } $40 \text{ (i.e., } 80\% \text{ of } $50) \text{ and for gift purposes, the basis is } $10 \text{ (i.e., } 20\% \text{ of } $50)\).

In part gift-part sale transactions, the holding period of the entire basis of the property will be tacked under the theory that the language “in whole or in part” under IRC § 1223(2) would apply. See, 

Citizens Nat’l Bank of Waco v. United States, 417 F.2d 675 (5th Cir. 1969)

**d) Inherited Property – Deemed Holding Period**

1. **Long-Term**

The general rule is that all inherited property (from a decedent) that is sold or exchanged receives long-term gain or loss treatment. The reason for this is that even if the property is sold within a year of death, IRC §§ 1223(9) and (10) provide that such sold property will have been deemed to have been held for more than one year (thus achieving long-term capital gain or loss treatment).

In the event that property was gifted by the decedent during life and is included in the decedent’s estate, the rules under IRC § 1223(9) and (10) would apply, instead of IRC § 1223(2).

It should be noted that IRC § 1223(9) and (10) provide that the person who disposes of the property must have “acquired property from a decedent or to whom property passed from a decedent (within the meaning of 1014(b)).” Thus, if a beneficiary gifts property received from an estate to the beneficiary’s child, for example, the beneficiary’s child does not get the automatic long-term gain treatment, rather such child’s holding period begins at the decedent’s date of death.

**Example V-8**

On January 1, 2018, P dies leaving his entire estate to his son, S. The estate distributed all of P’s assets to S on February 1, 2018. On February 2, 2018, S sells some of the assets that S received and recognizes a gain. S also gives some of the assets to his daughter, D. On February 3, 2018, D sells the gifted assets and recognizes a gain. S’s gain would be characterized as a long-term gain under IRC § 1223(9), however, D’s gain will not be afforded the long-term treatment under § 1223(9), rather it will be a short-term gain, because D did not “acquire property from a decedent.”

2. **Holding Period and the IRC § 1022 Election**

In the case of decedents who died after December 31, 2009, and before January 1, 2011, where IRC § 1022 applied, the automatic “more than one year” deemed holding period rule under IRC § 1223(9) would not apply. Instead the holding period under IRC § 1223(2), which is generally applies to gifts would apply. This position is supported by IRC § 1022(a) which provides that to the extent that § 1022 applies, then the property is treated as “transferred by gift.”

If the IRC § 1022 election is made and the basis is increased, the decedent’s holding period would become the beneficiary’s holding period. Rev. Proc. 2011-41, 2011-35 IRB 188, Sec. 0.06(1).

Interestingly, Rev. Proc. 2011-41 provides that to the extent that the recipient’s basis is acquired from the decedent under IRC § 1022, that the recipient’s holding
period of that property shall “include the period during with the decedent held the
property, whether or not the executor allocates any basis increase to that prop-
erty.” Thus, the revenue procedure appears to apply to basis increases.

Interestingly, the revenue procedure did not address the situation where the basis
is required to be decreased as a result of basis limitation rule under IRC §
1022(a)(2)(B). Thus, if the basis is to be decreased as a result of IRC
§ 1022(a)(2)(B), it is unclear whether the holding period would tack the dece-
dent’s holding period, or whether it begins at the decedent’s date of death. Fortu-
nately, this will be a very limited issue related to very few estates. And, it would
only apply for assets sold within a year of the decedent’s death.

C. Holding Period for Marketable Securities

For marketable securities transactions, when purchasing the security, whether equity (e.g., stocks) or debt
(e.g., bonds), the “trade date” or “contract date” starts and ends the holding period. Thus, since the acquisition
date is disregarded, when acquiring the security, the taxpayer’s holding period begins on the date after the
VI. KEY BASIS CONCEPTS: UNIFORM BASIS RULES

A. Generally

Property acquired from a donor or decedent has a single or uniform basis, even if multiple persons acquire an interest in the property. The uniform basis of the property remains fixed subject to the usual adjustments under IRC §§ 1016 and 1017 for capital additions and subtractions. Reg. §§ 1.1014-1(b), 1.1015-1(b). The point of the uniform basis rules is that the basis of the property is unaffected by the identity of the persons who own interests in it; whether the life tenant is old or young has no effect on the property’s basis. The regulations generally cross-reference the rules on recognition of gain under IRC § 1001(f).

B. Passage of Time

The value of the parts of the uniform basis represented by the respective interests of the life tenant and remainderman or other proportionate owners are adjustable to reflect the change in the relative values of such interest on account of the lapse of time. Reg. §§ 1.1001–1(l)(2), 1.1014–4(b), 1.1015-1(b). For example, the portion of the basis attributable to a remainder interest increases as the life tenants age or as a term-for-years becomes shorter. Conversely, portions of the basis attributable to a term interest tend to shrink as time passes. Both of these adjustments, however, may be offset by changes in the prevailing interest rates, since higher interest rates under IRC § 7520 generally increase the value of the term interest, while lower interest rates tend to increase the value of the remainder interest. The uniform basis in the property itself, however, remains constant.

C. Actuarial Calculations

1. Generally

The regulations use the actuarial factors contained in Reg. § 20.2031-7(d)(7) to determine the basis of the life interest, remainder interest, or term certain interests in property on the date such interest is sold, exchanged, or otherwise disposed of. Presumably, with respect to current gifts, the correct actuarial tables are those contained in Reg. § 25.7520-1. See Reg. §§ 1.1001–1(l)(3), 1.1014–5(a)(3), 1.1015-1(b).

Example VI-1

Securities worth $1 million and having a $500,000 adjusted basis are given by Donor to an irrevocable non-grantor trust for the lifetime benefit of Wife, remainder to Son. Wife is 48 years of age when she receives the life interest. The IRC § 7520 rate on the date of the gift is 2.2%. Under the IRS actuarial tables, Wife’s life estate is worth 48.042% of the value of the securities, or $480,420. Son’s remainder interest is worth 51.958% of the value of the securities, or $519,580. Wife’s share of the uniform basis on the date of the gift is $240,210 (48.042% x $500,000 uniform basis). Son’s share of the uniform basis on the date of the gift is $259,790 (51.958% x $500,000).

Example VI-2

Assume the same facts as in Example VI-1, except that Wife retains the life interest for 12 years, until she is 60 years of age. The IRC § 7520 rate has increased to 3.2%, and the securities have increased in value to $3 million. The value of Wife’s life estate is then $1,402,410 and the value of Son’s remainder interest is then $1,597,590. Wife’s share of the uniform basis on the 12th anniversary of the gift is 46.747% ($1,402,410 / $3 million), or $233,735 (46.747% x $500,000 uniform basis). Son’s share of the uniform basis on that date is 53.253%, or $266,265.
2. **Property Received from a Decedent**

The actuarial shares of the uniform basis in property received from a decedent is based on the value of the interests on the date of death, rather than the date of distribution or when the particular interest vests or becomes possessory. Reg. § 1.1014–4(a)(2).

**Example VI-3**

Securities worth $1 million on the date of Decedent’s death are left in trust for lifetime benefit of Wife, remainder to Son. Wife is 48 years of age when Decedent dies, but she is 50 years of age when the estate is settled and she receives the benefit of her life interest. The IRC § 7520 rate on the date of death is 2.2%. Under the IRS actuarial tables, Wife’s life estate is worth 48.042% of the value of the securities, or $480,420, based on the figures applicable on the date of death. This also represents her share of the trust’s uniform basis in the securities. Son’s remainder interest is worth 51.958% of the value of the securities, or $519,580 which also represents his share of the trust’s uniform basis.

**Example VI-4**

Assume the same facts as in Example VI-3, except that Wife retains the life interest for 10 years after receiving it (12 years after the date of death), when she is 60 years of age. The IRC § 7520 rate has increased to 3.2%, and the securities have increased in value to $3 million. The value of Wife’s life estate is then $1,402,410 and the value of Son’s remainder interest is then $1,597,590. Wife’s share of the uniform basis at that time is 46.747% ($1,402,410 / $3 million), or $467,470 (46.747% x $1 million basis). Son’s share of the uniform basis on that date is 53.253%, or $532,530.

3. **Property Sold to a Beneficiary**

The uniform basis rules do not apply when a trust or estate sells property to a beneficiary. The beneficiary’s basis in such property is determined under the usual basis rules applicable between unrelated persons. Reg. § 1.1014–4(a)(3).

**Example VI-5**

Trustee of Testamentary Trust transfers to Beneficiary, in satisfaction of a $100,000 specific bequest, securities worth $90,000 on the date of death and $100,000 on the date of distribution. Trustee realizes a $10,000 taxable gain and the basis of the securities in the hands of Beneficiary would be $100,000. Reg. § 1.1014–4(a)(3).

**Example VI-6**

Executor transfers to a trust property worth $2 million, which had a fair market value of $1.75 million for estate tax purposes, in satisfaction of the decedent's bequest in trust for the benefit of Wife of cash or securities to be selected by the executor in an amount sufficient to utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other property qualifying for the marital deduction). The estate realizes a $250,000 gain and the basis of the property in the hands of the trustees would be $2 million.

Had this bequest been a fractional share of the residuary estate, rather than a pecuniary amount, no gain would be realized by the estate upon transfer of property to the trust, and the basis of the property in the hands of the trustee would be its estate tax value.

D. **Sale of Term Interests**
1. Generally

Perhaps the oddest feature of the uniform basis rule is that gain or loss from the sale or other disposition (after October 9, 1969), of a term interest (a life interest or term-for-years in property or an income interest in trust) that was acquired by gift ‘so that the adjusted basis is determined under IRC § 1015 or IRC § 1041) or at death ‘so that the adjusted basis is determined under IRC § 1014), is determined by disregarding entirely that part of the adjusted uniform basis assignable to the term interest. IRC § 1001(e); Reg. §§ 1.1001–1(f)(1), 1.1014-5(b), 1.1015-1(b).

Example VI-7

Securities worth $500,000 are given by Donor to a trust to pay income to Wife for life, remainder to Son. Wife is 48 years of age when the life interest is acquired. The IRC § 7520 rate on the date of the gift is 2.2%. Under the IRS actuarial tables, Wife’s income interest is worth 48.042% of the value of the underlying securities, or $480,420. Son’s remainder interest is worth 51.958% of the value of the securities, or $519,580. Wife’s share of the uniform basis on the date of the gift is $240,210 (48.042% x $500,000 uniform basis). Son’s share of the uniform basis on the date of the gift is $259,790 (51.958% x $500,000). Wife sells her income interest to Nephew for $480,420 one week after the gift, when Wife is still 48 years of age and the IRC § 7520 rate is still 2.2%. Wife recognizes $480,420 of gain on the sale, because none of her share of the uniform basis is allocated to the sale.

Example VI-8

Assume the same facts as in Example VI-7, except that Wife retains the income interest for 12 years, until she is 60 years of age. The IRC § 7520 rate has then increased to 3.2%, and the securities have increased in value to $3 million. The value of Wife’s income interest is then $1,402,410 or 46.747% of the trust fund. The value of Son’s remainder interest is then $1,597,590, or 53.253% of the value of the trust fund. On that date, Wife sells her remaining income interest to Grandson for $1 million. Wife’s share of the uniform basis on the 12th anniversary of the gift is 46.747%, or $233,735. Wife recognizes a $1 million gain, rather than a $233,735 loss, on this sale, because her basis is ignored for purposes of calculating the gain or loss.

Example VI-9

Securities worth $1 million are left in trust to pay income to Wife for life, remainder to Son. Wife is 48 years of age on the date of death and the IRC § 7520 rate is 2.2%. Under the IRS actuarial tables, Wife’s income interest is worth 48.042% of the value of the underlying securities, or $480,420, which is also Wife’s share of the uniform basis. Son’s remainder interest is worth 51.958% of the value of the securities, or $519,580, which is also his share of the uniform basis. Wife sells her income interest to Nephew for $480,420 one week after the date of death, when Wife is still 48 years of age and the IRC § 7520 rate is still 2.2%. Wife recognizes $480,420 of gain on the sale, because none of her share of the uniform basis is allocated to the sale.

Example VI-10

Assume the same facts as in Example VI-9, except that Wife retains the income interest for 12 years, until she is 60 years of age. The IRC § 7520 rate has then increased to 3.2%, and the securities have increased in value to $3 million. The value of Wife’s income interest is then $1,402,410 or 46.747% of the trust fund. The value of Son’s remainder interest is then $1,597,590, or 53.253% of the value of the trust fund. On that date, Wife sells her remaining income interest to Grandson for $1 million. Wife’s share of the uniform basis on the 12th anniversary of the date of death is 46.747% of $1 million, or $467,470. Wife
recognizes a $1 million gain on this sale, because her basis is ignored for purposes of calculating the gain or loss.

2. Remainder Interests

This rule does not apply to the sale of a remainder interest, regardless of how it was acquired; such a sale is subject to the usual gain recognition rules for the sale of other assets, and the remainder owner’s share of the uniform basis is applied against the consideration received to determine the amount realized.

3. Unitrust Interests

The IRS construes the term “life interest” to include more than a pure life estate or lifetime income interest. It also includes, for example, a unitrust interest in a net income charitable remainder trust. See PLRs 200833012 (net income charitable remainder unitrust), 200827009 (net income charitable remainder unitrust), 200733014 (net income charitable remainder unitrust). Logically, this same analysis would extend IRC § 1001(e) to a lifetime annuity interest, a lifetime unitrust interest, or a lifetime right to discretionary distributions of income, principal, or both.

E. Sale or Disposition of Entire Interest

1. Generally

This rule does not apply to a sale or other disposition that is part of a transaction in which the entire interest in property is transferred to any person or persons. IRC § 1001(e)(3); Reg. §§ 1.1014-6(a)(1), 1.1015-1(b); PLRs 201136011 – 201136016, 201026014 – 201026017.

Example VI-11

Securities worth $1 million and having a $500,000 adjusted basis are given by Donor to a trust to pay income to Wife for life, remainder to Son. Wife is 48 years of age when the life interest is acquired. The IRC § 7520 rate on the date of the gift is 2.2%. Under the IRS actuarial tables, Wife’s income interest is worth 48.042% of the value of the underlying securities, or $480,420. Son’s remainder interest is worth 51.958% of the value of the securities, or $519,580. Wife’s share of the uniform basis on the date of the gift is $240,210 (48.420% x $500,000 uniform basis). Son’s share of the uniform basis on the date of the gift is $259,790 (51.958% x $500,000). Wife and Son sell their interests to Nephew for $1 million, in a single transaction one week after the gift, when Wife is still 48 years of age and the IRC § 7520 rate is still 2.2%. The sales proceeds are divided equally between Wife and Son. Wife realizes a gain of $259,790 ($500,000 - $240,210 basis) and Son realizes a gain of $200,210 ($500,000 - $259,790) on the sale.

Example VI-12

Securities worth $1 million are left in trust to pay income to Wife for life, remainder to Son. Wife is 48 years of age on the date of death and the IRC § 7520 rate is 2.2%. Under the IRS actuarial tables, Wife’s income interest is worth 48.042% of the value of the underlying securities, or $480,420, which is also Wife’s share of the uniform basis. Son’s remainder interest is worth 51.958% of the value of the securities, or $519,580, which is also his share of the uniform basis. Twelve years after the date of death, when Wife is 60 years of age, she the securities have increased in value to $3 million and Wife and Son sell their interests in the trust to Grandson for $3 million, dividing the sales proceeds equally between Wife and Son. The IRC § 7520 rate has then increased to 3.2%. The value of Wife’s income interest is then $1,402,410 or 46.747% of the trust fund. The value of Son’s remainder interest is then $1,597,590, or 53.253% of the value of the trust fund. Wife’s share of the uniform basis on the date of the sale is 46.747% of $1 million, or $467,470.
Son’s share of the uniform basis is 53.253% of $1 million, or $532,530. Wife realizes a $1,032,430 million gain on this sale ($1.5 million - $467,570), and Son realizes a $967,470 gain on this sale ($1.5 million - $532,530).

2. **Commuting Trusts**

The IRS deems the commutation of a trust, in which the term interest holders and remainder interest holders receive their respective shares of the underlying assets, as a sale of each beneficiary’s interest, to which IRC § 1001(e) applies. In a commutation, therefore, the term interest holder realizes gain equal to the amount realized, whereas the remainder interest holder realizes gain to the extent that the amount realized exceeds his or her basis in the remainder interest. See, e.g., PLRs 201136016 (noncharitable trust), 201136015 (noncharitable trust), 201136014 (noncharitable trust), 201136013 (noncharitable trust), 201026027 (noncharitable trust), 201026026 (noncharitable trust), 201026025 (noncharitable trust), 201026024 (noncharitable trust), 200833012 (net income charitable remainder unitrust), 200827009 (net income charitable remainder unitrust), 200733014 (net income charitable remainder unitrust), 200648017 (noncharitable trust), 200648016 (noncharitable trust), 200443023 (noncharitable trust), 200442020 (noncharitable trust), 200231011 (nonqualifying split-interest charitable remainder trust), 200210018 (noncharitable trust). On the other hand, if the trust is terminated by selling both the term and remainder interests to a third-party, the exception for transfers of the all interests in the trust applies and the selling term interest owner party can apply his or her basis to determine gain.

**F. Effect of Sale of Interest on Uniform Basis**

The sale of an interest in a trust or partial interest in property has no effect on the uniform basis, whether or not gain is recognized on the sale. Reg. §§ 1.1014-5(b) and 1.1015-1(b).

**Example VI-13**

Securities worth $1 million are left in trust to pay income to Wife for life, remainder to Son. Wife is 48 years of age on the date of death and the IRC § 7520 rate is 2.2%. Under the IRS actuarial tables, Wife’s income interest is worth 48.042% of the value of the underlying securities, or $480,420, which is also Wife’s share of the uniform basis. Son’s remainder interest is worth 51.958% of the value of the securities, or $519,580, which is also his share of the uniform basis. Wife sells her income interest to Nephew for $480,420 one week after the date of death, when Wife is still 48 years of age and the IRC § 7520 rate is still 2.2%. Wife recognizes $480,420 of gain on the sale, because none of her share of the uniform basis is allocated to the sale. The trust’s adjusted basis in the property remains $1 million, because the sale of Wife’s interest has no effect on the uniform basis. Nephew acquires an income interest per autre vie (during Wife’s lifetime), and Nephew’s share of the uniform basis is the same as Wife’s share would have been had she retained it.

**Example VI-14**

Assume the same facts as in Example VI-13, except that the property was rental real estate and that, rather than leaving it in trust, Wife was left a legal life estate and Son was left the remainder interest. Again, Wife’s life estate is worth 48.042% of the value of the property, or $480,420, which is also Wife’s share of the uniform basis. Son’s remainder interest is worth 51.958% of the value of the property, or $519,580, which is also his share of the uniform basis. Wife sells her life estate to Nephew for $480,420 one week after the date of death, when Wife is still 48 years of age and the IRC § 7520 rate is still 2.2%. Wife recognizes $480,420 of gain on the sale, because none of her share of the uniform basis is allocated to the sale. The adjusted basis in the property remains $1 million, because the sale of Wife’s life estate has no effect on the uniform basis. Nephew acquires a life estate per autre vie (for Wife’s lifetime), and his share of the uniform basis is the same as Wife’s share would have been had she retained it.
Assume the same facts as in Example VI-13, except that the property held by the trust is depreciable real property. Wife sells her life estate to Stranger for $600,000 five months after the date of death, when Wife is still 48 years of age and the IRC § 7520 rate is still 2.2%. Wife recognizes $600,000 of gain on the sale, because none of her share of the uniform basis is allocated to the term interest for this purpose. The uniform adjusted basis in the property remains $1 million, however, notwithstanding the fact that Wife sold her interest for more than her share of the adjusted basis. Stranger acquires an income interest per autre vie (for Wife’s lifetime). Stranger’s share of the uniform basis is $480,420—the same as Wife’s share would have been had she retained it—despite having paid $600,000 for the income interest. Gain or loss on sale of trust assets by the trustee will be determined without regard to the sale of Wife’s interest in the property. The trust’s depreciation deductions with respect to its assets will be made to the uniform basis of the property without regard to Wife’s sale. Stranger has only a $480,420 basis in his or her interest for purposes of future sales of his interest, despite having paid $600,000 for it. See Reg. § 1.1014–5(a)(1).

G. Depreciation and the Uniform Basis

1. Generally

The uniform basis is used to calculate depreciation, amortization, or cost depletion of the subject property. Reg. §§ 1.1014-5(b) and 1.1015-1(b).

a) Property in a Trust or Estate

IRC § 642(e) directs the practitioner to IRC §§ 167(d) (depreciation) and 611(e) (cost depletion) for directions on allocating these deductions between the relative interests of a trust or estate. Section 642(f) also states that certain amortization deductions are allowed to trusts and estates in the same manner as to individuals, but, again, must be apportioned between the fiduciary and the beneficiaries. Cost recovery deductions are allocable to beneficiaries directly, unlike other kinds of deductions that reduce the entity’s distributable net income (DNI). See Reg. §§ 1.167(h)-1, 1.611-1(c)(4), and 1.611-1(c)(5). For much, much more on the allocation of depreciation and depletion deductions for trusts, estates and beneficiaries, see R. Danforth, N. Lane, and H. Zaritsky, Federal Income Taxation of Trusts and Estates, ¶ 2.06 (Thomson-Reuters/WG&L, 3d ed.).

b) Allocation for Trusts and Beneficiaries

The regulations apportion cost recovery deductions for a trust to the fiduciary and to beneficiaries on the basis of their respective shares of trust income, unless by the terms of the instrument or local law the trustee is required to and does maintain a reserve for depreciation.

(1) Trustee’s Share

The trustee is allocated a share of depreciation regardless of whether the trustee is required to maintain a depreciation reserve or does so in his or her discretion. The deduction is first allocated to the trustee, to the extent of the reserve, so that it offsets what would otherwise be accumulated income taxable to the trustee.

(2) Beneficiaries’ Share

Any remaining deduction (in excess of the reserve provision) is allocated on the basis of the trust income (less the amount of income credited to the reserve) allocated to each beneficiary. The beneficiaries’ share of the deduction is divided
among the beneficiaries in accordance with their respective shares of trust income. Reg. § 1.167(h)-1(b)

Example VI-16

Trust provides that the trustee may distribute or retain net income, in the trustee's discretion, and that in determining the amount of available net income, the trustee may deduct and withhold a reasonable allowance for depreciation, which need not correspond to any allowable tax deduction.

In Year X, Trust generates net rental income, before deducting depreciation, of $80,000. Trust's depreciation allowance is $50,000. The trustee determines that $20,000 should be withheld from distribution to beneficiaries in order to reflect economic depreciation on the property so that the trust net income for fiduciary accounting purposes is $60,000. The trustee makes a distribution of $30,000 to Beneficiary-1 and retains the remaining $30,000 of net income, which it accumulates for future distribution.

The trust is allocated $35,000 of the total deduction ($20,000 reserve plus 50% of ($50,000 / $20,000)). Beneficiary-1 is allocated $15,000 of the total deduction.

Example VI-17

Assume the same facts as in Example VI-16, except that the trustee distributes $40,000 to Beneficiary-1 and $10,000 to Beneficiary-2, and retained only $10,000 of net income, plus the $20,000 provision for depreciation.

The depreciation is allocated as follows: $20,000 to Beneficiary-1, $5,000 to Beneficiary-2, and $25,000 to the trustee. The first $20,000 of the allowance was allocated to the trustee, and of the $30,000 remaining allowance, two thirds was allocated to Beneficiary-1, one sixth to Beneficiary-2, and one sixth to the trustee.

(3) Other Allocations Prohibited

No effect is given to any allocation of depreciation between the fiduciary and the beneficiaries that is inconsistent with these rules. Reg. § 1.167(h)-1(b). See also Dusek v. Comm'r, 376 F.2d 410 (10th Cir. 1967), aff'g 45 T.C. 355 (1966).

c) Allocation for Estates and Beneficiaries

The cost recovery deduction for an estate is allocated without regard to the provisions of the decedent's will: the deduction strictly follows the allocation of income. IRC § 167(d).

Example VI-18

Estate owns depreciable property on which the allowance is $40,000 in the current taxable year. During Year X, the estate's net income, before any deduction for depreciation, is $60,000. The personal representative distributes $15,000 (1/4 of the income) to Residuary Beneficiary, which it can deduct and which Residuary Beneficiary must include in gross income. Estate may deduct $30,000 of the depreciation allowance, and Residuary Beneficiary may deduct $10,000.
2. Property Not in Trust
   
a) Life Estate and Remainder

   When property is owned free of trust as a life estate and remainder, the cost recovery deductions are simpler to allocate. IRC § 167(d) states that:

   “In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.”

   IRC § 611(b), dealing with cost depletion of mineral interests, contains similar language. While depreciation and depletion are deductible in full by the life tenant, they are charged against the uniform basis of the entire property, thus reducing the basis of both interests.

b) Term-for-Years and Remainder

   Neither IRC § 167(d) nor 611(b) addresses the treatment of term interests other than life estates, such as terms-for-years. There appear to be no cases or rulings on point. The most logical approach is to treat a term-for-years like a life estate, as is done in IRC § 1001(e)(2), for purposes of determining gain or loss on the sale of a term interest. Of course, one could also argue that the existence of a specific rule for that limited purpose negates the ability to imply a similar rule for other purposes not covered by IRC § 1001(e)(2).

H. Transfer of a Remainder Interest at Remainder Owner’s Death

1. Remainder Owner’s Basis Not Adjusted

   No adjustment is made to the uniform basis of property held by a life tenant and remainder beneficiary, when the remainder beneficiary who holds his or her interest in fee, predeceases the life tenant. Reg. § 1.1014–8(a)(1).

2. Basis of Remainder Owner’s Heir, Legatee, or Devisee

   The basis of the remainder beneficiary’s heir, legatee, or devisee is determined by adjusting the portion of the uniform basis assigned to the remainder beneficiary under IRC § 1014, for the difference between the value of the remainder interest included in the remainder beneficiary’s estate, and the basis of the remainder interest immediately prior to the remainder beneficiary’s death. Reg. § 1.1014–8(a)(1).

3. Remainder of Distributed Property

   The basis of any property distributed to the heir, legatee, or devisee upon termination of a trust or legal life estate or at any other time (unless included in the gross income of the distributee), is determined by adding to (or subtracting from) the adjusted uniform basis of the distributed property the difference between the value of the remainder interest in the property included in the remainder beneficiary’s estate, and the basis of the remainder interest in the property immediately prior to the remainder beneficiary’s death. Reg. § 1.1014–8(a)(2).
VII. KEY BASIS CONCEPTS: PROVING BASIS

A. Keeping Records

As stated above, donors and donees should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value on the date of the gift. Reg. § 1.1015-1(g).

B. Lifetime Gifts – Failure to Keep Records

1. IRC § 1015(a)

If the donee of a gift does not have the facts necessary to determine the basis in the hand of the donor, IRC § 1015 puts the burden on the Service to obtain such facts from the donor or anyone who may know the facts. If it becomes impossible to obtain such facts, then the basis shall be the fair market value of such property as of the date or approximate date when the donor acquired the property. IRC § 1015(a); Reg. § 1.1015-1(a)(3).

2. Cases

a) Initial Burden -- IRS Can’t Ignore Facts

In Burnett v. Houston, 283 U.S. 223 (1931), the Supreme Court, citing to its earlier cases established that, “[t]he burden of proof to establish a deductible loss and the amount of it, clearly, was upon the respondent.” The court goes not to state:

“We cannot agree that the impossibility of establishing a specific fact, made essential by the statute as a prerequisite to the allowance of a loss, justifies a decision for the taxpayer based upon a consideration only of the remaining factors which the statute contemplates. The definite requirement of section 202 (a) (1) of the act is not thus easily to be put aside. The impossibility of proving a material fact upon which the right to relief depends simply leaves the claimant upon whom the burden rests with an unenforceable claim, a misfortune to be borne by him, as it must be borne in other cases, as the result of a failure of proof.”

Although the statement seems fairly harsh, the Supreme Court went on and found that there was sufficient evidence to establish that there was some evidence of the basis in the loss property. In finding for the taxpayer, the Court set a standard for the IRS in determining basis, stating,

“[The Commissioner] was bound to produce the best available evidence of value which the circumstances and nature of the transaction permitted. It does not appear that he made any attempt to do so.”

b) Close May be Good Enough - Cohan Rule

In Cohan v. Comm’r, 39 F.2d 540 (2nd Cir. 1930), Judge Learned Hand, on behalf of the Court of Appeals set forth what is sometimes now called the “Cohan Rule,” which allows taxpayers and the IRS to approximate the deductible item or basis in the absence of original documents that may otherwise establish absolute proof. See also, Cinelli v. Comm’r, 502 F.2d 695 (6th Cir. 1974), where basis of home in Italy was approximated, and Ternovsky v. Comm’r, 66 T.C. 695 (1973), where stamp collection value was approximated. In Cinelli and Ternovsky, the facts seem to show that the taxpayer provided sufficient extrinsic evidence to approximate basis.
In other circumstances, taxpayers have been able to show that there were past transactions and other extrinsic evidence (including expert testimony) that established that there was some basis in the property. *Burr v. Comm’r*, T.C. Memo 1966-112, and *Alameda Realty Corporation*, 42 T.C. 273 (1955).


c) Service’s Obligation

In *Caldwell & Co. v. Comm’r*, 234 F.2d 660 (6th Cir. 1956), rev’g 24 T.C. 597 (1955), the Court of Appeals reversed the Tax Court, and agreed with Tax Court Judge Bruce’s dissenting opinion. In Caldwell, the taxpayer sold shares of stock that were gifted to him. The taxpayer had no records to support: (1) the basis in the hands of the donor or the identity of the last preceding owner by whom the share were not acquired by gift, and (2) the fair value of the stock that was acquired by the donor, the prior owner or at the time of the gift.

The Tax Court’s majority held that since there was no such evidence, that the Service could attribute zero basis to the stock, resulting in taxing the entire proceeds from the sale to the taxpayer as gain. The Appeals Court’s opinion said that they disagreed with the Tax Court’s majority opinion and wholly agreed with the dissent, stating that they could add nothing to the dissent written by Judge Bruce (joined by two other judges).

The dissenting opinion (which is the Appeals Court opinion) cited to *Burnett v. Houston*, discussed above, stating that it is the taxpayer’s burden in the first instance to provide evidence, but once the taxpayer has provided what it has, it is incumbent on the Service to take the evidence and make a finding as to the basis. In situations where the taxpayer cannot determine the basis, but has relevant information, the burden is not on the taxpayer to prove the amount of basis. The Tax Court’s dissenting opinion found that there was sufficient evidence to find the fair market value of the stock around the time that the donor (or the last prior owner) acquired the property. See discussion below in the section titled, “Shifting the Burden of Proof – IRC § 7491”.

Caldwell stands for the proposition that if there is some evidence to prove basis, the IRS cannot ignore it, and must make an effort to determine the same.

C. Shifting the Burden of Proof – IRC § 7491

In general, the burden of proof is generally on the Taxpayer. Tax Court Rule 142(a); *Helvering v. Taylor*, 293 U.S. 507 (1935). If there is a court proceeding and the taxpayer produces credible evidence, complies with the requirement to substantiate the item in question, maintained all records required, and cooperated with reasonable requests by the IRS for witnesses, information, meetings and interviews, the burden will shift from the taxpayer to the IRS. Thus, taxpayers who may not have sufficient direct evidence of the basis, may wish to consider this approach, if they decide to go to court over the matter. See IRC § 7491.
VIII. KEY BASIS CONCEPTS: BASIS OF GIFTS INCLUDED IN THE DONOR’S GROSS ESTATE – A PROBLEM FOR GIFTS WITH STRINGS

A. Gifts in Trust or Split-Interest Gifts Included in the Gross Estate

If gift property is acquired from a decedent prior to his death by multiple persons with different interests, their shares of the basis are determined under the uniform basis rules, regardless of whether they are or are not included in the decedent’s gross estate. Reg. § 1.1014-6(b)(1). See discussion in section VI above for a discussion of the uniform basis rules.

B. Property Fully Included in Gross Estate

Where property is acquired from a donor and the donor dies and the entire property is included in the deceased donor’s gross estate (i.e., the uniform basis of the property, as well as the basis of each of the several interests). Reg. § 1.1014-6(b)(2).

Example VIII-1

Decedent gives 100 shares of X Corporation common stock to a trust for the benefit of A for life, remainder to B or to B’s estate. The basis of the stock on the date of the gift was $100,000. Decedent dies when the stock is worth $200,000. The transfer is includible in Decedent’s gross estate, because Decedent retained control over its beneficial enjoyment, which Decedent relinquished two years prior to death. The uniform basis of the property in the hands of the trustee, the life tenant, and the remainder beneficiary, is adjusted to $200,000. Immediately prior to Decedent’s death, A’s share of the uniform basis of $100,000 was $60,000, and B’s share was $40,000. Immediately after Decedent’s death, A’s share of the uniform basis of $200,000 is increased to $120,000, and B’s share is increased to $80,000. Reg. § 1.1014-6(b)(2).

C. Property Partially Included in Gross Estate

1. Generally

Where only part of the property acquired from a donor before his or her death is included in the deceased donor’s gross estate, such as where the donor retained a reversion to take effect upon the expiration of a life estate in another, the uniform basis of the entire property is determined by taking into account any basis adjustments under IRC § 1014(a) resulting from the partial inclusion.

The uniform basis is the adjusted basis of the entire property immediately prior to the decedent's death, adjusted by an amount which bears the same relation to the total appreciation or diminution in value of the entire property (over the adjusted basis of the entire property immediately prior to the decedent's death) as the value of the property included in the decedent's gross estate bears to the value of the entire property. Reg. § 1.1014-6(b)(3).

Example VIII-2

Decedent creates a trust to pay the income to A for life, remainder to B or B’s estate. The trust instrument provides that if Decedent survives A, the income shall be paid to Decedent for life. Decedent predeceases A, and only the present value of the remainder interest is included in Decedent’s gross estate. The trust consists of 100 shares of X Corporation common stock with an adjusted basis immediately prior to Decedent's death of $100,000. At the time of Decedent’s death, the stock is worth $200,000 and the remainder interest is worth $80,000. The uniform basis of the entire property following Decedent's death is $140,000, computed as follows:

| Uniform basis prior to death | $100,000 |
2. **Basis for Cost Recovery Purposes**

Where only a portion of the value of property is included in a decedent's gross estate, the basis for computing the depreciation, amortization, or depletion is the uniform basis for property received from a decedent, with several special limitations.

a) **Life Estate Excluded from Gross Estate**

The cost recovery deductions, where the value of the life interest is not included in the decedent's gross estate, the gross estate inclusion can increase, but not decrease, the uniform basis that existed immediately before death, with proper adjustments as required by IRC § 1016. Reg. § 1.1014-6(b)(3)(iii)(a).

b) **Life Tenant Does Not Share in Some Basis Increases**

Any remaining portion of the increase in the amount of cost recovery deductions resulting from any increase in the uniform basis of the property in these situations is not allowed to the life tenant, but rather is allowed to the trustee, to the extent that the trustee both: (a) is required or permitted, by the governing trust instrument (or under local law), to maintain a reserve for depreciation, amortization, or depletion, and (b) actually maintains such a reserve. If the trustee does maintain such a reserve, the remaining allowance shall be taken into account, under IRC § 1016 in adjusting the uniform basis of the property in the hands of the trustee and in adjusting the basis of the remainder interest in the hands of the remainder beneficiary, but shall not be taken into account, in determining the basis of the life interest in the hands of the life tenant. Reg. § 1.1014-6(b)(3)(iii)(b). See also Reg. § 1.1014–7 for a complex example of this rule.

3. **Cost Recovery Deductions During Before Donor’s Death**

The uniform basis of property acquired from a decedent before death must be reduced for depreciation, depletion, or other cost recovery deductions allowed in respect of the property during the decedent's lifetime, other than those allowed to the decedent personally. If only part of the value of the property is included in the decedent’s gross estate, the basis adjustment for the cost recovery deductions is proportionate, based on the portion of the value of the total property that is includible in the gross estate. Reg. § 1.1014-6(c)(1).

**Example VIII -3**

Decedent creates a trust to pay the income to A for life, remainder to B or B’s estate. The property transferred in trust consists of an apartment building with a basis of $5 million at the time of the gift. Decedent dies two years after the transfer and the gift is included in Decedent’s gross estate because Decedent retained a power to alter beneficial enjoyment, which Decedent relinquished two years prior to death. Depreciation on the property was allowed in the amount of $100,000 annually. On the date of death, the value of the property

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3 Determined by the following formula:

\[
\frac{\text{Increase in uniform basis}}{\text{Value of property included in gross estate}} = \frac{40,000}{10,000} = 0.04
\]

\[
\frac{\$20,000}{\text{Value of entire property}} = 0.04
\]

---

$140,000
was $5.8 million. The uniform basis of the property in the hands of the trustee, the life tenant, and the remainder beneficiary, immediately after Decedent's death, is $5.6 million ($5.8 million fair market value of the property immediately after Decedent's death, reduced by $200,000, deductions for depreciation allowed prior to Decedent's death). Reg. § 1.1014-6(c)(2), Ex. 1.

Example VIII-4

Decedent creates a trust to pay the income to A for life, remainder to B or B’s estate. The trust instrument provides that if Decedent survives A, the income shall be paid to Decedent for life. Decedent predeceases A and the present value of the remainder interest is included in Decedent’s gross estate for estate tax purposes.

The property transferred consists of an apartment building with a basis of $1.1 million at the time of the transfer. Following the creation of the trust and during the balance of Decedent's life, deductions for depreciation were allowed on the property in the amount of $100,000. At the time of Decedent's death the value of the entire property is $1.5 million, and the value of the remainder interest is $1 million. Accordingly, the uniform basis of the property in the hands of the trustee, the life tenant, and the remainder beneficiary is $1,266,666, computed as follows:
Uniform basis prior to decedent's death $100,000

+ Increase in uniform basis—before Reduction\(^4\) $ 33,333

\[\text{Uniform basis} = 133,333\]

- Deductions allowed prior to Decedent's death—taken into account under IRC § 1014(b)(9) \(^5\) ( 6,667)

\[\text{Uniform basis} = 126,666\]

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\(^4\) The reduction is determined by the following formula:

\[
\frac{\text{Increase in uniform basis to be determined}}{\text{$50,000 (total appreciation of property since time of transfer) \text{ included in gross estate)$}} = \frac{\text{$100,000 (value of property included in gross estate)$}}{\text{$150,000 (value of entire property)$}} = 133,333
\]

\(^5\) These deductions taken into account are determined by the following formula:

\[
\frac{\text{Prior deductions taken into account (to be determined)}}{\text{$10,000 (total deductions allowed prior to decedent's death) \text{ included in gross estate)$}} = \frac{\text{$100,000 (value of property included in gross estate)$}}{\text{$150,000 (value of entire property)$}}
\]
IX. KEY BASIS CONCEPTS: CONSISTENT BASIS RULES

A. Background

1. Generally

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Public Law 114-41, 129 Stat. 443 (the “Surface Transportation Act”) adopted new rules to improve the consistency between the adjusted basis of a recipient of property acquired from a decedent and the estate tax values of that property.

2. History

The Administration has included in its budget proposals for fiscal years 2009 – 2016 a suggestion that taxpayers who receive property from a decedent must use the relevant estate tax value as their basis, even if they disagree with the estate tax value selected by the estate. Under the Administration’s proposals, a taxpayer who received property from a decedent under conditions in which the basis is determined under Section 1014, would be required to use as his or her basis the value as reported for estate tax purposes ‘subject to later adjustments). A taxpayer who receives property by gift would be required to use as his or her basis the donor’s basis determined under IRC § 1015, and as reported for gift tax purposes ‘subject to later adjustments). A reporting requirement would be imposed on the executor of the decedent’s estate and on the donor of a lifetime gift to provide the necessary information to both the recipient and the IRS.

3. Enactment

The Surface Transportation Act added new IRC §§ 1014(f), 6035, 6662(b)(8), 6662(k), 6724(d)(1)(D), and 6724(d)(2)(II), create and provide for enforcement of two distinct sets of rules.

a) Section 6035

(1) Generally

New IRC § 6035 requires the executor of a decedent’s estate that is required to file a Federal estate tax return must also file a valuation statement (Form 8971) with the IRS and with each person acquiring any interest in property included in the decedent’s gross estate ‘schedule A).

(2) Statutory Requirements for Form 8971 and Schedule A

(a) Contents

The Code states that the statement must identify the value reported on the decedent’s estate tax return for each property interest and whatever other information the Secretary prescribes. IRC § 6035(a)(1). A similar valuation statement must be filed by a person other than an executor who holds a legal or beneficial interest in property that is included in a decedent’s gross estate, as to which the executor lacks sufficient information to prepare a complete return, and who is notified by the IRS that he or she is obligated to file an additional estate tax return. See IRC §§ 6018(b), 6035(a)(2).

(b) Filing Date

These valuation statements must be filed at such time as the Secretary prescribes, but not later than the earlier of: (a) the date 30 days after the date on which the estate tax return was required to be filed (including
extensions, if any); and (b) the date 30 days after the estate tax return was actually filed. IRC § 6035(a)(3)(A). Thus, an executor who files an estate tax return early must also file the valuation statements early; an executor who files an estate tax return late must still file the valuation statements within 30 days of the date the estate tax return should have been filed.

(c) Supplemental Statements

A supplemental statement reporting any later adjustment in the value of the property or any other information on these statements, must be filed not later to the date 30 days after the adjustment. IRC § 6035(a)(3)(B).

(d) Regulatory Authority

The Secretary is given broad authority to prescribe such regulations as necessary to carry out these reporting requirements, including adopting rules relating to the application of the valuation reporting requirements to property with regard to which no estate tax return is required to be filed, and situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property. IRC § 6035(b).

(3) Penalties

The valuation statement that must be filed with the IRS is an “information return” for penalty purposes, and the valuation statement that must be filed with the beneficiaries or other persons receiving property from a decedent is a “payee statement” for penalty purposes. IRC §§ 6724(d)(1)(D) and 6724(d)(2)(II). The penalty for failing to file a complete and timely valuation statement with either the IRS or a beneficiary is $250 ($100 for returns or statements required before 2016), with a $3 million maximum penalty for all failures during the same calendar year ($1,500,000 for statements required before 2016). If the failure to furnish the required statement is due to intentional disregard, the penalty is $500 ($250 for statements required before 2016) or if greater, 10% of the aggregate amount of the items required to be reported correctly. IRC §§ 6721(e) and 6722(e).

(4) Effective Date

The reporting requirements apply with respect to property with respect to which an estate tax return is filed after July 31, 2015 (the date of the enactment).

b) Section 1014(f)

(1) Generally

The Surface Transportation Act adds IRC § 1014(f), which states that the income tax basis of any property received from a decedent to which the basis adjustment rules of IRC § 1014(a) apply, cannot exceed the value of the property for estate tax purposes or, if an estate provides a statement to beneficiaries under new IRC § 1014(f)(1), 6035(a), the value reflected in that statement. IRC § 1014(f)(1).

(2) Background

(a) Basis Under Section 1014(a)
The income tax basis of property received from a decedent is most often determined under IRC § 1014(a), which creates a basis equal to the fair market value of the property at the date of the decedent's death or, if properly elected, the alternate valuation date.

(b) Presumptive Value

The value reported on a Federal estate tax return is presumed to be correct for purposes of determining the recipient's basis, but the beneficiary has always been able to establish a different date-of-death (or alternate valuation date) value for the property by his or her own analysis and evidence. See Reg. § 1.1014-3(a) (for purposes of IRC § 1014, “the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value”); Rev. Rul. 54-97, 1954-1 C.B. 113 (“the value of the property as determined for the purpose of the Federal estate tax shall be deemed to be its fair market value at the time of acquisition. Except where the taxpayer is estopped by his previous actions or statements, such value is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence”); TAM 19993001. See also Hawkinson v. Comm'r, T.C. Memo. 1972-32 (upholding the validity of Reg. § 1.1014-3(a), but characterizing it as establishing only an evidentiary presumption).

(c) Duty of Consistency

Courts have imposed a duty of consistency where the executor and the beneficiary are the same person or in privity. See Estate of Letts v. Comm'r, 109 T.C. 290 (1997) (wife's estate estopped from asserting that trust did not qualify for QTIP treatment); LeFever v. Comm'r, 100 F.3d 778 (10th Cir. 1996) (taxpayer was the executor of the decedent's estate); Cluck v. Comm'r, 105 T.C. 324 (1995) (estoppel applied because the taxpayer's spouse was executor and the spouses had filed joint tax returns for the years at issue); Beltzer v. United States, 495 F.2d 211 (8th Cir. 1974) (taxpayer was co-executor of the decedent's estate); Hess v. United States, 537 F.2d 457 (Cl. Ct. 1976), cert. denied, 430 U.S. 931 (1977) (testamentary trust whose trustees were executors of the estate). Courts have not estopped beneficiaries from arguing a different value than that reported on the estate tax return where such a close relationship did not exist. Ford v. United States, 270 F.2d 17 (Cl. Ct. 1960) (decedent's minor beneficiaries residing outside of the United States were not estopped from arguing a different value because they were not fiduciaries of the decedent's estate and had no knowledge of the decedent's estate tax return); Shook v. United States, 713 F.2d 662 (11th Cir. 1983) (estoppel not extended to an estate beneficiary for merely indicating approval of the executor's handling of the estate over which the executor had total control and the beneficiary none).

(3) Scope of New Statutory Rule

IRC § 1014(f) applies only to property whose inclusion in the decedent's estate "increased the liability for the "[estate tax] (reduced by credits allowable against such tax) on such estate." IRC § 1014(f)(2). The consistent basis rule will not, therefore, apply to estates that are not themselves taxable (after application of the available credits), or to property the transfer of which qualifies for the estate tax marital or charitable deduction. This appears to reflect the fact that the IRS is
placed in an especially difficult position when an estate reduces its estate taxes by using a lower value for an asset, and the recipient of that asset then reduces income taxes by using a higher value. The consistent basis rules will apply only where such a whipsaw could occur.

(4) Basis Determination under New Rule

For purposes of determining the basis of property for this purpose, the basis of property is determined for estate tax purposes if: (i) the value of the property is shown on an estate tax return and not contested by the Secretary before the expiration of the time for assessing a deficiency; (ii) the value of property is not shown on an estate tax return, but is specified by the Secretary and not timely contested by the executor of the estate; or (iii) the value is determined by a court or pursuant to a settlement agreement with the Secretary. IRC § 1014(f)(3).

(5) Broad Regulatory Authority

The Treasury Secretary is given broad authority to issue regulations providing exceptions to the application of the consistent basis rule. IRC § 1014(f)(4). This broad authority will make it difficult for taxpayers to challenge any reasonable approach taken by the Treasury in forthcoming regulations.

(6) Penalties

IRC § 6662(b)(7) imposes a penalty on a taxpayer who reports a basis that exceeds the basis determined under IRC § 1014(f). The penalty under IRC § 6662 is equal to 20% of the portion of the underpayment attributable to the inconsistent basis reporting. See IRC § 6662(a).

(7) Effective Date

The consistent reporting requirement applies with respect to property with respect to which an estate tax return is filed after July 31, 2015.

(8) 2018 Update

The Treasury issued a report highlighting efforts to reduce regulatory burden pursuant to President Trump’s mandate under Executive Order 13772, issued February 2017. Pursuant to that mandate, Treasury added to its “burden-reducing guidance” projects the regulations under Code Sections 1014(f) and 6035. Regulatory Reform Accomplishments under President Trump’s Executive Orders, U.S. Department of Treasury, April 24, 2018.

c) Revenue Estimate

The Joint Committee on Taxation estimated that this change in the law will raise $1.542 billion between 2015 and 2025. This is not an insignificant amount of money, but it will be raised at the expense of all estates that are above the applicable exclusion amount, and the reporting requirements, in particular, are likely to prove relatively time-consuming and, therefore, expensive for many executors and the estates they serve.

B. Delayed Filing Date

The Treasury has repeatedly delayed the filing date of the first Form 8971.

Not long after enactment of the Surface Transportation Act, the IRS provided that, despite the legislative requirement that executors and certain other persons to file a notice of the valuation of certain assets with beneficiaries and the IRS within 30-day after the estate tax return due date, effective July 31, 2015, the first such returns need not be filed until February 29, 2016.

The IRS noted that IRC § 6081(a) allows it to grant a reasonable extension of time for filing any return, declaration, statement, or other document, though except in the case of taxpayers who are abroad, no such extension shall be for more than 6 months. This IRS stated that this delay was needed to allow the Treasury Department and IRS to issue guidance implementing the reporting requirements of IRC § 6035.

The IRS also stated that executors and other persons required to file or furnish a statement under IRC § 6035(a)(1) or (a)(2) should not do so until the issuance of forms or further guidance by the Treasury Department and the IRS addressing the requirements of IRC § 6035, which the IRS and the Treasury expect to issue.


When guidance was not forthcoming promptly, the IRS again extended the filing date until March 31, 2016, for the first returns under IRC § 6035. The IRS again repeated its cautionary suggestion that persons should not attempt to file these forms until after the IRS has issued guidance.


The IRS again extended the filing date until June 30, 2016, for the first returns under IRC § 6035. The IRS noted that it had received numerous comments that executors and other persons “have not had sufficient time to adopt the systemic changes that would enable the filing of an accurate and complete Form 8971 and Schedule A.” As indicated above, the Treasury is reconsidering how to revise these regulations in light of the current administration’s mandate to make them less burdensome.


Temporary regulations issued on March 4, 2016, reiterate that executors or other persons required to file or furnish a Form 8971 or Schedule A before March 31, 2016, need not do so until March 31, 2016.

C. Section 6035 – IRS Guidance (Proposed Regulations)

1. Generally

The proposed regulations confirm that Form 8971, “Information Regarding Beneficiaries Acquiring Property from a Decedent,” including a Schedule A “statement) for each person who has received or will receive property from the estate or by reason of the decedent’s death, is the information return to which IRC § 6035 refers.

2. Who Must File

a) Generally

The proposed regulations confirm what the instructions state, that an executor who is required to file a Federal estate tax return also must file Form 8971 to report the final estate tax value of certain property, the recipient of that property, and other information prescribed by that form and instructions. The executor also is required to furnish a Statement
to each beneficiary who has acquired (or will acquire) property from the decedent or by reason of the death of the decedent to report the property the beneficiary has acquired (or will acquire) and the final value of that property. Prop. Reg. § 1.6035-1(a)(1).

b) **Surviving Joint Tenants or Other Recipients**

The preamble to the proposed regulations states that IRC § 6018(b) already requires that an executor who cannot make a complete return as to any part of the gross estate, must include on the return a description of that part of the gross estate and the name of every person holding a legal or beneficial interest in it. See Reg. § 20.6018-2. Upon notice from the IRS, any such person, such as a surviving joint tenant or other recipient who has better information than the executor regarding the basis or fair market value of the property received from a decedent, must make an estate tax return. Likewise, IRC § 6035 requires that a Form 8971 and Schedule A be filed by any person required to file an estate tax return under IRC § 6018(b), so these rules extend to joint tenants and other recipients in such cases.

c) **“Executor” Defined**

(1) **Generally**

The proposed regulations adopt the estate tax definition of “executor” contained in IRC § 2203 and expand it to include a person required to file a return under IRC § 6018(b). This rule applies for both reporting requirements under IRC § 6035 and the consistent basis requirement under IRC § 1014(f), discussed below. See Prop. Reg. § 1.1014-10(d).

(2) **Section 2203 Examined**

(a) **Code**

IRC § 2203 states that a decedent's “executor” means (i) the executor or administrator of the decedent's estate as properly appointed by the local court or (ii) if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent.

(b) **Regulations**

Reg. § 20.2203-1 states that:

“The term “person in actual or constructive possession of any property of the decedent” includes, among others, the decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding, as collateral, securities belonging to the decedent; and debtors of the decedent in this country."

(c) **Application**

It is not uncommon for some or all of a decedent's assets to be held in forms of title that do not require the probate of a will or the appointment of an executor. Where there is no executor or administrator appointed by a state court to oversee the estate administration (because there is no probate estate), a trustee of the decedent's revocable trust, a beneficiary
under the decedent's life insurance policy, or a beneficiary under a de- 
cendent's retirement plan will all be deemed “executors” of the decedent's 
estate for purposes of the modified carryover basis regime election. In 
such cases, all of these people will be required to file Form 8971 and 
Schedule A for the assets under their control.

3. Estates for Which No Form 8971 Required

No Form 8971 is required for an estate that is not required to file an estate tax return because it is 
below the filing threshold of IRC § 6018. Furthermore, no Form 8971 is required for an estate that 
files a return solely to make the portability election or a GST tax election or GST exemption allo-
cation, because these returns are not required by IRC § 6018. The proposed regulations do not 
explain how this should be reconciled with the statement in the portability regulations that “[a]n 
estate that elects portability will be considered, for purposes of subtitle B and subtitle F of the Inter-
nal Revenue Code (Code), to be required to file a return under section 6018(a),” Reg. § 20.2010-
2(a)(1). Subtitle F of the Code covers procedure and administration, and includes IRC § 6035, 
prompting some to speculate that the IRS could have extended IRC § 6035 to returns filed solely to 
elect portability.

4. Property to be Reported on Form 8971 and Schedule A

a) Generally

The property that must be reported on Form 8971 (and Schedule A) includes all property 
included in the decedent’s gross estate for Federal estate tax purposes, except for four spe-

b) Excepted Assets

The Form 8971 does not include any of the following:

- Cash (other than a coin collection or other coins or bills with numismatic value). 

- Items of income in respect of a decedent (as defined in Section 691). Prop. Reg. 
  § 1.6035-1(b)(1)(ii). This will include, for example, retirement benefits.

- Tangible personal property for which an appraisal is not required under Reg. § 
  20.2031-6(b). This includes household and personal effects articles that do not 
  have a marked artistic or intrinsic value of a total of more than $3,000. Prop. Reg. 
  § 1.6035-1(b)(1)(iii).

- Assets that are sold, exchanged, or otherwise disposed of (and therefore not dis-
  tributed to a beneficiary) by the estate in a transaction in which capital gain or loss 

Example IX-1

D’s gross estate includes the contents of D’s residence. The executor attaches to 
the required estate tax return a room-by-room itemization of household and per-
sonal effects, as required by the regulations under IRC § 2031. All articles are 
named specifically. Each room contains a number of articles, none of which has 
a value in excess of $100. A value is provided for each named article. Included 
in the household and personal effects are a painting, a rug, and a clock, each of 
which has a value in excess of $3,000. The executor obtains an appraisal from a 
disinterested, competent appraiser of recognized standing and ability, or a dis-
interested dealer in the class of personal property involved for the painting, rug, and
clock, and attaches these appraisals to the estate tax return. The reporting requirements of IRC § 6035 apply only to the painting, rug, and clock. Prop. Reg. § 1.6035-1(b)(2), Ex. 1.

Example IX-2

D’s estate includes shares in C, a publicly traded company. After D’s death but before the estate tax return is filed, C is acquired by T, another publicly traded company, for cash and stock of T, in a fully-taxable exchange. The reporting requirements of IRC § 6035 do not apply to the new shares in T or the cash. Prop. Reg. § 1.6035-1(b)(2), Ex. 2.

c) What is Cash?

The exception for “cash” is particularly confusing, as the Code and regulations are replete with uses of the term “cash,” but there are few definitions and they tend to be inconsistent.

It may be noteworthy that the proposed regulations under Section 6035 do not refer to either “cash or cash equivalents” or to “currency.”

Regulations under several Code sections adopt various definitions of “cash,” generally including coins and currency of the United States, but sometimes also including cashier’s checks, traveler’s checks, or money orders and other bank drafts. See Temp. Reg. § 1.71-1T, A-5; Reg. § 1.6050I-1(c)(1)(ii)(B); Prop. Reg. § 1.42-18(c)(6)(i).

One may also note that IRC § 170(f)(17) states that, for purposes of charitable contributions, “No deduction shall be allowed under subsection (a) for any contribution of a cash, check, or other monetary gift unless the donor maintains as a record of such contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.” This suggests that “cash” and “check” are both monetary gifts, but that they are not necessarily the same as each other. Prop. Reg. § 1.170A-15(b)(1) also defines a “monetary gift” as including “a transfer of a gift card redeemable for cash, and a payment made by credit card, electronic fund transfer . . . , an online payment service, or payroll deduction.” This suggests that an electronic fund transfer or credit card payment may not be treated as a cash gift to a charity for purposes of the 60% limitation.

See also, Reg. §15a.453-1(b)(3)(i), involving the installment sales method, states “receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, . . . .” This states that a bank certificate of deposit or a treasury note are not cash, at least for some purposes.

No reasonable view of the word “cash” can include items that can have a basis other than their face amount. Similarly, any reasonable definition should include payment by check or credit card. It is less clear, however, whether cash includes, for this purpose, money market funds, bitcoins, traveler’s checks, or certificates of deposit.

With respect to foreign currency, the rules are not consistent. IRC § 643(i)(2)(A) states that “cash” includes “foreign currencies and cash equivalents” for purposes of the taxation of certain loans from foreign trusts. IRC § 6050I(d) (relating to returns filed by a business that receives a payment of more than $10,000 in cash) states that cash includes foreign currency and checks drawn on foreign currency. Reg. § 1.446-3T(g)(4)(C)(1), dealing with notional principal contracts, states that cash includes “U.S. dollars or cash in any currency in which payment obligations under the notional principal contract are denominated.” These limited definitions suggest that foreign currency and checks drawn on foreign currency are not necessarily “cash,” and that Congress and the IRS know how to state that, in
a particular context, cash specifically includes various foreign currencies and checks payable in foreign currency.

IRC § 6867(d) (dealing with certain persons found in possession of more than $10,000 of cash), states that cash includes a cash equivalent, and defines “cash equivalent” as including foreign currency and any bearer obligation. Again, context is important, this limited definition suggests that cash does not normally include foreign currency or bearer obligations, or other “cash equivalents.”

d) IRD that Has a Basis?

The exception for items of income in respect of a decedent leaves unclear the treatment of items of IRD that have a basis, such as promissory notes or retirement benefits to which the decedent had contributed. One could reasonably either view those items as IRD exempt from the reporting requirement, or as a combination of exempt IRD and an asset that requires reporting. Either approach is arguably correct, though the safer approach is for a practitioner to err in favor of reporting, rather than not reporting. There are penalties for not reporting the estate tax value of an asset that should have been reported; there are no penalties for reporting the estate tax value of an asset that did not need to be reported.

e) “Pick and Choose” Clauses

One could also argue that an executor who has a “pick and choose” power and can satisfy a bequest with any asset, should report to each beneficiary the value of all assets other than these excluded assets that could be used to satisfy the bequest. This clearly would not be true if the cash legacy included a statement that “This gift shall, in all events, be satisfied only in cash and may not be satisfied by distributions of property other than cash.”

This analysis is more complicated than it at first appears. An estate or trust must recognize all realized gain or loss on the distribution of property in satisfaction of a cash legacy. Reg. § 1.661(a)–2(f)(1); Kenan v. Comm’r, 114 F.2d 217 (2d Cir.1940), aff’g 40 B.T.A. 824 (1939); and Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), aff’d per curiam, 83 F.2d 1019 (2d Cir.1936). The distribution of property in satisfaction of a pecuniary bequest should be a disposition “in a transaction in which capital gain or loss is recognized.” The proposed regulations do not state when the distribution must occur. Therefore, the best analysis is that the executor can reasonably determine that a cash legacy will either be satisfied in cash or satisfied by a disposition in a transaction in which capital gain or loss is recognized.

One should also recognize that the reference in the proposed regulations to a transaction in which capital gain or loss is recognized includes a transaction in which no gain or loss is recognized because the value of the asset is the same as its basis. The phrase “transaction in which gain or loss is recognized” is used throughout the Code and regulations, and it defines a class of transactions in which a carryover basis is not allowed and gain or loss is not deferred.

An executor who really does not want to file Form 8971 and Schedule A could consider selling the estate assets (other than cash, IRD, and limited amounts of tangible personal property), before the estate tax return is filed. This would leave only assets exempt from reporting on the Form 8971. That seems a bit of an extreme solution, but it is available and the executor who anticipates selling some assets may choose to do so earlier, rather than later, in order to avoid listing them on Form 8971.

f) Where Selecting the Funding is Unknown

Few estates can be distributed completely within 30 days after filing a federal estate tax return, and often the executor will not know the exact distribution of the estate's property
by the filing date of the Form 8971. This occurs when, for example, there are multiple residuary beneficiaries. The proposed regulations, like the Instructions, state that such an executor must report on the Schedule A for each beneficiary all of the property that could be used to satisfy that beneficiary’s interest. Prop. Reg. § 1.6035-1(c)(3). This means that there will usually be duplicate reporting of assets on multiple Schedules.

Note, however, that no supplemental Form 8971 is required when the assets are finally chosen for distribution, as long as the selected assets were already reported on Form 8971 and Schedule or, presumably, are excludible assets (such as assets acquired after the date of death). The executor can, but is not required to, file such a supplemental Form 8971 and Schedule A. Prop. Reg. § 1.6035-1(c)(3) (last sentence).

g) Beneficiaries Entitled to Receive Schedule A

(1) Generally

The proposed regulations state that each beneficiary (including a beneficiary who is also an executor) who receives property that is required to be reported on the Form 8971 must receive a copy of the Schedule A reporting the property distributable to him or her. Prop. Reg. § 1.6035-1(c)(1).

(2) Entities as Beneficiaries

As indicated in the instructions to Form 8971, where a trust, estate, or business entity is a beneficiary, rather than an individual, the executor must send Schedule A to the trustee, executor, or to the business entity itself, and not to the beneficiaries of the trust or estate or to the owners of the business entity. Prop. Reg. § 1.6035-1(c)(2).

(3) The Revocable Trust

If a decedent has a fully funded revocable trust, there would not usually be an executor and the trustee would be the “executor” for this purpose. The trustee would then file the Form 8971 and Schedule A with respect to all distributions from the trust to its beneficiaries.

If a revocable trust holds some, but not all, of the decedent’s assets and an executor is appointed, the executor must file Form 8971 and Schedule A with respect to distributions from the trust of those assets already held by the trust on the date of death. The trust is not a beneficiary of the estate, because it receives no distribution from the estate, so it seems inappropriate to view the trustee as the beneficiary.

The executor should, however, report assets poured-over to the trustee as a distribution to the trustee, without regard to the ultimate distributees of the trust. Neither the executor nor the trustee appears to have an obligation to file another Form 8971 or Schedule A with respect to re-distribution of the assets received by the trust from the estate. Note that a different rule is adopted, as discussed below, with respect to the supplemental Form 8971 and Schedule A that is required to be filed in certain situations, but the express adoption of a separate rule only in this limited situation supports the notion that no similar rule applies for filing the initial Form 8971 and Schedule A. See Prop. Reg. 1.6035-1(e)(4)(ii). Perhaps the final regulations will address this odd result, but at present, this appears to be the applicable rule.
(4) Trusts Created by Others

The executor must also file a Form 8971 and Schedule A with respect to assets held in trusts created by others, but included in the decedent’s gross estate, such as a QTIP or power of appointment trust created for the decedent’s benefit. The executor is treated, for this purpose, as possessing the trust assets, and so must report to the trust’s beneficiaries as if they were beneficiaries of the decedent’s estate. An executor cannot obtain information from the trustee with which to do the report must notify the IRS of this fact. The IRS will then require that the trustee file both an estate tax return, reporting those assets, and Form 8971.

(5) IRC § 645 Election

It is unclear whether an election under IRC § 645 to treat the revocable trust and the estate as a single entity for income tax purposes would alter this result.

(6) Life Tenants, Remainder Owners, Contingent Beneficiaries

The beneficiary of a life estate for purposes of IRC § 6035 is the life tenant; the beneficiary of a remainder interest is the remainder beneficiary (identified as if the life tenant were to die immediately after the decedent); and the beneficiary of a contingent interest is a beneficiary, unless the contingency has occurred prior to the filing of Form 8971. The executor must file a supplemental Form 8971 and Schedule A if the contingency subsequently negates the beneficiary’s inheritance. Prop. Reg. § 1.6035-1(c)(1).

The rule on contingent interests is problematic for several reasons. First, it means that the executor should give Schedule A to every person who could be a beneficiary under the contingency, which could be a substantial number of persons. Second, a contingency can negate a beneficiary’s inheritance at any point during the lifetime of the measuring lives (and subject to any applicable rule against perpetuities). This seems to impose on the executor a continuing obligation to file another Form 8971 and Schedule A years or decades after the estate is otherwise closed, if a contingency has caused the beneficiary’s interest to terminate. One can only hope that this will be clarified in the final regulations.

(7) Missing Beneficiaries

(a) Duty of Due Diligence

An executor must use reasonable due diligence to identify and locate all beneficiaries, but an executor who is unable to locate a beneficiary by the due date of Form 8971 is required to report this fact on that form and explain the efforts the executor has taken to locate the beneficiary and to satisfy the obligation of reasonable due diligence. Prop. Reg. § 1.6035-1(c)(4).

(b) The Late-Discovered Beneficiary

An executor who later locates the beneficiary must furnish the beneficiary with a Schedule A and file a supplemental Form 8971 with the IRS within 30 days of locating the beneficiary. Id.

(c) The Undiscovered Beneficiary

An executor who cannot locate a beneficiary and ultimately distributes the estate property to someone else who was not identified in the Form
8971 as the recipient of that property, must file a supplemental Form 8971 with the IRS and furnish the successor beneficiary with a Schedule A within 30 days after distributing the property. Id.

h) Due Date

(1) Generally

An executor must file Form 8971 with the IRS, and furnish each beneficiary with that beneficiary's Schedule A, on or before the earlier of the date that is 30 days after the due date of the Federal estate tax return (including any extensions actually granted), or the date that is 30 days after the date on which that return is filed with the IRS. Prop. Reg. § 1.6035-1(d)(1).

Thus, even if the estate tax return is not timely filed, the executor must still file the Form 8971 within 30 days after the date on which the estate tax return was due or face additional penalties. If the estate tax return is filed early, the due date for the Form 8971 is advanced to 30 days after the actual filing date.

(2) Estate Tax Returns Due Before August 1, 2015

The due date for the Form 8971 and Schedule A with respect to a Federal estate tax return that was due on or before July 31, 2015, but that was actually filed after July 31, 2015, is 30 days after the date on which the return is filed. Prop. Reg. § 1.6035-1(d)(1). Otherwise, the due date for the Form 8971 and Schedule A could be earlier than the actual effective date of Section 6035.

5. Supplemental Form 8971 and Schedule A

a) Mandatory Supplemental Form and Schedule

(1) Generally

A supplemental Form 8971 and Schedule A is required whenever there is a change to the information required to be reported that causes the reported information to be incorrect or incomplete. Prop. Reg. §§ 1.6035-1(e)(1) and 1.6035-1(e)(2). Such changes include, for example, the discovery of property that should have been, but was not, reported on the Federal estate tax return, a change in the value of property pursuant to an examination or litigation, or a change in the identity of the beneficiary to whom the property is to be distributed (for example, pursuant to a death or disclaimer).

(2) Due Date of Mandatory Supplemental Return

(a) Generally

A mandatory supplemental Form 8971 and Schedule A must be filed not later than 30 days after (i) the date on which the final value is determined; (ii) the date on which the executor discovers that information on the Form 8971 or Schedule A was incorrect or incomplete; or (iii) the date on which a supplemental estate tax return is filed reporting property not previously reported on the estate tax return. Prop. Reg. § 1.6035-1(e)(4).

(b) Event Occurs Before Distribution

If an event that determines the date for filing a supplemental Form 8971 and Schedule A occurs after the date of death but before or on the date
the property is distributed to the beneficiary from the decedent’s estate or revocable trust, the due date for the supplemental Form 8971 and Schedule A is not later than 30 days after the date the property is distributed to the beneficiary.

b) Optional Supplemental Form and Schedule

(1) Details of the Actual Distribution

An executor may, but is not required to, file Form 8971 or Schedule A to specify the actual distribution of assets from among a group of assets that were listed on a prior Form 8971 and Schedule A. Prop. Reg. § 1.6035-1(e)(3).

Example IX-3

D’s Will provided for D’s residuary estate to be distributed to D’s three children (E, F, and G). D’s residuary estate includes stock in X Co., a publicly traded company, D’s personal residence, and three paintings. On the due date of the Form 8971 and Schedule A, D’s executor had not yet determined which property each child would receive from D’s residuary estate in satisfaction of that child’s bequest. In accordance with Prop. Reg. § 1.6035-1(e)(3), D’s executor reported on Form 8971 and on each child’s own Schedule A that each child might receive an interest in the stock in X Co., the personal residence, and the three paintings. Several months later, the executor determined that E would receive the stock in X Co., F would receive the residence, and G would receive the paintings. No child will receive any assets not already reported on his or her Schedule A, so the executor may, but is not required to, file a supplemental Form 8971 and Schedule A to report accurately which beneficiary received what property. Prop. Reg. § 1.6035-1(e)(3)(ii), Ex. 1.

Example IX-4

D’s Will leaves D’s jewelry and household effects to be distributed among D’s three children (E, F, and G) as determined by the children. D’s executor reports on Form 8971 and on each child’s own Schedule A each item of personal property (other than items with an aggregate value of under $3,000). Several months later, the children agree who is to receive each item of personal property. The executor may, but is not required to, file a supplemental Form 8971 and Schedule A to report accurately which beneficiary received which items of personal property. Prop. Reg. § 1.6035-1(e)(3)(ii), Ex. 2.

(2) Inconsequential Error

An executor may, but need not, file Form 8971 or Schedule A to correct an inconsequential error or omission. Id. An “inconsequential error or omission” means any failure that cannot reasonably be expected to prevent or hinder the payee from timely receiving correct information and reporting it on his or her return or from otherwise putting the statement to its intended use. Reg. § 301.6722-1(b)(1). Errors or omissions relating to the following are never inconsequential (i) a dollar amount; (ii) the significant items in the address of a payee, which is the address provided by the payee to the filer; and (iii) the appropriate form for the information provided (i.e., whether or not the form is an acceptable substitute for an official form of the IRS). Id.
c) Due Date for Supplemental Form

Supplemental Form 8971 and Schedule A are due 30 days after: (i) the final value of property is determined; (ii) the executor discovers that the information reported on the Information Return or Statement is otherwise incorrect or incomplete; or (iii) a supplemental Federal estate tax return is filed. Prop. Reg. § 1.6035-1(e)(4). If these occur before the distribution to the beneficiary of probate or revocable trust property, a supplemental Form 8971 or Schedule A is not due until 30 days after the property is distributed.

This is likely to be approximately the same time when the executor would provide the beneficiary with information as to changes, if any, to the basis of the property that have occurred since the decedent's death and prior to the distribution. That basis adjustment information is not part of what is required to be reported under IRC § 6035, so if the executor chooses to provide that basis adjustment information on the Schedule A provided to the beneficiary, the basis adjustment information must be shown separately from the final value required to be reported on the beneficiary's Schedule A.

6. Subsequent Transfers

a) Generally

The Treasury states that IRC § 6035 reporting is intended to enable the IRS to monitor whether the basis claimed by an owner of the property is properly based on the final value of that property for estate tax purposes, so Treasury and IRS are attempting to eliminate some opportunities to circumvent the statute. The proposed regulations require that when a recipient of previously reported property (including unreported property that was required to be reported), distributes or transfers (by gift or otherwise, directly or indirectly) all or any portion of that property to a “related transferee” in a transaction in which the transferee's basis is determined in whole or in part with reference to the transferor's basis, the transferor must file with the IRS and furnish the IRS and the transferee a supplemental Schedule A documenting the new ownership of this property. Prop. Reg. § 1.6035-1(f).

This creates a chain letter effect, under which a beneficiary who disposes of an asset to a related transferee, other than by sale for full and adequate consideration, will need to file another Schedule A with both the IRS and the transferee, as if he or she were an executor. The practitioner should note this in the cover letter to the beneficiaries accompanying the Schedule A.

There is no time limit on the retransfer rules. The retransfer of property received from a decedent to a related transferee could occur decades after the original transfer, and still require the original transferee to file a Schedule A.

It is also unclear whether a subsequent retransfer by the first re-transferee requires yet another Schedule A. Unless the final regulations clarify this point, it is best to assume that all retransfers to related parties with a carryover basis, in whole or in part, no matter how long after the original distribution from the decedent’s estate or trust, must be reported on a new Schedule A filed with the transferee and the IRS.

b) “Related Transferee” Defined

The retransfer rules apply only to transfers to a “related transferee.” A “related transferee” means (a) a member of the transferor's family (as defined in IRC § 2704(c)(2)); (b) a controlled corporation or other entity in which the transferor and members of the transferor's family, whether directly or indirectly, have control (as defined in IRC § 2701(b)(2)(A) or (B)); and (c) any trust of which the transferor is a deemed owner for income tax purposes. Prop. Reg. § 1.6035-1(f).
c) **Covered Retransfers**

The related transferee rule applies both to transfers to a related transferee and distributions or transfers of property the basis of which is determined, in whole or in part, by reference to the basis of property that was reported on Form 8971. *Id.* Thus, for example, a transfer of property to a grantor trust requires a supplemental Form 8971 and Schedule A, and so should a distribution from such a trust to a family member of the original transferee.

d) **“Member of the Transferor’s Family” Defined**

IRC § 2704(c)(2) states that a “member of the family” of an individual means (i) such individual's spouse, (ii) any ancestor or lineal descendant of such individual or such individual's spouse, (iii) any brother or sister of the individual, and (iv) any spouse of any individual described in items (ii) or (iii). Prop. Reg. § 1.6035-1(f).

e) **“Controlled” Entity Defined**

IRC § 2701(b)(2) states that a corporation or other entity in which the transferor and members of the transferor's family, directly or indirectly, have control is a controlled entity, if the transferor and members of his or her family have (i) in the case of a corporation, at least 50% (by vote or value) of the stock of the corporation; or (ii) in the case of a partnership, at least 50% of the capital or profits interests in the partnership, or in the case of a limited partnership, the holding of any interest as a general partner.

(1) **Voting Rights**

Equity interests that carry no right to vote other than on liquidation, merger, or a similar event are not considered to have voting rights for purposes of corporate control. Generally, a voting right is considered held by an individual to the extent that the individual, either alone or in conjunction with any other person, is entitled to exercise (or direct the exercise of) the right. Voting rights held in a fiduciary capacity are not considered held by the fiduciary, but rather held by each beneficial owner of the interest and by each individual who is a permissible recipient of the income from the interest. A voting right does not include a right to vote that is subject to a contingency that has not occurred, other than a contingency that is within the control of the individual holding the right. Regs. § 25.2701-2(b)(5)(ii)(B).

(2) **Guaranteed Payments**

With respect to partnership control, any right to a guaranteed payment under IRC § 707(c) of a fixed amount is disregarded in making this determination. Regs. § 25.2701-2(b)(5)(iii).

f) **Retransfers and Trusts**

A trust will only be deemed a related transferee if it is a grantor trust deemed owned by the grantor for income tax purposes. Prop. Reg. § 1.6035-1(f). The regulations do not limit this to irrevocable grantor trusts, so that a transferee who retransfers property to a revocable trust would be required to file a new Schedule A, even though the trustee of that trust is not required to make such filings when it distributes the trust assets to the ultimate beneficiaries. This seems an unnecessary burden that could be alleviated in the final regulations.

It is strange that the proposed regulations do not require that a supplemental Schedule A be filed to report a gift to a trust that is not a grantor trust, even if the trust is solely for members of the transferor’s family. Such a trust is not, under the proposed regulations, a
“related transferee.” This is particularly odd, because the preamble to the proposed regulations states that this rule is an attempt to address "opportunities [that] may exist in some circumstances for the recipient of such reporting to circumvent the purpose of the statute (for example, by making a gift of the property to a complex trust for the benefit of the transferor's family).” The regulations, however, do not appear to treat such transfers as a further transfer requiring a Schedule A, unless the trust is a grantor trust.

The regulations do not state what to do where property received from a decedent is then transferred to a trust that is not a grantor trust, but that later becomes a grantor trust. Arguably, the transferee (grantor) should file Schedule A when the trust becomes a grantor trust, but the regulations do not actually say this. In some ways, it would have been more logical for the regulations to state that any transfer to a trust for family members required another Schedule A, unless the trust was a grantor trust, because for income tax purposes a grantor trust is not a separate taxpayer from the grantor. This deserves clarification in the final regulations, but it is difficult to guess what that clarification might be. One possibility is that the regulations could just remove the grantor trust reference and require a new Schedule A to report a retransfer to any trust that has family members as beneficiaries, whether or not it is a grantor trust.

It is also not clear whether a distribution to a trust a trustee of which is a member of the transferor’s family will be treated as a distribution to a related transferee. Certainly, the trust is the beneficiary for purposes of IRC § 6035 reporting, but the proposed regulations on the consistent basis rule state that a trust is a related transferee only if it is a grantor trust. Thus, the best interpretation, pending further clarification, appears to be that the relationship between the transferor and the trustee of a transferee trust should be irrelevant.

7. Subsequent Transfers Before Final Value Determined

If a retransfer to a related person occurs before the final value of the property is determined (see discussion of Prop. Reg. § 1.1014-10(c), below), the transferor must provide the executor with a copy of the supplemental Schedule A reporting the new ownership of the property. When a final value is determined, the executor will then provide a supplemental Schedule A to the new transferee instead of to the transferor. The supplemental Schedule A is due no later than 30 days after the transferor distributes or transfers all or a portion of the property to the transferee. Prop. Reg. § 1.6035-1(f).

The proposed regulations do not, however, explain how the retransfer rule might apply where a decedent transfers property to a trust in which someone is given a limited power of appointment. The exercise of that limited power of appointment in favor of a related transferee appears to be a retransfer under these rules, but it is unclear whether the new Schedule A must be filed by the trustee or the holder of the power of appointment.

The proposed regulations also do not expressly state whether a testamentary transfer by a transferee is a retransfer for this purpose, but it should not be, for two reasons. First, the transferee’s death would produce a new basis, so the Schedule A reporting the original transferor’s estate tax value would be misleading and rather useless to the retransferee. Second, this would create a conflict with the statutory rule that a Schedule A should only be filed for estates that are required to file an estate tax return.

D. Consistent Basis Rule of IRC § 1014(f) – IRS Guidance (Proposed Regulations)

1. Generally

As noted above, IRC § 1014(f)(1) states that the basis of certain property acquired from a decedent cannot exceed that property's final value as determined for Federal estate tax purposes. This is the consistent basis rule. Prop. Reg. § 1.1014-10(a)(1).
This sets a highest basis – it does not set a floor on basis. A lower basis may exist with respect to property received from a decedent the basis of which is not determined with reference to the value of the property for estate tax purposes, such as items of IRD, assets transferred to the decedent within one year of the date of death and which are left back to the transferor, or stock of a domestic international sales corporation. See, IRC §§ 1014(c) (IRD), 1014(d) (stock of a DISC), 1014(e) (appreciated property acquired by decedent by gift within one year of death).

2. **Effective Date**

Starting with the date on which the final regulations are published, the regulations will apply to property acquired from a decedent by reason of the death of the decedent whose estate tax return was required to be filed after July 31, 2015. “Persons may rely upon these rules before the date of publication of the Treasury Decision adopting these rules as final in the Federal Register.” Prop. Reg. § 1.1014-10(f).

3. **“Final Value” Defined**

   a) **Generally**

   The taxpayer’s initial basis in property acquired from a decedent may not exceed the “final value” of the property. Prop. Reg. § 1.1014-10(a)(1). The “final value” of property received from a decedent is, in order of priority: (i) the value reported on the federal estate tax return, once the statute of limitations on assessment of deficiencies has expired without that value having been timely adjusted or contested by the IRS; (ii) otherwise, the value determined or specified by the IRS once the statute of limitations for assessment and for claim for refund or credit of estate tax have expired without that value having been timely contested; (iii) if neither of these rules apply, the value determined in an agreement, once that agreement is final and binding on all parties; or (iv) if none of these rules apply, the value determined by a court, once the court’s determination is final. Prop. Reg. § 1.1014-10(c)(1).

   The preamble explains that the IRS may specify a value for property by determining a value in the course of an audit, and if it determines a value different from the value reported, the final value is that value determined by the IRS, once that value can no longer be contested by the estate. If the value determined or specified by the IRS is timely contested by the estate, the final value is the value determined in an agreement that is binding on all parties, or the value determined by a court once the court’s determination is final.

   **Example IX-5**

   At D’s death, D owned 50% of Partnership P, which owned a rental building with a fair market value of $10 million subject to nonrecourse debt of $2 million. D’s sole beneficiary is C, D’s child. P is valued at $8 million. D’s interest in P is reported on a federal estate tax return at $4 million. The IRS accepts the return as filed and the time for assessing estate tax deficiencies expires. C sells the interest for $6 million shortly thereafter. The final value of D’s interest is $4 million under the consistent basis rule. Under Section 742 and the regulations thereunder, C’s basis in the partnership interest at the time of its sale is $5 million (the final value of D’s interest ($4 million) plus 50% of the $2 million nonrecourse debt). Following the sale, C reports taxable gain of $1 million. C has complied with the consistent basis rule. However, had the IRS adjusted the value of the partnership interest from $4 million to $4.5 million, and had the estate not contested that adjustment before expiration of the statute of limitations on assessment, the final value of D’s partnership interest would have been $4.5 million, requiring that C claim a $5.5 million basis at the time of sale and that C report gain on the sale of $500,000. Prop. Reg. § 1.1014-10(e), Ex. 1.
Example IX-6

At D's death, D's gross estate includes a residence valued at $300,000 encumbered by nonrecourse debt in the amount of $100,000. Title to the residence is held jointly by D and C (D's child) with right of survivorship. D provided all the consideration for the residence and the entire value of the residence was included in D's gross estate under Section 2040. D’s executor reports the value of the residence as $200,000 on the estate tax return for D's estate and claims no other deduction for the debt. Schedule A reports the value of the residence as $300,000. C sells the residence before the final value is determined for $375,000 and claims a gain of $75,000 on C's Federal income tax return. A court subsequently determines that the value of the residence was $290,000 and the time for contesting this value in any court expires before the expiration of the statute of limitations for assessing C's income tax for the year in which the property was sold. The final value of the residence is $290,000 and, because C claimed a basis in the residence that exceeds the final value, C may have a deficiency and underpayment. Prop. Reg. § 1.1014-10(e), Ex. 4.

b) Only Initial Basis Determined by Consistent Basis Rule

(1) Generally

IRC § 1014(f) applies only to determine the taxpayer’s initial basis in property received from a decedent. That basis may thereafter be adjusted for depreciation, depletion, capital improvements, sales and other events that otherwise affect basis. Prop. Reg. § 1.1014-10(a)(2).

(2) Decedent’s Debt Amortization

Post mortem payments on debts of the decedent do not affect basis. Id.

Example IX-7

At D's death, D owned (among other assets) a private residence that was not encumbered. D's sole beneficiary is C, D's child. D's executor reports the value of the residence on the estate tax return at $600,000 and pays the estate tax liability. The IRS timely contests the reported value and determines that the value of the residence is $725,000. The parties enter into a settlement agreement that provides that the value of the residence for estate tax purposes is $650,000. The final value of the residence is $650,000. Several years later, C adds a master suite to the residence at a cost of $45,000, and under Section 1016(a), C's basis in the residence is increased by $45,000 to $695,000. Subsequently, C sells the residence to an unrelated third party for $900,000. C claims a basis in the residence of $695,000 and reports a gain of $205,000 ($900,000 - $695,000). C has complied with the consistent basis requirement. Prop. Reg. § 1.1014-10(e), Ex. 2.

c) Basis Pending Determination of Final Value

The proposed regulations also state that, if no final value has been determined when the taxpayer's basis in the property becomes relevant (such as to calculate depreciation or gain or loss on the sale, exchange or disposition of the property), the taxpayer must use the value reported on the Form 8971 (the fair market value reported on the Federal estate tax return) to determine the taxpayer's basis for Federal tax purposes. If the final value is determined before the statute of limitations on assessment expires for any Federal income tax return of
the recipient on which the basis is relevant, and the final value differs from the initial basis claimed with respect to that return, a deficiency and an underpayment may result. Prop. Reg. § 1.1014-10(c)(2).

4. Property to which the Consistent Basis Rule Applies

a) Generally

The consistent basis rule applies only to property the inclusion of which in the decedent’s gross estate for Federal estate tax purposes increases the estate’s actual Federal estate tax liability. Prop. Reg. § 1.1014-10(b)(1).

b) Covered Property

(1) Includible in Federal Gross Estate

Property is covered by IRC § 1014(f) if it is includible in the decedent’s gross estate under IRC § 2031 or the taxable estate of a nonresident alien individual under IRC § 2106, if that inclusion generates a Federal estate tax liability in excess of allowable credits. Prop. Reg. § 1.1014-10(b)(1).

The only issue is the inclusion of the property in the gross estate for Federal estate tax purposes. The fact that there may be state, local, or even foreign estate taxes imposed is immaterial.

Note also that the regulations refer to property “that is includable in the decedent’s gross estate under Section 2031, any property subject to tax under section 2106. . . .” The reference to IRC § 2031 is odd for several reasons. First, IRC § 2031, despite its title, is a valuation provision, rather than an inclusion provision. It directs that the value of property that is included in the gross estate shall be its fair market value on the date of death, except as otherwise provided. It does not actually state that any particular property is includible in the gross estate. That is covered by IRC §§ 2033 – 2044. IRC § 1014(f) merely refers to property includible in the gross estate, so one should not try and read too much into the reference to IRC § 2031.

(2) Transferred Basis Property

Property is also covered by IRC § 1014(f) if it has a basis determined, in whole or in part, by reference to the basis of property that was includible in the decedent’s gross estate and that generated a Federal estate tax liability. Prop. Reg. § 1.1014-10(b)(1). Thus, for example, property obtained in a tax-free exchange for property to which IRC § 1014(f) applies also takes a mandatory basis under that subsection.

c) Excluded Property

(1) Deductible Property

The proposed regulations exclude property that qualifies for a charitable or marital deduction under IRC §§ 2055, 2056, or 2056A, because this property does not increase the Federal estate tax liability. Prop. Reg. § 1.1014-10(b)(2).

(2) Modest Amounts of Tangible Personal Property

The proposed regulations also exclude from the consistent basis rule any tangible personal property for which an appraisal is not required under Reg. § 20.2031-
6(b) (under $3,000 aggregate value of personal effects). It appears that the language issued by Treasury was to exempt lower-valued items of tangible personal property. However, the language was not quite exact, thus, some confusion exists as to what items of tangible personal property is exempt. See, generally, ABA Section of Real Property Trust & Estate Law letter to Treasury dated June 23, 2016, addressing the issues in the Proposed Regulations 1.1014-10 and 1.6035-1.

(3) Property Under the Available Credits

The proposed regulations also exclude from the consistent basis rule property reported on an estate tax return if no estate tax was imposed upon the estate due to allowable credits (other than a credit for a prepayment of that tax). Prop. Reg. § 1.1014-10(b)(2). Thus, an estate that generates no estate tax because of the unified credit, modest amounts of tangible personal property, and deductible bequests, is not subject to consistent basis rule. Prop. Reg. § 1.1014-10(b)(3).

Of course, such an estate is still required to file Form 8971 and Schedule A.

d) After-Discovered or Omitted Property (and the Dreaded “Zero Basis Rule”)

(1) Generally

The basis of property that is discovered after the filing of the Federal estate tax return or is otherwise omitted from that return, which had it been reported would have generated a Federal estate tax liability, takes a different basis under the consistent basis rule, depending upon whether the statute of limitations on the estate tax return has expired.

For an excellent discussion of the problems with the zero basis rule, including its possible invalidity, see Bramwell & Tucci, Treasury’s Proposed Zero Basis Rule: Will It Survive?, 159 TAX NOTES 683 (April 30, 2018).

(2) Property Reported within the Statute of Limitations on Assessing Estate Tax Deficiency

Where an estate tax return is filed, after-discovered or omitted property that is reported on a supplemental estate tax return filed before the expiration of the statute of limitation on assessment of deficiencies, takes an initial basis determined under the regular consistent basis rule. Prop. Reg. § 1.1014-10(c)(3)(i)(A).

(3) Property Not Reported within the Statute of Limitations

Where an estate tax return is filed, after-discovered or omitted property that is not reported on a supplemental estate tax return filed before the expiration of the statute of limitation on assessment of deficiencies, takes a final value and initial basis of zero. Prop. Reg. § 1.1014-10(c)(3)(i)(B).

(4) No Estate Tax Return Filed

Where an estate tax return should be filed but none has been filed, the basis of all property includible in the gross estate subject to the consistent basis requirement is zero, until the final value is determined, if it ever is determined. Prop. Reg. § 1.1014-10(c)(3)(ii).

Example IX-8
At D’s death, D owned various assets. D’s sole beneficiary is C, D’s child. D’s executor reports the value of the assets on the estate tax return and pays the estate tax liability. After the expiration of the statute of limitations for assessing an estate tax deficiency, D’s executor discovers property that had not been reported on the estate tax return, but which, if reported, would have generated additional estate tax on the entire value of the newly discovered property. For income tax purposes, C’s basis in the additional unreported property is zero. Had an estate tax return been required to be filed before discovering the additional property (and none in fact was filed) but, after the application of the applicable credit amount, D’s taxable estate including the unreported property would have been $200,000, the final value of all property included in D’s gross estate (other than excluded property) would be zero, until the executor files an estate tax return with the IRS pursuant or the IRS determines a value for the property. In either of those events, the final value of property reported on the return is determined in accordance with the usual consistent basis rules. Prop. Reg. § 1.1014-10(e), Ex. 3.

(5) Problems with After-Discovered or Omitted Property

The rules on after-discovered or omitted property raise several points of note.

(a) After-Discovered Cash

If the statute of limitations has expired or no return was filed, how does one treat after-discovered or omitted cash that has a zero basis? Since cash always is supposed to take a basis equal to its face value, it is possible that the receipt of the cash would be taxed as ordinary income under the tax benefit rule. On the tax benefit rule generally, see Bierman & Severin, Effect of Deduction Phase-Out on Tax Benefit Rule, 80 J. Tax’n 181 (Mar. 1994); Bittker & Kanner, The Tax Benefit Rule, 26 UCLA L. Rev. 265 (1978); Goldman, Tax Benefit Rule Affects Trusts and their Beneficiaries, 75 Pract. Tax Strat. 293 (Nov. 2005); Yin, Supreme Court’s Tax Benefit Rule Decision: Unanswered Questions Invite Future Litigation, 59 J. Tax’n 130 (1983).

(b) No Obligation to File a Supplemental Estate Tax Return

There appears to be no legal requirement that a supplemental estate tax return be filed to report after-discovered property. See discussion in Pratt & Karibjianian, Filing a Supplemental Estate Tax Return After Probate Litigation, 36 Est. Plan. 17 (Sept. 2009) (noting, in part, that the Supreme Court referred to an amended estate tax return as not required by statute and “a creature of administrative origin and grace.” Bada-racco v. Comm’r, 464 US 386, at 393 (1984)); see also CCM 1998-024. Thus, Treasury is arguably penalizing executors for not filing a return that they do are not otherwise required to file. Executors may, however, want to consider the relative merit of filing a supplemental estate tax return and incurring an estate tax of 40% on the after-discovered assets, in exchange for a higher adjusted basis. In most cases, the tax cost of the lost basis will be less than 40%, but the additional estate taxes may be charged generally against the residue, while the tax savings from the higher basis will accrue only to the beneficiary who receives the after-discovered property.

(c) Estates Near the Filing Threshold
The zero-basis rule poses a particular problem for executors of estates that are very near in value to the threshold amount for filing an estate tax return. If the assets are all marketable and there is no chance of an estate tax return being required, the executor need not file a return, but if there are assets whose value may be disputed, not filing a return could expose the beneficiaries to having a zero basis for all of the inherited assets. It may be better in such cases to file a return and report the values at below the filing threshold. That should avoid the zero-basis risk.

5. Penalties

IRC § 6662(b)(8) imposes an accuracy-related penalty on the portion of any underpayment of tax required to be shown on a return that is attributable to an inconsistent estate basis, which IRC § 6662(k) defines as arising if the basis of property claimed on a return exceeds its final value as determined under IRC § 1014(f). The proposed regulations clarify that this relates to the initial basis and that basis adjustments as a result of post mortem events, such as capital improvements or depreciation, will not result in accuracy-related penalties. Prop. Reg. §§ 1.1014-10(a)(2) and 1.6662-8(b).

E. Form 8971 and Instructions

1. Overview

On January 29, 2016, the IRS issued Form 8971, (Information Regarding Beneficiaries Acquiring Property from a Decedent), and the accompanying instructions, which must be used to provide this information to the IRS and the beneficiaries of a decedent’s estate.

a) Short

Form 8971 is a relatively short form (one page, plus a two page Schedule A. The real issue is Schedule A, which must be prepared for and provided to each beneficiary receiving property from an estate.

b) Caveat

Both the form and the instructions very specifically caution executors not to provide the entire Form 8971 to any beneficiary, in order to protect the identities and personal information of the other beneficiaries. Rather, the executor must provide Form 8971 and a copy of Schedule’s) A to the IRS and provide each beneficiary with only the Schedule A for that particular beneficiary.

2. Form 8971, Part I

Part I of Form 8971 provides the basic information to identify the estate and the executor, including the decedent's name, date-of-death, and Social Security Number, and the executor’s name, address, telephone number, and taxpayer identification number (TIN).

a) Multiple Executors

If there are multiple executors, the information in Part I is provided for the executor who signs the form, but that executor must attach a statement with the names, addresses, telephone numbers, and TINs of the additional executors.

b) Change of Address
Form 8822, (Change of Address) should be filed to report a change of the executor’s address. See instructions, page 3, columns 1 and 2.

c) **Alternate Valuation Date**

Part 1 also requires a notification whether the estate elected alternate valuation, and, if so, the alternate valuation date.

3. **Form 8971, Part II**

a) **Generally**

Part II of Form 8971 requires a statement of the number of beneficiaries who have received or are expected to receive property from the estate, and each beneficiary’s name, TIN, address, and the date the Schedule A is given to the beneficiary.

The form asks “How many beneficiaries received (or are expected to receive) property from the estate?” It does not ask “how many Schedule A’s are required to be filed with the Form 8971.” The number entered on Part II regarding the number of beneficiaries who are to receive estate assets will often be substantially higher than the number of Schedule A’s, because it will include beneficiaries who receive cash, items of IRD, minor amounts of tangible personal property, and assets acquired by the estate after the date of death. It seems likely that the IRS intended to ask for the number of beneficiaries who are going to receive Schedule A, but as they did not, you should answer the question that they do ask and accept that there will be a mis-matching of the number entered and the number of Schedules A. You may, however, wish to explain in the cover letter accompanying Form 8971 why these two figures are different.

b) **Trusts, Estates, Etc. as Beneficiaries**

The instructions explain that a beneficiary, for this purpose, can be an “individual, trust, or other estate who has acquired (or is expected to acquire) property from the estate.” Instructions, page 3, column 2. Clearly, therefore, testamentary transfers to a trust require only a single Schedule A to the trustee, rather than separate Schedules A to each beneficiary. This is logical, as the fiduciary of the distributee trust or estate will be the most likely person to report a gain or loss on the disposition of the asset.

4. **Form 8971 Filing, Generally**

a) **Executors Who Are Also Beneficiaries**

There is no special exception for executors who are also beneficiaries of the estate. The instructions state that an executor who is also a beneficiary and who has acquired (or is expected to acquire) property from the estate, must provide himself or herself a Schedule A and be included in the list of beneficiaries under Form 8971. Instructions page 3, column 2.

b) **TINs Count**

The IRS is adamant about obtaining the TIN for a beneficiary. The Instructions state that “[e]ntering ‘none,’ ‘unknown,’ or similar language, or otherwise failing to enter a TIN, will cause the form to be considered incomplete and may subject the estate to penalties.” Instructions, page 3, columns 2 and 3.

c) **Power of Attorney**
As with estate tax returns, the IRS will discuss an estate’s Form 8971 only with the executor of the estate, and not with the return preparer, unless a complete Form 2848, (Power of Attorney and Declaration of Representative) has been provided to the IRS.

d)  Preparers

Anyone who is paid to prepare the Form 8971 and/or any Schedule A must sign the form as a paid preparer and give a copy of the completed Form 8971 and/or Schedule A to the executor required to file the estate tax return or Form 706-A. “The preparer may, however, sign the return by rubber stamp, mechanical device, or computer software program.” Instructions, page 3, column 3.

e)  Responsible Persons

All executors shown on Form 8971 or listed on an attached statement are responsible for the reporting requirements under Section 6035, though only one signs the form. The return, like other returns, is signed under penalties of perjury and all executors are responsible for the information included on Form 8971 and Schedules A filed with the IRS or provided to beneficiaries. All executors are also liable for all applicable penalties for failure to file. Instructions, page 3, column 3.

5.  Who Must File

a)  Persons Responsible for 706, 706-NA, or 706-A

The instructions explain that an executor or any other person required to file a federal estate tax return (Form 706 or 706-NA) under Sections 6018(a) and 6018(b) or a qualified heir required to file Form 706-A under IRC § 2032A, must file Form 8971 and the Schedules A. Anyone required to file Form 8971 must also provide each beneficiary listed on the form with that beneficiary’s Schedule A.

b)  Portability-Only and GST Allocation Returns

The instructions state that the Form 8971 need not be filed by an executor who is not required to file an estate tax return because the gross estate plus adjusted taxable gifts is less than the basic exclusion amount, but the estate tax return “is filed solely to make an allocation or election respecting the generation-skipping transfer tax ... [or] to elect portability of the deceased spousal exclusion amount (DSUE).” Instructions, Page 1, column 2.

6.  Effective Date

Form 8971 is required only if the return is filed after July 2015, but it does not matter whether the return was actually required to be filed before that date. An executor filing an estate tax return after July 31, 2015 that was actually required to be filed before August 1, 2015 must file Form 8971 and Schedule(s) A.

7.  When to File

a)  Generally

The instructions state that the Form 8971 and the Schedules A must be filed not later than the earlier of (a) 30 days after the date on which the estate tax return (or Form 706-A) is required to be filed, or (b) 30 days after such a return actually is filed.
b) Extensions

The filing deadlines in the instruction reflect those set by IRC § 6035, and there is no provision in the statute for extensions of that date. It appears unlikely that extensions will be permitted, even under Reg. § 301.9100-3. Nothing in the form or instructions mentions obtaining an extension of the time to file this return and Schedules.

8. File Form 8971 Separately from the Estate Tax Return

a) Generally

Form 8971 is a separate filing requirement from the estate tax return (or Form 706-A), and the IRS cautions that it should never be attached to the estate tax return (or Form 706-A). It must be filed separately. Instructions, page 1, column 2.

b) What Happens if You File Them Together

The IRS does not state that it will treat a Form 8971 that is filed with the estate tax return as not having been filed for penalty purposes -- only that one should not do this. Some additional clarity on this issue would be helpful, though it seems unlikely that the IRS will treat as filed a Form 8971 that is actually filed with an estate tax return. Practitioners, therefore, should adopt the practice of filing Form 8971 in a separate envelope, though they may file it at the same time as the related estate tax return (or Form 706-A).

9. Where to File

File Form 8971 (including all Schedules A) must, for all estates, be filed with Department of the Treasury, Internal Revenue Service Center Mail Stop #824G, Cincinnati, OH 45999. Other than adding a mail stop, this is the same address at which estate tax returns (and Form 706-A) are required to be filed. Additionally, unlike the Form 706 or Form 706-A, where the IRS provides a separate address for a private delivery source (e.g., Fed Ex or UPS), there is no separate address for private delivery of the Form 8971 (and Schedules A), the instructions merely say to go to the IRS website and find the address, which would be the same address as one uses for filing an estate tax return (i.e., 201 W. River Center Boulevard, Covington, KY 41011, Attn: Submission Processing, Stop 31).

10. Schedule A

Section 6035(a)(2) requires that Schedule A be provided to “each other person who holds a legal or beneficial interest in the property to which such return [estate tax return or Form 706-A] relates.”

a) How to Provide

The instructions state that Schedule A can be provided to the beneficiary or the fiduciaries of a beneficiary trust or estate: (a) in person; (b) by email; (c) by U.S. mail to the beneficiary's last known address; or (d) by an approved private delivery service to the beneficiary's last known address (the approved private delivery services are listed in the Instructions). Instructions, page 1, column 3.

b) Certification

The executor (or other person required to file) must certify on Form 8971, Part II, Column D, the date on which Schedule A was provided to each beneficiary, and the instructions suggest that the executor should retain proof of mailing, proof of delivery, acknowledgment of receipt, or other information relevant for the estate's records. Instructions, page 1, column 3. They also state that a private delivery service can tell you how to get written proof of the mailing date. Instructions, page 2, column 1.
c) **Trust or Estate with Multiple Fiduciaries**

Where a trust or estate is a beneficiary and has multiple fiduciaries, the instructions state expressly that “providing Schedule A to one trustee or executor is enough to meet the requirement.” Instructions, page 3, column 2.

d) **Contents**

A beneficiary’s Schedule A must list all property acquired (or expected to be acquired) by the beneficiary. An executor who has not determined which beneficiary is to receive a particular item of property by the Form 8971 due date must list on the beneficiary’s Schedule A all items of property that could be used to fund the beneficiary’s distribution. The same property can, and often will, therefore, be reflected on more than one Schedule A. Instructions, page 4, column 1.

e) **Schedule A, Part 1**

Part 1 of Schedule A includes the basic identifying information, including the decedent’s name and Social Security Number, the beneficiary’s name and TIN, and the executor’s name, address and telephone number.

f) **Schedule A, Part 2**

(1) **Columns A and B – List of Assets**

Part 2 of Schedule A lists the items passing to the beneficiary. Part 2 requires that each item be numbered (column A) and described (column B).

(a) **Consistency**

The instructions state that the description of property acquired from the decedent should be the same as that reported on the estate tax return or Form 706-A, and should include the schedule and item number where reported on the estate tax return or Form 706-A.

(b) **Partial Interests**

If a beneficiary acquired (or is expected to acquire) a joint interest, a fractional interest, or any other interest in property which is less than 100%, the executor should indicate the interest that the beneficiary will acquire. Instructions, page 4, column 1.

(2) **Column C – Assets Increasing Estate Tax Liability**

The executor states on Column C whether the asset increased the estate tax liability. This is a “yes or no” question. There is no requirement that the executor explain why the asset did or did not increase the estate tax liability, or the amount of any such increase. IRC § 1014(f)(2) states that this rule applies to property the inclusion of which in the decedent’s estate actually increased the decedent’s estate tax liability. It would not be relevant to a nontaxable estate or to property qualifying for the charitable or marital deduction. Any property that qualifies for the estate tax marital deduction or the estate tax charitable deduction should be reported as not having increased the estate tax. Instructions, page 4, column 2.

(3) **Column D – Valuation Date**
The executor includes in Column D the valuation date, which will be either the date-of-death or the alternate valuation date.

(4) Column D – Estate Tax Return Value

Column E provides the estate tax return value of the asset or assets listed.

11. Thoughts on the Form and Instructions

a) You May Not Really be a Winner

One criticism of the new Schedule A is an annoying notice at the bottom of the Schedule A, which begins “You have received this schedule to inform you of the value of property you received from the estate of the decedent named above.” It seems highly unlikely that the person receiving Schedule A will, in fact, have received any property from the decedent’s estate by the time they receive Schedule A. In most taxable estates, no significant distributions will be made until the estate tax liability has been settled between the estate and the IRS. One cannot even request a closing letter until four (4) months after the return has been filed, so distributions will be delayed and the declaration in the Schedule A will almost always be false.

Another error in the form is the statement in Schedule A, Part II, that the value reported on Schedule A is the “estate tax return value.” There are situations in which the estate tax return may show a different value from that which should be reported on Form 8971, such as where there is non-recourse debt that affects the estate tax value of the property but that does not encumber the property received by the decedent. See Prop. Reg. § 1.1014-10(e), Ex. 4. The title to this column is likely to be confusing, and should be addressed in the cover letter accompanying Schedule A.

The executor will need to address this issue in the cover letter sent with the Schedule A, explaining that the Schedule A shows the estate tax value of property that the beneficiary may or may not actually receive, and that while this value may be relevant in determining basis, it may not actually reflect the basis of the property in the hands of the beneficiary. The beneficiary should be urged to consult a personal tax advisor to determine the beneficiary’s actual adjusted basis, since in most jurisdictions the attorney and accountant for the fiduciary do not actually represent the beneficiaries.

b) Over-Reporting Will Be the Norm

The requirement that the executor list all items of property that could be used to satisfy the beneficiary’s gift will, in many cases, mean that every residuary beneficiary must receive a list of all estate assets that have not been specifically bequeathed or devised. This both requires that the fiduciary prepare a number of relatively long Forms 8971 and Schedules As, and also that this mass of data will most often be incorrect. Most estates sell or buy some assets during estate administration, whether for investment purposes or to raise money for estate expenses and taxes. Such purchases and sales will alter the accuracy of the beneficiary’s Schedule A. The date for providing Schedule A to the beneficiaries is set by statute, so it is not clear how else the IRS could have handled this issue. A technical correction in the statute to require that the Schedule A be provided within 30 days of the date on which the assets are actually distributed would make far more sense and, one hopes, will be added by the next Congress to its already-impressive “to-do list.”

c) Caution: This Is Not Your Real Basis

Note also that no attempt is made to inform the beneficiary of his or her actual basis in the asset. The basis of depreciable or depletable assets of the decedent could be well below
the asset’s estate tax value but Form 8971 and Schedule A only requires that the estate tax value be reported.

d) **Why Stop at Just One**

The requirement that a supplemental Form 8971 and Schedules A be filed whenever there is an adjustment to the information that was reported means that all fiduciaries should expect to file several forms and Schedules during the administration of a taxable estate. Every time an asset reported on Form 8971 or a Schedule A is sold or other assets are bought, a supplemental Form 8971 and Schedule A should probably be filed.
X. BASIS PLANNING: BASIS AND PORTABILITY – PERHAPS THE MOST IMPORTANT QUESTION IN MARITAL DEDUCTION PLANNING

A. Generally

Portability is probably the single biggest change in planning for the married couple since the passage of the unlimited marital deduction in 1981. Much has been written about portability since its inception and there will be much more to come in the future. In light of this game changing evolution in marital planning, some question the efficacy of the traditional by-pass trust. For those, however, who choose to use the by-pass or credit shelter (which we call a “non-marital”) trust, with the increased basic exclusion amounts, it may be worth considering how to possibly include part or all of the by-pass trust’s assets into the survivor’s gross estate to accomplish a step-up at death. We discuss this in section XI.E below.

B. Factors Favoring Portability Type Plans

There is no single factor that favors portability; there are a number of factors. From a pure mathematical and tax perspective, however, we found that use of the traditional non-marital trust planning, is less beneficial than using a qualified terminal interest property (QTIP) trust, combined with subsequent giving to a grantor trust after the first spouse dies. See, Law and Zaritsky, Portability – So Many Questions, So Few Answers, 51st Heckerling Est. Pl. Inst. (2017), and Franklin and Law, Clinical Trials with Portability, 48th Heckerling Est. Pl. Inst. (2014).

1. Small Estates – Less than One Basic Exclusion Amount

Portability is probably most favorable where the anticipated combined gross estates of the couple will not be more than one spouse’s anticipated basic exclusion amount (currently $11,180,000 at the time of the writing of this paper in October 2018).

In cases such as this, if there are no asset protection issues, then perhaps consider holding assets jointly with rights of survivorship (or tenants by the entireties), for simplicity. If there is some concern with asset protection, consider having the first spouse’s estate pour into a QTIP trust for the benefit of the surviving spouse, with flexible provisions to allow an independent trustee to distribute the assets for the survivor’s best interest.

2. Medium Estates – Between One and Two Basic Exclusion Amounts

For those couples with estates that are anticipated to be greater than one basic exclusion amount, but less than two basic exclusion amounts, a portability-based estate plan may be also be the best viable alternative (over a traditional non-marital trust plan). By using a QTIP marital trust, since there will likely be no estate tax upon the survivor’s death, not only can one preserve all of both spouse’s GST exemptions (through the use of a reverse QTIP election), but one would also be able to obtain a basis adjustment (under IRC § 1014(b)(1)) in the assets that pass to the QTIP trust upon

the first spouse’s death, and obtain a second step up in basis with regard to all of the assets (i.e., those in the QTIP trust (by reason of IRC § 2044) and those owed by the survivor) on the survivor’s death (under IRC § 1014(b)(10)). This portability type plan reduces any built-in gain tax typically associated with traditional non-marital trust plans (imposed on the non-marital trust’s assets when later sold after the second spouse’s death).

Both the QTIP marital and non-marital trusts have asset protection qualities, and both will be able to preserve first spouse’s GST exemption. Thus, as to those issues there is really little or no difference between a portability type or traditional non-marital type plan.

3. Larger Estates – Over Two Basic Exclusion Amounts

For the larger estates, the portability type plan, purely from a tax perspective, is generally still a better plan. However, where there is a state death tax imposed either upon the first, second or both spouses’ deaths, a pure portability type plan may not be better. In those cases, it may be better to use a traditional non-marital type trust to absorb the state death tax credit, and to the extent that a QTIP trust can be used for assets in excess of the state death tax credit, that would be the preferable plan.

C. Factors Favoring Traditional Non-Marital Trust Plans

Going forward, non-marital trusts may be favored in those states where there is a state death tax credit, and no state portability provision. And, it would likely be favored only to the extent of the state death tax credit and if there is a state QTIP marital deduction. If there is no such state QTIP marital deduction, then perhaps using the non-marital to the extent of the federal basic exclusion amount may be the better alternative. Non-marital trusts may also be favored in 2nd, 3rd, 4th, etc., marriage situations; however, see Franklin and Karibjanian, Portability and Second Marriages – Worth a Second Look, BNA – Tax Management Estates, Gifts, and Trusts Journal, Sept. 11, 2014, where the authors suggest some planning that may make marital trusts viable in certain multiple marriage situations.

Non-marital trusts may also be worthwhile for those who already have such a plan, and the planner would find it difficult to change the plan for client reasons. Typically, this would be the case where the client is reluctant to consider any changes. Non-marital trusts may be worthwhile in cases where the client may be unable (due to some incapacity) to change the documents.

Some argue that non-marital trusts are worthwhile because the appreciation avoids future transfer tax (where there will be a taxable estate subject to tax on the survivor’s death). This argument has some merit, however, use of a marital QTIP trust (where there is a reverse QTIP election to preserve the GST exemption) combined with giving by the surviving spouse into an irrevocable grantor trust soon after the decedent-spouse’s death, is far superior from a tax perspective. The grantor trust captures any appreciation, and more importantly, the assets in the grantor trust grow income tax free while the survivor is alive, and there is a possibility that with proper attention, basis can be adjusted by “swapping” assets of equivalent value during the survivor-grantor’s lifetime. However, if this is too complicated for the survivor, or if there is concern that the survivor may not make the gift after the decedent-spouse’s death, then perhaps the non-marital trust approach has some merit.

D. Running the Numbers

The above suggestions for using portability type versus traditional non-marital plans only make sense when the planner runs the numbers, taking into consideration the impact of time (deaths of the spouses), taxes (transfer as well as income taxes) and returns (the rates of return and turn-over of assets). Additionally, the planner should also consider consumption of assets/income by the surviving spouse, and alternative planning that the survivor can do during his/her lifetime, and the ability for the survivor to implement post-death planning after the first spouse dies. Finally, the planner has to consider non-tax reasons to see if one plan is better than the other. Running the numbers is very important, but it is not the only factor. Additionally, from
a practical standpoint, the planner needs to weigh the benefits and burdens, together with the costs of analysis, on presenting and helping to guide his/her clients to select one plan over the another).

Unfortunately, the authors have yet to find any “number-crunching” software that takes all of the different variables into consideration and provides a mechanism that gives reasonable certainty that one plan works better than another. The authors surmise that it is because there are too many variables to take into consideration and building such a piece of software would be cumbersome to build and difficult to use. For example, the software would have to not only take federal gift and estate taxes into consideration, but also state gift and death taxes. Moreover, the software would have to be able to have an income tax calculator to look at computing ordinary and AMT income tax, as well as having side computations for state income taxes. Additionally, it would have to have a module that would do side income tax computations (both federal and state) for income taxed in trusts (i.e., the QTIP and/or non-marital trusts). With all of these complexities, building such a piece of software would be daunting.

To run the numbers the planner is faced with the challenging task of using old fashioned spreadsheets and tailoring it to the particular client. Based on the foregoing, because of the risk of making the many assumptions, together with the time-consuming nature of the above, it would not surprise the authors if the planner simply relies on the planning vehicles of yore and continues to plan the way they did years before. This will likely be the case in those close calls (i.e., in larger estates, estates that may be subject to a state death tax and those with multiple marriage situations).
XI. BASIS PLANNING: OBTAINING A BASIS ADJUSTMENT IN A NON-MARITAL TRUST AT THE SURVIVING SPOUSE'S DEATH

A. Generally

Let’s assume that the planner decides that s/he wishes to use a traditional non-marital type plan, however, s/he realizes that using the traditional plan may not be the best planning vehicle. S/he may wish instead to change the typical non-marital trust and include a mechanism that would achieve a basis adjustment upon the second spouse’s death.

There are four potential mechanisms to achieve the basis step-up:

- Independent trustee power of distribution;
- Contingent general power of appointment;
- Trust protector with the ability to create a general power of appointment; and
- Delaware Tax Trap.

An analysis of these four mechanisms as well as the planning benefits and risks are discussed below.

B. Independent Trustee Power of Distribution

1. Generally

The first alternative to achieve a basis step-up is to grant an independent trustee broad authority to make distributions to the surviving spouse (i.e., not limited to an ascertainable standard, as defined in the regulations under IRC § 2041).

Using such power, the independent trustee could make distributions to the surviving spouse of appreciated by-pass trust property. If the amount distributed does not exceed the surviving spouse’s excess exclusion, federal estate taxes are not triggered. Once the asset is distributed, the asset will be part of the surviving spouse’s gross estate for federal estate tax purposes. IRC § 2033. The asset will be considered to have been acquired from the decedent (i.e., who is the second spouse to die) so that it is subject to the general basis adjustment rule. IRC § 1014(b)(1).

2. Benefits

a) Selection of Appreciated Assets

This method allows the independent trustee to pick and choose the appreciated assets to be distributed.

b) Retention of Depreciated Assets

Depreciated assets can remain in the by-pass trust preserving the existing basis and preventing a step-down in basis to fair market value.

c) Simplicity

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7 Much of the information written in this part of this paper was taken from Franklin and Law, *Clinical Trials in Portability*, 48th Heckerling Est. Pl. Inst. (2014). Richard Franklin, Esq., was the primary contributor to that portion of *Clinical Trials in Portability* which discussed basis adjustment, any mistakes in this section are those of the authors; Mr. Franklin does not make mistakes herein.

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This is a relatively simple arrangement, not based on a formula or involving complicated power of appointment issues. It is likely that clients, accountants, and financial representatives could all understand this approach.

Explaining formula or springing general powers of appointment or the Delaware Tax Trap will be more challenging. Therefore, the simplicity of this approach should not be dismissed lightly.

3. Risks

a) Finding a Bold Independent Trustee is Hard

The greatest risk is that the independent trustee may be shy in exercising the authority and that the surviving spouse’s death may occur unexpectedly. The result of which is that the distributions might not occur and the opportunity is lost.

b) Timing Problems

The ideal time for distributing appreciated property is close to the death of the surviving spouse, so that any estimation of his or her potential taxable estate is more likely to be correct. This means that the independent trustee needs to have current information on the health and finances of the spouse. This may not be easy to obtain in many cases, as elderly surviving spouses may not wish to share this information.

c) Diversion Creditors

Another risk is that any distributed assets might be given by the spouse to persons other than those intended by the first spouse, such as a new spouse or the family of a new spouse or a charity with which the first spouse was not comfortable. Similarly, the assets could be diverted to other persons by exposing them to the surviving spouse’s creditors.

d) Irrevocability of Distribution

Once you distribute assets to the surviving spouse, they belong to the spouse. There is no means of correcting this if the independent trustee later determines that the assets should not be held by the spouse, because of the possibility of diversion or creditor claims, or because the spouse’s estate grows faster than anticipated, cannot be remedied.

C. Contingent Formula General Power of Appointment

1. Generally

An alternative to the independent trustee’s distribution power is for the by-pass trust to grant a contingent general power of appointment to the surviving spouse. As explained below, this strategy has some gaps in the legal analysis, and is thus not without its risks.

If the surviving spouse is granted a general power of appointment over all, or a portion, of the by-pass trust the general power of appointment will cause inclusion in the estate of the surviving spouse for Federal estate tax purposes. IRC § 2041.

If the surviving spouse exercises a testamentary general power of appointment, the property passing, without full and adequate consideration, as a result of the exercise is considered to have been acquired from or to have passed from the now deceased surviving spouse, and thereby the general basis adjustment rule will apply. IRC § 1014(b)(4).
If the surviving spouse does not exercise the general power of appointment, the property required to be included in determining the value of the surviving spouse’s gross estate is considered to have been acquired, or to have passed, from the now deceased surviving spouse, and thereby the general basis adjustment rule will also apply. IRC § 1014(b)(9).

Granting the surviving spouse a general power of appointment over all, or a portion, of the by-pass trust is not abusive for purposes of the general basis adjustment rule. The by-pass trust is funded upon the death of the deceased spouse. The surviving spouse is granted a testamentary general power of appointment over that trust. Even if the surviving spouse dies within one year of the deceased donor spouse’s death, the by-pass trust cannot ever pass assets back to the deceased donor spouse. Therefore, IRC § 1014(e) (i.e., the one-year rule) is inapplicable.

2. Is it Possible to Create a Contingent General Power of Appointment?

   a) Generally

   This section of the paper addresses whether it is possible to create a formula general power of appointment that is (i) contingent on the surviving spouse having any unused applicable exclusion amount, and (ii) structured to be applicable to particular assets in the by-pass trust that, without an automatic basis adjustment under IRC § 1014, upon the surviving spouse’s death would have the potential of triggering an income tax liability upon disposition as a result of appreciation in value or for other reasons such as having been depreciated for income tax purposes.

   Also addressed is whether it is possible to structure the general power of appointment over the assets or classes of assets that (i) have the most significant appreciation, (ii) will be taxed at the highest rates (e.g., collectables at higher capital gains rates or depreciated assets subject to recapture at ordinary rates), or (iii) will be subject to disposition at the earliest point in time.

   b) Limiting a Formula General Power of Appointment Based on the Surviving Spouse’s Unused Applicable Exclusion Amount

   (1) Private Rulings

   The Service has approved of formula general powers of appointment based on the remaining estate tax exclusion of the decedent spouse. In PLRs 200403094 and 200604028, the decedent spouse was granted a formula general power of appointment over a share of the surviving spouse’s revocable trust based on the amount of the decedent spouse’s applicable exclusion amount that would otherwise be unused. The power of appointment in PLR 200403094 is quoted in the ruling as follows:

   “At my wife's death, if I am still living, I give to my wife a testamentary general power of appointment, exercisable alone and in all events to appoint part of the assets of the Trust Estate, having a value equal to (i) the amount of my wife's remaining applicable exclusion amount less (ii) the value of my wife's taxable estate determined by excluding the amount of those assets subject to this power, free of trust to my deceased wife's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my wife may direct in her Will.”

   The power of appointment in PLR 200604028 is described as follows:
“Trust 1 provides that if Wife is living at the time of Husband's death, Husband shall have a testamentary general power of appointment equal to the amount of Husband's remaining applicable exclusion amount set forth in § 2010 of the Internal Revenue Code (“Code”) minus the value of Husband's taxable estate (determined by excluding the amount of those assets subject to this power).”

The strategy of the planning outlined in these PLRs allowed for the use of the lesser moneyed spouse’s applicable exclusion amount if he or she died first by granting the lesser moneyed spouse a general power of appointment over the moneyed spouse’s revocable trust but only to the extent the lesser moneyed spouse had exclusion that would otherwise be unused. This structure enables the moneyed spouse to retain control over his or her assets to be used for this purpose, unless and until the lesser moneyed spouse died first.

These rulings raise many interesting tax questions that are not of concern for purposes of this discussion. Importantly, however, no one questioned the scope of the formula general power of appointment being defined by reference to the deceased spouse’s remaining unused applicable exclusion amount, which by definition would not be determined until the deceased spouse died.

(2) Regulations

Similar formula structures are sanctioned in the contexts of disclaimers and partial QTIP elections. For example, Reg. § 25.2518-3(d), Ex. 20, allows a fractional formula disclaimer by reference to the smallest amount which would allow the decedent’s estate to pass free of Federal estate tax.

Additionally, Reg. § 25.2523(f)-1(b)(3) provides that the taxpayer may make the gift tax QTIP election by means of a formula that relates to a fraction or percentage of the QTIP trust, but the gift tax regulations provide no examples of such an election.

The estate tax QTIP regulations, however, are helpful in illustrating such formula elections. See, Examples 7 and 8 of Reg. § 20.2056(b)-7(h).

The type of contingent general power of appointment contemplated as a basis increase mechanism upon the surviving spouse’s death must be fixed and determinable upon the surviving spouse’s date of death. A power of appointment is considered to exist even when the time for the exercise of the power is determined by the date of the donee’s death.

While the assets of the by-pass trust may fluctuate during the surviving spouse’s lifetime, the rights of the surviving spouse should not be considered a mere expectancy. For example, the Eighth Circuit Court of Appeals, in Estate of Margrave v. Comm’r, considered a situation in which the wife owned a life insurance policy made payable by revocable beneficiary designation to trust over which the husband held an inter vivos general power of appointment. The court found that the husband had a mere expectancy in the policy because the designation could be revoked; additionally, it held that the policy was not includible under section 2041 or 2042 in husband’s estate. This is distinguishable from a funded by-pass trust subject to a testamentary general power of appointment. The surviving spouse’s beneficial interests in and the testamentary general power of appointment over the by-pass trust are generally considered vested. Perhaps the testamentary general power of appointment could be vested subject to divestment based on the trustee’s exercise of fiduciary discretion to make distributions.
In *Kurz v. Comm’r*, 101 T.C. 44 (1993), the Tax Court decided the issue of whether the decedent’s 5% withdrawal right over a family trust would be included in her gross estate.

The unremarkable facts are as follows: The decedent, a surviving spouse, had a 5% withdrawal right over the family trust, but only after the marital trust was exhausted. The surviving spouse was not the trustee, there was an independent trust who could make the distributions.

The Service, interpreting its own regulations (Reg. § 20.2041-3(b)), argued that since the Marital Trust was not in fact exhausted, the contingency (i.e., the withdrawal power) could not be triggered in the family trust, thus, the decedent did not have a general power of appointment (over 5% of the family trust’s principal). The taxpayer argued the Service’s interpretation and administration of its own regulations were overly broad and did “violence to the intent of the statute.”

The Tax Court held for the taxpayer, however, it held “for purposes of section 2041, although the condition does not have to be beyond the decedent’s control, it must have some significant non-tax consequence independent of the decedent's power to appoint the property. [Taxpayer] has not demonstrated that withdrawing principal from the Marital Trust Fund has any significant non-tax consequence independent of decedent’s power to withdraw principal from the Family Trust Fund. Such condition is illusory and, thus, is not an event or a contingency contemplated by the Reg. § 20.2041-3(b).

The Court continued, stating,

“[i]f by its terms a general power of appointment is exercisable only upon the occurrence during the decedent’s lifetime of an event or contingency that has no significant non-tax consequence independent of the decedent’s ability to exercise the power, the power exists on the date of decedent’s death, regardless of whether the event or contingency did in fact occur during such time. Because [taxpayer] has failed to demonstrate any significant non-tax consequence independent of decedent's right to withdraw principal from the Family Trust Fund, we hold that, on the date of her death, decedent had a general power of appointment over 5 percent of the Family Trust Fund that causes that portion to be includable in her estate under section 2041.”

Thus, fairly read, the import of *Kurz* is that there must be some real economic effect independent of tax reasons.

Thus, one may ask the question, when using a formula contingent general power of appointment for basis adjustment purposes, “should the surviving spouse be prohibited from acting as trustee?” Remember, as trustee, the surviving spouse would have discretion over investments. Additionally, the trustee could sell appreciated assets or retain them. Retaining the appreciated asset would potentially subject the asset to the surviving spouse’s formula general power of appointment if the form language in section (II) or (III) is used.
Arguably, the surviving spouse as trustee has a duty to invest the trust assets fairly and prudently for the benefit of all trust beneficiaries. The principles governing the trustee’s fiduciary obligations for investment are not illusory and should have independent significance. Thus, perhaps the surviving spouse could be trustee.

Another issue that may arise is whether the surviving spouse’s ability to affect the scope of the general power of appointment would cause the contingent general power of appointment to lack independent significance.

For instance, the surviving spouse could enlarge the scope of the general power of appointment by making transfers upon surviving spouse’s death from his or her estate that qualify for the unlimited estate tax marital or charitable deduction. The giving of assets to the surviving spouse or to charity seems again to be an independent act having significance separate and apart from taxes. In other words, the surviving spouse and/or the charity is economically enhanced by the transfer, thus, it appears that there is independent non-tax significance. Perhaps this point of view is stronger as concerns gifts where the surviving spouse is parting with property during lifetime.

The law is not well developed, however, and caution may mean attempting to limit the surviving spouse’s ability to manipulate scope of the formula. One alternative is to provide that the formula operates without considering any transfers by the surviving spouse that qualify for the estate tax charitable or marital deduction.

3. Benefits
   a) Power Over Appreciated Assets

The regulations under Section 2041 do not directly address situations in which the power holder has a power over particular assets. The term power of appointment is defined as follows:

“The term “power of appointment” includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. Similarly, a power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment. Treas. Reg. § 20.2041-1(b)(1).”

The regulations refer to powers over “part” of a trust or an interest in a trust:

“If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 applies only to such part or interest. For example, if a trust created by S provides for the payment of income to A for life, then to W for life, with power in A to appoint the remainder by will and in default of appointment for payment of the remainder to B or his estate, and if A dies before W, section 2041 applies only to the value of the remainder interest excluding W’s life estate. If A dies after W, section 2041 would apply to the value of the entire property. If the power were only over one-half the remainder interest, section 2041 would apply only to one-half the value of the amounts described above. Treas. Reg. § 20.2041-1(b)(3).”
The following examples illuminate the issues presented in the regulations:

**Example XI-1**

Let’s suppose the assets of Trust A consist of a tract of land and shares of a family company. Additionally, assume that B, a beneficiary, is granted a general power of appointment over the land. Since B has a power to affect the beneficial enjoyment of the trust property, the power of appointment should be taxed as a general power of appointment.

No ruling or cases could be found in which the power was defined in terms of specific assets rather than a fraction or share of the trust. But it appears that this would not be a concern to establishing the general power of appointment.

**Example XI-2**

Same facts as Example XI-1, additionally, let’s further suppose that the general power of appointment over the land is contingent on whether an increase in basis would be possible if the property were considered to have passed from the surviving spouse as contemplated by IRC §1014(b).

There appears to be no impediment to this contingency or means of classification of assets over which the general power of appointment should be granted.

b) **Retention of Depreciated Assets**

The power need not extend to depreciated assets, which can remain in the by-pass trust preserving the existing basis and preventing a step-down in basis to fair market value.

c) **Complexity**

This is a far more complex strategy than an outright distribution of assets, but it is self-effectuating and, therefore, the surviving spouse need not understand it quite as well as he or she does an outright distribution.

d) **Self-Adjusting Power Removes Need for Data on Spouse’s Health and Finances**

Unlike an outright distribution, the formula general power of appointment automatically adjusts to a change in the spouse’s estate. Furthermore, there is no need for the trustee to monitor the spouse’s health and finances, because the grant of the power adjusts itself.

e) **The Trustee Need Not be Bold**

The trustee does nothing to make this grant of a general power occur. It is automatic, so the trustee need not be particularly bold or even attentive.

4. **Risks**

a) **Inaccurate Formula**

It is possible that the formula grant of a general power creates a problem under *Estate of Kurz* to the extent that the surviving spouse can, by his or her own actions, change the amount of property subject to the power. For example, the spouse could leave more assets to charity, or remarry and leave property to a new spouse. One solution is to use a formula that ignores the marital and charitable deduction, but this produces a formula power of appointment that may not be nearly large enough to take full advantage of the spouse’s...
unused applicable exclusion amount. One may also give an nonadverse third-party the power to increase the amount of property to which the formula power applies, thereby obtaining an automatic modest amount of appointive property and a possible correct full amount of appointive property.

b) **Spouse’s Creditors**

Some states provide that the creditors of a decedent can reach property over which the decedent has a general power of appointment. It is unclear, however, how this interacts with a power that can be exercised only with the consent of a nonadverse party.

c) **Disclaimer Funded Nonmarital Trusts**

Reg. § 25.2518-2(e)(1) states:

“(1) In general. A disclaimer is not a qualified disclaimer unless the disclaimed interest passes without any direction on the part of the disclaimant to a person other than the disclaimant . . . . If there is an express or implied agreement that the disclaimed interest in property is to be given or bequeathed to a person specified by the disclaimant, the disclaimant shall be treated as directing the transfer of the property interest. The requirements of a qualified disclaimer under section 2518 are not satisfied if— (i) The disclaimant, either alone or in conjunction with another, directs the redistribution or transfer of the property or interest in property to another person (or has the power to direct the redistribution or transfer of the property or interest in property to another person unless such power is limited by an ascertainable standard); or (ii) The disclaimed property or interest in property passes to or for the benefit of the disclaimant as a result of the disclaimer . . . .”

This appears to preclude a spouse who funds a nonmarital trust by disclaimer of all or part of the marital share, from retaining any form of power of appointment (other than a right to invade the trust limited by an ascertainable standard).

5. **Requiring Consent of a Non-Adverse Party**

If the donor of the power is concerned with the surviving spouse actually exercising the power or exercising it in an undesirable manner, the contingent general power of appointment could be designed with the requirement that the donee obtain the consent of a nonadverse person. Caution is warranted, however, because under IRC § 2041(b)(1)(C)(ii), a person is not treated as holding a general power of appointment if the power is not exercisable except in conjunction with a person having a substantial interest, in the property subject to the power, which interest is adverse to exercise of the power in favor of the person who holds the power. A taker in default of the power’s exercise is adverse.

6. **Drafting**

a) **Simple Formula General Power of Appointment over Share that Will Not Increase Federal Estate Tax**

Consider the following sample language in drafting a formula general power of appointment attempting to take advantage of the basis adjustment rule for income tax purposes, while limiting any inclusion in the donee spouse’s estate to the maximum amount that will not cause an estate tax liability.

“[By-Pass Trust - Spousal Testamentary General Power of Appointment]
I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the By-Pass Trust. The fractional share and other terms applicable to the power are as follows:

**Fractional Share.** The numerator of the fraction shall be the largest amount which, if added to my spouse’s taxable estate, will not result in or increase the federal estate tax payable by reason of my spouse’s death. The denominator of the fraction shall be the value of the By-Pass Trust as of my spouse’s death.

**How Exercised.** My spouse may exercise the power by appointing the said fractional share free of trust to my spouse’s estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse’s Will that specifically refers to this general power of appointment.”

b) **Detailed Formula General Power of Appointment over Share that Will Not Increase Federal Estate Tax**

The language that one would have to consider is how to draft a clause that, on the one hand, will minimize and eliminate any federal (and possibly state) estate tax, and on the other hand provide the largest basis to an asset, which when sold would minimize income taxes. This is perhaps the most difficult part of using this basis-adjustment planning to ol.

To simply allocate basis across the board to all assets may not maximize the tax benefits. One of the issues is some assets may not be sold in the foreseeable future (e.g., it may be a family heirloom or family business that will pass from generation to generation, accordingly, the likelihood of triggering income tax is little or none). Another issue is that of the assets may be taxed at higher rates than other assets (e.g., sale of bullion is taxed at a different rate than stock and bonds). But, grouping the assets based on tax rates (when sold) may not be the best result, because they may have high enough basis, so that the tax liability when sold may be minimal, and you would have wasted the use of exemption on those assets. Another issue is to segregate the assets with the largest difference between basis and fair market value at the date of death. This again may not be beneficial, since some assets may not be sold in the foreseeable future and some may have higher income tax rates. It appears that the better way to draft a clause may be to have a general power of appointment granted over those assets that would yield the lowest income tax burden when sold. The problem with this is that when the asset will be sold is generally unknown to the drafter at the time of drafting.

For a more detailed explanation of the issues and for sample language that may be possible, see, Franklin and Law, *Clinical Trials with Portability*, 48th Heckerling Institute.

c) **Sample Language**

(1) **Formula Automatic General Power of Appointment**

The following is sample language for a formula general power of appointment attempting to take advantage of the basis adjustment rule for income tax purposes, while limiting any inclusion in the donee spouse’s estate to the maximum amount that will not cause an estate tax liability. It does not assure the avoidance of the arguments.
“Spousal Testamentary General Power of Appointment. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the By-Pass Trust. The fractional share and other terms applicable to the power are as follows:

**Fractional Share.** The numerator of the fraction shall be the largest amount which, if added to my spouse’s taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse’s death. The denominator of the fraction shall be the value of the By-Pass Trust as of my spouse’s death.

**How Exercised.** My spouse may exercise the power by appointing the said fractional share free of trust to my spouse’s estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse’s Will that specifically refers to this general power of appointment.”

(2) Granting Power of Appreciated Assets

(a) Generally

One could also attempt to grant this general power of appointment over specific trust assets that have most substantially appreciated. There is no direct authority for the ability to so direct a power of appointment, but the regulations do appear to acknowledge that a power of appointment may be limited to specific assets within a trust. See Reg. § 20.2041-1(b)(3).

(b) Sample Language

“Spousal Testamentary General Power of Appointment. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the Appreciated Assets (as such term is defined hereunder). The fractional share and other terms applicable to the power are as follows:

**A. Fractional Share.** The numerator of the fraction shall be the largest amount which, if added to my spouse’s taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse’s death. The denominator of the fraction shall be the value of the Appreciated Assets as of my spouse’s death.

**B. Appreciated Assets.** The Appreciated Assets shall mean those assets owned by the By-Pass Trust upon my spouse’s death the income tax basis of which may increase (and not decrease) pursuant to Code
§ 1014(a), if such assets passed from my spouse within the meaning of Code § 1014(b).

C. How Exercised. My spouse may exercise the power by appointing the said fractional share of the Appreciated Assets of the By-Pass Trust free of trust to my spouse’s estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse’s Will that specifically refers to this general power of appointment.”

(3) Tiered Formula General Powers of Appointment

(a) Generally

As discussed above, not all gains are taxed alike. Ideally, one would like to include in the powerholder’s estate only those assets likely to produce the highest tax on sale or exchange. One approach would be to have a tiered formula. This tiered formula would be a series of sequential contingent general powers of appointment.

(b) Tiered Classes of Assets

(i) General

One approach is to establish tiers by class of assets. The first general power of appointment would be over a fractional share of the appreciated assets that would be exposed to the highest tax rate if sold by the by-pass trust immediately prior to the surviving spouse’s death. The second power would be over a fractional share of the appreciated assets that would be exposed to the second highest tax rate if sold by the by-pass trust immediately prior to the surviving spouse’s death, and so on.

(ii) Sample Language

“Spousal Testamentary General Power of Appointment.

A. General Power of Appointment Over Class #1 Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Class #1. The numerator of the fraction shall be the largest amount which, if added to my spouse’s taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse’s death. The denominator of the fraction shall be the value of Class #1 as of my spouse’s death. Class #1 shall mean those Appreciated Assets (as such term is defined below), if any, that would be subject to the highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse’s death.
B. General Power of Appointment Over Class 
#2 Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Class 
#2. The numerator of the fraction shall be the excess of 
(a) the largest amount which, if added to my spouse’s taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse’s death over (b) the denominator of the fraction in Paragraph A above. The denominator of the fraction shall be the value of Class #2 as of my spouse’s death. Class #2 shall mean those Appreciated Assets, if any, that would be subject to the second highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse’s death.

C. General Power of Appointment Over Class 
#3 Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Class 
#3. The numerator of the fraction shall be the excess of 
(a) the largest amount which, if added to my spouse’s taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse’s death over (b) the sum of the denominators of the fractions in Paragraphs A and B above. The denominator of the fraction shall be the value of Class #3 as of my spouse’s death. Class #3 shall mean those Appreciated Assets, if any, that would be subject to the third highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse’s death.

D. Additional General Powers of Appointment Over Additional Classes of Appreciated Assets. I give to my spouse additional testamentary general powers of appointment following the pattern of Paragraphs A, B and C over additional Classes of Appreciated Assets, with each successive Class of Appreciated Assets being those assets of the By-Pass Trust subject to the next highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse’s death. The numerator of the fraction of each successive power of appointment shall be the excess of 
(a) the largest amount which, if added to my spouse’s taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by
reason of my spouse’s death over (b) the sum of the de-
nominators of the fractions used in the prior powers of
appointment.

E. Last General Power of Appointment. Not-
withstanding the above, the last general power of ap-
pointment granted by this Section shall be the power
whose fraction has a numerator less than its denomina-
tor.

F. Appreciated Assets of the By-
Pass Trust.
For purposes of this Section, the term “Appreciated As-
sets” shall mean those assets owned by the By-Pass
Trust upon my spouse’s death the income tax basis of
which may increase (and not decrease) pursuant to
Code § 1014(a) if such assets passed from my spouse
within the meaning Code § 1014(b).

G. How Exercised. My spouse may exercise
the powers granted by this section by appointing the
said fractional shares of the particular Class of Appre-
ciated Assets free of trust to my spouse’s estate or to or
for the benefit of one or more persons or entities, in such
proportions, outright, in trust, or otherwise as my
spouse may direct in my spouse’s Will that specifically
refers to this general power of appointment.”.

d) Tiered Individual Assets

(1) Generally

This formula may not achieve the best results, because grouping the assets by
classes having the highest to lowest rate of income tax applicable to a sale will
not necessarily increase the basis of the assets that have the most potential gain
subject to tax.

(2) Example

For example, assume that the trust owns asset A, worth $1 million and with an
adjusted basis of $900,000, and asset B, worth $1 million and with an adjusted
basis of $500,000. The surviving spouse has $1 million of available applicable
exclusion amount. If sold immediately prior to the surviving spouse’s death, the
assume rate of tax applicable to asset A is 30% and asset B is 25%. The formula
recited above would grant a general power of appointment first over asset A,
which would achieve a less favorable result than if it were granted over asset B,
because granting it over asset B would save more total taxes, even though the rate
of tax applicable to asset B is less than the rate that would be applicable to asset
A.

(3) The Better Approach

A possible better result will be achieved by restructuring the formula to be based
on each asset, such that the general power of appointment is first subject to the
individual asset that would produce the most income tax liability if sold by the
by-pass trust immediately prior to the surviving spouse’s death. This approach
will consider both the by-pass trust’s adjusted basis in each asset, as well as the
rate of tax that would be applicable on a sale by the by-pass trust.
(4) Sample Language

“Spousal Testamentary General Power of Appointment.

A. General Power of Appointment Over Asset #1 of the Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #1. The numerator of the fraction shall be the largest amount which, if added to my spouse’s taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse’s death. The denominator of the fraction shall be the value of Asset #1 as of my spouse’s death. Asset #1 shall mean that asset from among the Appreciated Assets (defined below), if any, that if sold by the By-Pass Trust immediately prior to my spouse’s death would generate the greatest aggregate amount of federal and state income tax.

B. General Power of Appointment Over Asset #2 of the Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #2. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse’s taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse’s death over (b) the denominator of the fraction in Paragraph A above. The denominator of the fraction shall be the value of Asset #2 as of my spouse’s death. Asset #2 shall mean that asset from among the Appreciated Assets, if any, that if sold by the By-Pass Trust immediately prior to my spouse’s death would generate the second greatest aggregate amount of federal and state income tax.

C. General Power of Appointment Over Asset #3 of the Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #3. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse’s taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse’s death over (b) the sum of the denominators of the fractions in Paragraphs A and B above. The denominator of the fraction shall be the value of Asset #3 as of my spouse’s death. Asset #3 shall mean that asset from among the Appreciated Assets, if any, that, if sold by the By-Pass Trust immediately prior

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8 This clause may be desirable if the testator resides or owns substantial tangible property in a state, locality, or the District of Columbia, that imposes a significant state estate tax.
to my spouse’s death would generate the third greatest aggregate amount of federal and state income tax.

D. Additional General Powers of Appointment Over Additional Assets of the Appreciated Assets. I give to my spouse additional testamentary general powers of appointment following the pattern of Paragraphs A, B and C over additional assets of the Appreciated Assets, with each successive asset of the Appreciated Assets being that asset of the By-Pass Trust subject to the next highest aggregate amount of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse’s death. The numerator of the fraction of each successive power of appointment shall be the excess of (a) the largest amount which, if added to my spouse’s taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse’s death over (b) the sum of the denominators of the fractions used in the prior powers of appointment.

E. Last General Power of Appointment. Notwithstanding the above, the last general power of appointment granted by this Section shall be the power whose fraction has a numerator less than its denominator.

F. Appreciated Assets of the By-Pass Trust. For purposes of this Section, the term “Appreciated Assets” shall mean those assets owned by the By-Pass Trust upon my spouse’s death the income tax basis of which may increase (and not decrease) pursuant to Code § 1014(a) if such assets passed from my spouse within the meaning Code § 1014(b) [OPTIONAL PROVISION: provided, however, that any Family Assets shall be considered last (and then classed based on greatest aggregate amount of federal and state income tax in a similar manner as provided above) For purposes of this Section the term “Family Assets” means ______ (e.g., the family farm or private family company, which is unlikely to be sold in the near future, etc.). For this purpose, blocks of shares of the same stock in the same company and having the same basis shall be considered as one asset.

G. How Exercised. My spouse may exercise the powers granted by this section by appointing the said fractional shares of the particular assets of Appreciated Assets free of trust to my spouse’s estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse’s Will that specifically refers to this general power of appointment.”

e) Caveat

This clause still does not take into account that some assets may be sold quickly, while others may never be sold. Increasing the basis of heirloom assets that are unlikely ever to

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9 The instrument must elsewhere define “Code” to mean the Internal Revenue Code of 1986, as amended from time to time.
be sold is of little value. One may consider leaving such assets to a separate non-marital trust that does not include a contingent general power of appointment.

D. Independent Power to Grant a General Power of Appointment

1. Generally

Another basis-adjustment alternative is to grant an independent trustee or trust protector broad authority to grant the surviving spouse a general power of appointment. For the reasons discussed above, it appears that the independent trustee or trust protector could grant the surviving spouse a general power of appointment over particular appreciated by-pass trust assets – e.g., the assets that are likely to generate the greatest aggregate income tax liability if they do not receive a basis adjustment – and/or those assets that are likely to be sold nearest in time following the surviving spouse’s death.

If the value of the assets subject to the general power of appointment do not exceed the surviving spouse’s excess exclusion, federal estate taxes are not triggered, and yet there will be a basis adjustment under IRC § 1014.

2. Benefits

a) Selection of Appreciated Assets

This method allows the grant of a general power that applies only to those appreciated assets selected by the independent trustee or trust protector.

b) Retention of Depreciated Assets

The independent trustee or trust protector need not grant a general power over depreciated assets, preserving the existing basis and preventing a step-down in basis to fair market value.

c) Simplicity

This is a relatively simple arrangement, not based on a formula.

d) Revocability of Distribution

The independent trustee or trust protector can revoke or modify the general power after it is granted, as long as it is done before the surviving spouse’s death.

3. Risks

a) Finding a Bold Independent Trustee is Hard

The independent trustee or trust protector may be shy in exercising the authority and that the surviving spouse’s death may occur unexpectedly. The result of which is that the power might not be granted and the basis opportunity is lost.

b) Timing Problems

Again, the independent trustee or trust protector needs to have current information on the health and finances of the spouse. This may not be easy to obtain in many cases, as elderly surviving spouses may not wish freely to share this information.
c) Creditors

Some states provide that the creditors of a decedent can reach property over which the decedent has a general power of appointment. It is unclear, however, how this interacts with a power that can be exercised only with the consent of a nonadverse party.

d) Disclaimer Funded Nonmarital Trusts

Reg. § 25.2518-2(e)(1), as quoted above, provides that a spouse who disclaims a portion of the marital share in order to fund the nonmarital share cannot, therefore, retain any power of appointment over the disclaimed portion, whether general or limited (other than a right to withdraw subject to an ascertainable standard). The regulations, however, are not limited to retained powers to direct the beneficial enjoyment; they simply state that the property must pass "without any direction on the part of the disclaimant to a person other than the disclaimant." While there is no case or ruling on point, it is inadvisably risky for a spouse who funds a nonmarital share by disclaimer later to be granted a general power of appointment over the disclaimed portion of the trust.

Of course, the penalty for violating the disclaimer rules would be that the spouse is deemed to have made a taxable gift of the disclaimed assets. If the surviving spouse filed a gift tax return in the year in which the disclaimer was made and if the statute of limitations on that return has expired, the spouse could accept the power of appointment with relative impunity.

4. Drafting -- Clause Allowing Disinterested Trustee to Grant Surviving Spouse General Power of Appointment Over Assets in Nonmarital Trust, to Take Advantage of Increased Applicable Exclusion Amount

"ARTICLE __. Grant of a General Power of Appointment:

A "disinterested trustee" (defined below) may at any time and from time to time grant to my *husband/wife*, if *he/she* survives me, a power to appoint at *his/her* death, all or a portion of the assets of the family trust.

A. Granting the Power. A disinterested trustee shall grant this power of appointment by an instrument in writing delivered to my *husband/wife*, designating the specific trust assets or fractional share of the trust, which may include the entire trust, over which my *husband/wife* shall hold this power of appointment.

B. Changing or Rescinding a Granted Power. A disinterested trustee may revoke any prior grant of a general power of appointment under this article or change the property to which such previously granted power shall be exercisable, or the terms under which such previously granted power may be exercised.

C. Permissible Appointees. My *husband/wife* may exercise this power to appoint the subject trust assets to and among a class that includes the estate of my *husband/wife* and the persons who are otherwise current or potential beneficiaries of this trust.

1. Appointment Outright or in Further Trust. My *husband/wife* may exercise this power to appoint the trust assets outright or in further trust, and if exercised to appoint in further trust, may appoint on such terms and conditions as *he/she* shall select.
2. Unequal Appointment. My *husband/wife* may appoint the trust assets among this class of appointees unequally and in such proportions as *he/she* deems appropriate for any purpose whatsoever.

3. Appointment to My *Husband/Wife*'s Estate. My *husband/wife* may appoint trust assets to *his/her* estate only with the express signed written consent of a “nonadverse person” (defined below) designated by the disinterested trustee in the instrument granting the power of appointment under this article. For this purpose, a “nonadverse person” is any person who has no substantial interest in the property subject to the power of appointment, which interest is adverse to the exercise of the power in favor of my *husband/wife*'s estate. Any attempted appointment to my *husband/wife*'s estate without the express signed written consent of the nonadverse party designated by the disinterested trustee who granted *him/her* this power of appointment shall be void and of no effect, and this power of appointment shall be deemed not to have been validly exercised.

D. Exercise of This Power. My *husband/wife* may exercise this power of appointment by express reference to this power in *his/her* last will, or by express reference to this power in another dated and notarized writing signed by *him/her*, which writing shall be revocable and ineffective during *his/her* life and effective only upon the death of my *husband/wife*.

E. No Liability. I recognize the difficulty attendant in the exercise of the power of the disinterested trustee to grant my *husband/wife* a general power of appointment in a manner that best reduces income taxes on the disposition of the distributed assets without also increasing the estate tax obligation of the estate of my *husband/wife*. I direct that the disinterested trustee shall have no liability to any beneficiary of this trust or to any other person for the disinterested trustee’s actions under this article. Without exclusion, the disinterested trustee shall have no liability to any beneficiary or any other person for: (1) failing to grant my *husband/wife* a power of appointment; (2) granting my *husband/wife* a power of appointment that does not cause an amount of trust assets to be included in my *husband/wife*'s gross estate for Federal estate tax purposes that will obtain the optimal income tax benefit for the trust; (3) granting a power of appointment to my *husband/wife* under this instrument, even if such granting causes adverse income or estate tax results; (4) granting a power of appointment to my *husband/wife* that causes more property to be included in *his/her* gross estate than can be sheltered from Federal or state estate taxes by my *husband/wife*'s available exemptions and deductions; and (5) the actions of any nonadverse party in consenting or refusing to consent to the exercise of a granted power of appointment in favor of the estate of my *husband/wife*, or the action of the disinterested trustee in naming or refusing to name such a nonadverse party. A nonadverse party named by the disinterested trustee shall have no liability to any beneficiary of this trust or to any other person for consenting or refusing to consent to the exercise of any granted power of appointment in favor of the estate of my *husband/wife*.

F. Disinterested Trustee” Defined. A “disinterested trustee” means a trustee who is not an interested trustee. An “interested trustee” means a trustee who is also (1) a beneficiary of the trust of which he or she is the insured under a policy of insurance owned by a trust of which he or she is a trustee; (2) married to and living together with a beneficiary of the trust of which he or she is a trustee; (3) the father, mother, issue, brother or sister, of a beneficiary of the trust of which he or she is a trustee; (4) an employee of a beneficiary of the trust of which he or she is a trustee; (5) a corporation or any employee of a corporation in which the stock holdings of the trustee and the trust are significant from the viewpoint of
voting control; or (6) a subordinate employee of a corporation in which the trustee is an executive.”

E. Delaware Tax Trap

1. Generally

Perhaps the most technical of the basis adjustment mechanisms is the so-called “Delaware Tax Trap.” The practical hurdles of using this technique as a standardized basis adjustment mechanism in by-pass trusts seem almost insurmountable. The attorney preparing the document should understand it – and how many of us can honestly say that we do? The concept will be challenging to explain to the couple at that time of implementing the estate plan and at the time of springing the trap by the surviving spouse. Moreover, it will be challenging for rest of the estate planning team to understand, the trust officers, accountants and financial advisors. How likely is it that anyone other than the drafting attorney could spot the language and understand the potential planning possibilities?

2. The History – It is Complicated!

Just understanding the background of the Delaware Tax Trap – why it is called a trap – is complicated. Historically, Delaware allowed successive exercises of non-general powers of appointment in favor of non-charitable beneficiaries, which could in effect extend the life of a trust indefinitely without running afoul of the rule against perpetuities. Thus, assets that would otherwise have to be distributed and vest in a non-charitable beneficiary within the rule against perpetuities could be held in trust for a longer period of time (or indefinitely) simply by exercising the power and creating another non-general power of appointment. Historically, since donees of non-general power of appointments were not subject to gift and estate taxes at that time, not only could the assets be held in trust indefinitely, but estate and gift taxes could also be avoided indefinitely.

Congress responded by amending IRC §§ 2514 and 2041 so that exercises of the non-general powers of appointment in those cases would be considered the exercise of a general power of appointment and thus be subject to gift and estate taxes, respectively. Thus, if the non-general power of appointment was exercised, the exercise would be a taxable gift (if exercised during life) or included in the donee’s estate (if exercised in the donee’s testamentary instrument). Causing the donee of the non-general power to be taxed on the exercise (where the holder was a beneficiary and did not have the assets of the trust to pay the tax) was viewed as a tax trap – hence the “Delaware Tax Trap”. Delaware amended its law to eliminate the trap.


3. Planning for the Delaware Tax Trap

IRC § 2041(a)(3) provides that a non-general power of appointment will be taxed as if it were a general power of appointment if the non-general power of appointment is exercised to create another
power of appointment that can be exercised to postpone vesting beyond the rule against perpetuities applicable to the original special power of appointment.

The planning idea is that the surviving spouse as a beneficiary of the by-pass trust is granted a non-general power of appointment that can be exercised to create another power of appointment in a potential appointee that could extend the trust beyond the rule against perpetuities applicable to the by-pass trust. The surviving spouse would then have an option to spring the trap by exercising the special power of appointment in such manner and subject assets of the by-pass trust to federal gift and estate taxes in the surviving spouse’s estate and attain a basis adjustment. In this manner, the surviving spouse is intentionally springing the "trap" for the tax benefits it may provide.

How all of this is to be accomplished is, similar to the explanation of the Trap’s history … it’s complicated! The by-pass trust will need to be specially designed to enable the Trap to operate when, and if, the surviving spouse decides to spring it. The design must consider the applicable state law, particularly its perpetuities laws. Many states have prophylactic statutes that are designed prevent a non-general power of appointment from operating in a manner that could postpone vesting beyond the originally applicable rule against perpetuities. Many form trust instruments also have provisions designed to do the same. Thus, it may not be possible to use the trap in certain states (such as Florida).

4. The Delaware Tax Trap in States That Have No Rule Against Perpetuities

a) Generally


It is unclear how the Delaware tax trap applies when there is no applicable rule against perpetuities, and in some states, it may not be possible to spring the trap. Absent a restriction on vesting, ownership, or alienation, it is unclear whether the exercise of a non-general power of appointment to create a second power always, sometimes, or never executes the Delaware tax trap. One can reasonably argue that (1) the Delaware tax trap can never be executed in such states because the date on which the first power is created is irrelevant in determining the date on which vesting, ownership, or alienation can be postponed, and there is no date on which they must be allowed; (2) every new power postpones the vesting, ownership, or alienation, and because the date on which the first power was created is ignored in determining when such periods must end, the new power always executes the Delaware tax trap; or (3) the Delaware tax trap should operate the same in states that lack a rule against perpetuities as it does in those that have such a rule. See Greer, The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities, 28 Est. Plan. 68 (Feb. 2001).

Murphy v. Comm’r

(a) Facts

Murphy involved a trust created by the exercise of a testamentary power of appointment by the decedent, Mary Margaret Murphy. Mary Margaret was one of three beneficiaries of the Harris Trust, created by her late father. The Harris Trust provided for payment of income in equal shares to Mary, her sister, and their mother, until the death of Mary’s mother. Upon the death of Mary’s mother, the Harris Trust would terminate and its principal would be distributed in equal shares to the two sisters, if both were then living. If one of the sisters predeceased their mother, she could appoint her share of the trust to anyone she chose, other than to her own estate, her creditors, or the creditors of her estate.

Mary predeceased her mother and she appointed her share of the Harris Trust to a new trust created under her will—the MMM Family Trust. The MMM Family Trust terms provided for distribution of income to Mary’s husband as needed by him “to maintain himself in the manner of living to which he has become accustomed” and to her issue, in the discretion of the trustee. The MMM Family Trust was to continue for the lifetime of Mary’s husband and thereafter until her youngest child reached thirty-five years of age, at which time the trust fund would be distributed to Mary’s children or lineal issue. In addition, Mary’s will gave her husband a non-general testamentary power of appointment.

(b) Estate’s Argument

The personal representative of Mary’s estate argued that Mary had granted her husband only a testamentary power of appointment, and one that could not be exercised in his own favor, and so Section 2041(a)(3) could not apply. He noted that state law (Wisconsin) “expresses its rule against perpetuities in terms of a prohibition on the suspension of the power of alienation, and because the perpetuities period is measured from the date the first power is created, section 2041(a)(3) is not violated.” Murphy v. Comm’r, 71 T.C. 671 at 677 (1979).

(c) IRS Argument

The IRS disagreed and argued that the state statutory rule against perpetuities was concerned with the suspension of the power of alienation, rendering void any interest that suspends the power of alienation for a period longer than a life or lives in being, plus thirty years. Wis. Stat. Ann. § 700.16, as then in effect. That law also stated, however, that there was no suspension of the power of alienation when the property interest is held in a trust where the trustee has the power to sell the assets of the trust. Citing Wis. Stat. Ann. §§ 700.16(2), 700.16(3). Remoteness of vesting was not prohibited in Wisconsin (as is true in many other states), and the IRS argued that Mary’s husband could validly exercise his power of appointment by placing the property subject to the power in a perpetual trust for the benefit of his children and their descendants, as long as he gave the trustee a power of sale over the trust corpus so that the right of alienation was not postponed. Citing In re Walker’s Will, 258 Wis. 65, 45 NW2d 94 (1950). In essence, the IRS argued that Section 2041(a)(3) covered all situations, regardless of state law, where successive powers
of appointment can be validly created and exercised without violating the rule against perpetuities.

(d) **Tax Court Holds for Estate**

The Tax Court admitted that the IRS argument was consistent with a literal reading of Section 2041(a)(3), but it held for the estate, based on the legislative history of Section 2041(a)(3). The Tax Court concluded that Section 2041(a)(3) could not apply in the Wisconsin situation because it refers to the creation of a power which, under state law, can be validly exercised so as to postpone vesting or suspend ownership “for a period ascertainable without regard to the date of the creation of the first power.” The Wisconsin statute measured the period from the creation of the first non-general power, and so prevented the operation of the Delaware tax trap. The court noted that the regulations actually supported the estate’s position. The regulations indicate that postponing of vesting and suspension of ownership or alienation are mutually exclusive conditions of includibility, and the correct test is governed by applicable state law. Reg. § 20.2041-3(e)(1)(ii).

Under state law, ownership was not suspended because the trustee was given the power to sell trust assets. The regulation states that, because local law is phrased in terms of the suspension of ownership/power of alienation, and there is no such suspension under that local law, the Delaware tax trap cannot be executed.

(e) **Acquiescence**

The IRS acquiesced, noting in its Action on Decision that “the Tax Court’s holding is reasonable, and an appeal, (while possibly warranted based on the legislative history), would be inappropriate in light of the specific wording of the regulation and the last portion of section 2041(a)(3).” A.O.D. 1979-87, 1979 WL 53162 (May 30, 1979). In light of Murphy and the IRS’s acquiescence, one must consider carefully the operation of the state rule against perpetuities in order to determine whether the particular exercise of a power of appointment executes the Delaware tax trap. See Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 Est. Plan. 68 (Feb. 2001).

(2) **Planning Under Murphy**

Where state law imposes limitations on alienation, but not on vesting or outright ownership, Murphy seems to test the execution of the Delaware tax trap based on how the grant of a new power of appointment affects the right to alienate. Most states that permit a waiver of the rule against perpetuities with respect to a trust require that the trustee have the power to sell the trust assets.

Some might argue that this is functionally equivalent to imposing no limitation on the right to alienate, but this argument seems flawed, at least if the powerholder could exercise the power to create a continued trust in which the trustee had no power of alienation. The best analysis appears to be that the conventional rules by which the creation of a presently exercisable general power of appointment starts a new perpetuities period should apply in such cases.

The argument that the Delaware tax trap applies to the creation of all new powers of appointment in a state that lacks a rule against perpetuities also would result in
far more executions of the Delaware tax trap than the legislation appears to anticipate. This seems an unreasonable and unintended result. Practitioners must carefully scrutinize the law of the state that controls the construction of a decedent’s non-general power of appointment. If the state permits any fixed limit (even if a very long one) on vesting, alienation, or ownership, the Delaware tax trap should be executed only if the first power of appointment creates a presently exercisable general power of appointment.

Similarly, if the state does not limit vesting or ownership, but does limit alienation, the Delaware tax trap ought to be exercisable only if the first power creates an interest in trust in which the trustee lacks the power of sale within the period of the rule against perpetuities. This may also occur if a beneficiary is given a presently exercisable general power of appointment. If state law imposes no limitation on vesting, ownership, or alienation, the result is simply not clear. The better analysis in most such cases is that the exercise of a non-general power of appointment to create a new presently exercisable general power of appointment should execute the Delaware tax trap, but it is unclear whether this position will actually be approved by the IRS and the courts.

(3) Drafting Sample Language

Below is a rule against perpetuities clause under Missouri that contemplates the possibility of springing the Trap, compliments of Steven B. Gorin. It appears that, to accomplish the basis adjustment mechanism goal, the design of the bypass trust could be structured to grant the surviving spouse a non-general power of appointment that could be exercised to create in a possible appointee a presently exercisable general power of appointment. Under this structure, the second power of appointment is a general power of appointment and as such it would trigger the Trap by creating a taxable power in the object of power, and this structure should not be caught by the prophylactic statutes.

Drafting Suggestion for Provision in Will Exercising Non-General Power of Appointment to Give Appointees a Presently Exercisable General Power of Appointment and Suspending Trustee’s Power of Sale, to Trigger Delaware Tax Trap

“ARTICLE ............... Exercise of Power of Appointment

I am granted a power of appointment under Article ............... Paragraph ............... of the trust created under the law will of *grantor*. I am, under that instrument, authorized to appoint the trust held for my benefit to and among the descendants of *grantor*, outright or in further trust and on such terms as I select. I hereby exercise that non-general power to appoint the said trust share as follows:

A. Existence of Non-General Power of Appointment. The trustee shall divide the appointed trust fund into as many separate equal shares as shall be required to provide one (1) separate equal share for each of *grantor*’s children who survives me, and one (1) separate equal share for the then-living descendants, per stirpes, of each of *grantor*’s children who does not survive me but who is survived by then-living descendants.
B. Creation of Presently Exercisable General Power of Appointment. The trustee shall hold the share for each child or other descendant of *grantor* in trust as follows:

1. Until the termination date, defined below, the trustee shall distribute to or for the benefit of each such child or descendant (1) all of the net income of the trust, not less often than annually; (2) so much of the principal of the trust as is appropriate for such child or descendant’s health, education, support, or maintenance, taking into account other income available to such child or descendant from any source; and (3) so much of the trust fund (including all or none) held for such child or descendant as such child or descendant shall direct by specific exercise of this presently exercisable general power of appointment. Commencing twenty (20) years after the date of my death and continuing until the termination date, the trustee shall also have no authority to sell assets of this trust fund.

2. Upon the termination date, the trustee shall distribute the remaining trust fund as follows:

a. The trustee shall distribute the remaining assets of a child’s or descendant’s separate trust under this article as such child or descendant may direct, by specific reference to this non-general power of appointment in his or her last will or in a signed, dated, and written instrument delivered to a trustee. This power may be exercised to appoint a child’s or descendant’s separate trust fund, either outright or in further trust, to or among any of my descendants, excluding the person holding the power of appointment, his or her creditors, his or her estate, and the creditors of his or her estate.

b. The trustee shall distribute the unappointed assets of such child’s or descendant’s separate trust to the child’s or descendant’s then-living descendants, per stirpes. If there are no such then-living descendants, the trustee shall distribute the unappointed assets of such child’s or descendant’s separate trust to my then-living children and other then-living descendants, per stirpes, except that the share for any child or other descendant of mine who has not then reached the age of *Termination-Age* years shall be added to the trust for that child or descendant under this article.

C. “Termination Date” Defined. The termination date is the date on which the child or descendant dies.

F. Asset Protection Concerns for Basis Adjustment Mechanisms

1. Generally

Initially, when designing the estate plans, compare the asset protection issues involved with a traditional by-pass trust to that involved with a portability plan, such as the QTIP trust portability plan. Implementing traditional by-pass trust plans frequently involve transferring assets out of tenancy by the entirety into the spouses’ separate ownership to enable the by-pass trust funding. This destroys asset protection. It is important to evaluate asset protection issues in three phases: when both spouses are alive, after the first spouse's death and after both spouses' deaths. For example, with
portability planning, assets may remain in tenancy by the entirety when both spouses are alive. Moreover, many assets, such as retirement accounts, homestead property and insurance policies, already offer some creditor protection features depending on applicable state and federal law.

A discretionary by-pass trust with spendthrift provisions likely offers creditor protection for its beneficiaries. The QTIP trust in the portability plan would likely provide creditor protection as to the trust principal, but creditors may be able to reach the income of the trust once distributed to the surviving spouse. Also, in a portability plan, a disclaimer by the surviving spouse to enable the funding of the back-up disclaimer by-pass trust might be problematic if the surviving spouse has creditor problems at the time of the first spouse’s death. Some states require that the disclaimant be solvent or provide that a disclaimer by an insolvent person is treated as a fraudulent transfer, and a disclaimer may create a new period of ineligibility for Medicaid benefits.

The asset protection overlay to the approaches for applicable exclusion use is more complicated than it at first appears. If one of the basis adjustment mechanisms is used with the by-pass trust to soak-up any of the surviving spouse’s excess applicable exclusion, the asset protection features of the mechanism should also be considered.

2. Independent Power to Distribute

If an independent trustee actually distributes appreciated assets out of the by-pass trust to the surviving spouse to soak-up any of the surviving spouse’s excess applicable exclusion, then in most cases the spendthrift trust protection of the by-pass trust is lost and the distributed assets are exposed to the surviving spouse’s creditors. If the surviving spouse has creditor problems, this method of achieving a basis adjustment seems unsatisfactory.

3. General Power of Appointment

The rights of the creditors of the holder of a general testamentary power of appointment to reach the subject property depends on state law.

a) Uniform Trust Code

The Uniform Trust Code does not address creditor issues with respect to property subject to a testamentary general power of appointment. The comments to Uniform Trust Code § 505 refer to Restatement (Second) of Property: Donative Transfers §§ 13.1 to 13.7 (1986), discussed below.

b) Restatement (Second) of Property: Donative Transfers

Traditionally, property subject to an exercised general testamentary power of appointment could be subjected to the payment of claims against the powerholder’s estate. Restatement (Second) of Property § 13.4 (1986). The idea is that until the powerholder exercises the power, he or she has not accepted sufficient control over the subject property to be treated as if it were owned outright.

c) Restatement (Third) of Property: Donative Transfers

The more modern rule is reflected in Restatement (Third) of Trusts § 56, Comments (2007), which states that property subject to a testamentary general power of appointment is subject to the claims of the creditors of the powerholder’s estate, whether or not the power is exercised, because the power alone is equivalent to outright ownership. The subject property is subject to the claims of the powerholder’s creditors to the extent the powerholder’s estate is insufficient satisfy the claims of those creditors. Property subject to a general testamentary power of appointment does not enable the powerholder’s creditors to reach the trust assets during his or her lifetime. California, Michigan and New York all have specific statutory provisions following the pattern of the Restatement (Third) Trusts.
d) **Uniform Power of Appointment Act**

Section 502 of the Uniform Power of Appointment Act (2013) follows *Restatement (Third) Trusts* and permits the creditors of the estate of the powerholder to reach the subject property, to the extent the estate’s other property is insufficient to meet all claims. This right is subject to the powerholder’s right to direct the source from which liabilities are paid.

e) **Bankruptcy Act**

The U.S. Bankruptcy Code states that the trustee in bankruptcy “stands in the shoes” of the debtor and so may be able to exercise the general power on behalf of the debtor/powerholder and in favor of the bankrupt estate. 11 U.S.C. § 541(b)(1); *In re Behan*, 506 B.R. 8 (Bankr. D. Mass. 2014); *In re Gilroy*, 235 B.R. 512 (Bankr. TProtect Assets – More Power than You Ever Imagined*, 346 ACTEC L. J. 333, 338 (Fall 2010).

4. **Delaware Tax Trap**

Use of a Delaware Tax Trap may not cause an asset protection issue for the surviving spouse but may create an issue for the object of the power in whose favor it is exercised. If the powerholder is granted a presently exercisable general power of appointment, the assets subject to the power are likely exposed to the powerholder’s creditors. See the discussion above on general powers of appointment.
XII. BASIS PLANNING: THE POWER OF APPOINTMENT SUPPORT TRUST ("POAST") -- TAX SHELTER LEASING OF THE ELDERLY?

A. Generally

At the risk of being tactless, the death of a parent, grandparent, or other older relation or friend is a sad enough event without also wasting the opportunity for a significant basis increase. If such an older person (an “upstream person”) has an excess of applicable exclusion amount, his or her death will be a wasted opportunity to obtain additional basis increase.

B. Outright Upstream Gifts

One can, of course, give an upstream person sufficient appreciated assets to take advantage of his or her unused applicable exclusion amount. This is a relatively simple approach, but it presents several important problems.

1. Poor Use of Donor’s Applicable Exclusion Amount

The donor of an upstream gift will be subject to gift tax on the fair market value of the gift, to the extent that it exceeds the donor’s available gift tax annual exclusion. This can be offset by the donor’s applicable exclusion amount but using the donor’s applicable exclusion amount to move assets to a higher generation is contrary to most estate planning wisdom.

2. Diversion by Donee

The upstream gift allows the donee to give or leave the property to someone other than the donor or the natural objects of the donor’s bounty. This may be intentional – a gift or bequest – or unintentional – an elective share, forced share, or claim of a creditor.

3. Risk of Access by Donee’s Creditors and Spouse

A subset of the risk of diversion is the risk that the donee’s creditors and spouse may have claims against the assets given to the donee. This risk can be reduced by only making transfers to donees who have few or no creditors and who are unmarried or married with a very well drafted premarital agreement, but this eliminates an entire category of individuals who are likely to have a significant excess of unused applicable exclusion amount. Also, creditors can be created at any time, and the elderly are susceptible to incurring large medical expenses and to making poor investments.

4. Gift Back to Donor or Donor’s Spouse within One Year

IRC § 1014(e) states that there is no basis adjustment at a decedent’s death with respect to assets given to the decedent within one year of the date of death by the person to whom the asset passes at the decedent’s death. Therefore, if one makes a gift to an upstream person who dies within one year and leaves the asset back to the donor, there is no basis increase. For a discussion of what constitutes leaving the asset to the donor, see discussion at V, E, above.

C. The Power of Appointment Support Trust – A Death is a Terrible Thing to Waste

The power of appointment support trust ("POAST") involves a transfer of property to an irrevocable trust for donees, who may include (or even be limited to) the donor’s spouse, but which gives a general power of appointment over appreciated trust assets to one or more upstream persons. See Austin, Beaudry and Law, The Power of Appointment Support Trust, Trusts & Est. (Dec. 2015); Morrow, Morrow and the Upstream Optimal Basis Increase Trust, LISI Estate Planning Newsletter #2635 (April 17, 2018) at http://www.leimbergservices.com; and Morrow, Morrow and the Optimal Basis Increase Trust (OBIT), LISI
1. **Transfer Must be a Completed Gift**

The transfer must be a completed gift; the trust must be irrevocable and the donor cannot retain the power to alter beneficial enjoyment. Otherwise, the IRS will assert that the grant of a general power of appointment is completed only upon the death of the donee of the power, and that no basis increase is available under IRC § 1014(e). See discussion of the Tax Basis Revocable Trust below, at XIV, below.

2. **Granting a General Power of Appointment is Not Itself a Taxable Gift**

The gift tax law treats the exercise or lapse of a general power of appointment as a taxable gift, but the granting of a general power is not itself a taxable gift. IRC § 2501(a)(1) states that the gift tax is imposed on “the transfer of property by gift.” It does not apply to the grant of powers to appoint property, whether they are general or special powers. Merely granting someone a general power of appointment is not itself a taxable gift, because it does not involve the transfer of property. See also S. Rep. No. 665, 72nd Cong., 1st Sess. (1932), reprinted in 1939-1 (Part 2) C.B. 496, 524 (“property” for this purpose is to be construed broadly and include “the broadest and most comprehensive sense” to reach “every species of right or interest protected by law and having an exchangeable value.” Nonetheless, it still does not include a power to appoint property.)

3. **Holder of a General Power May be Naked (Figuratively)**

a) **Generally**

A general power of appointment causes the subject property to be included in the holder’s gross estate even if the holder has only a naked power of appointment and no beneficial interest in the trust. The power will still be taxable for estate tax purposes and its possession will still cause the subject assets to have their basis adjusted under Section 1014. See, e.g., PLR (TAM) 200907025 (“the fact that the Decedent could receive only income at the discretion of the trustee and could not receive distributions of corpus during life, is in no way indicative of the Settlors' intent to restrict Decedent's power to appoint the property at his death. A right to receive trust income and a power of appointment are separate interests among the possible interests that a beneficiary may have in a trust. It is the province of a settlor to control the rights and interests set forth in a trust according to the settlor's own wishes.”).

b) **Why Give Powerholder a Beneficial Interest**

One possible reason to give the upstream powerholder at least a contingent beneficial interest in the trust assets is to avoid the analysis proposed by the IRS in *Cristofani v. Comm'r*, 97 T.C. 74 (1991), *acq. in result only* 1992-1 C.B. 1, *acq. in result only* 1996-2 C.B. 1, that a naked power of appointment should be ignored for tax purposes. *Cristofani* involved the grant of Crummey withdrawal powers (which are themselves general powers of appointment) to persons who had little or no fixed beneficial interest in the trust. The IRS took the position that these grants were illusory; the beneficiaries would refrain from exercising these powers only if they had agreed in advance not to do so. The Tax Court disagreed and stated that no other beneficial interest was required to create a present interest. Even with this precedent, it may be practical to name the upstream person a contingent beneficiary in order to deter the IRS from disputing the validity of the grant of a general power. See also reliance on *Cristofani* in *Estate of Kohlsaat v. Comm'r*, T.C. Memo. 1997-212; and Morrow & Gassman, *Ed Morrow and Alan Gassman on Mikel v. Commissioner: Tax Court Approves the Mother of All Crummey Trusts with 60 Beneficiaries*, LISI Estate Planning Newsletter #2309 (May 14, 2015).
An important distinction between the situation in Cristofani and that in the upstream basis increase trust is that the IRS, in the latter situation, may not want to be recorded having argued that a general power of appointment is not taxable unless the powerholder has a beneficial interest in the trust. This argument may be utile to it in this particular context, but one can imagine many situations in which it would result in a substantial decline in estate tax revenues.

4. Introduction of the “Support” Concept

In light of the issues with giving a naked general power of appointment, consider allowing the Trustee to make discretionary distributions of income and/or principal for the benefit of the upstream beneficiary. Thus, the upstream beneficiary is given both a power of appointment and the ability to receive support; hence, the name “Power of Appointment Support Trust” or “POAST”.

5. Decedent Need Not Be Competent to Exercise the Power

A testamentary power to appoint the subject property to one’s estate or its creditors is taxed as a general power of appointment, even if the individual is, on the date of death and at all times when he or she held the power, legally incompetent to exercise it. The law taxes a powerholder on the property subject to a general power if he or she “possessed” the power on or before the date of death, not whether he or she could legally exercise it. *Fish v. United States*, 432 F.2d. 1278 (9th Cir 1970); *Estate of Alperstein v. Comm’r*, 613 F.2d 1213 (2nd Cir 1979), cert. denied sub nom. *Greenberg v. Comm’r*, 446 U.S. 918 (1980); *Williams v. United States*, 634 F.2d. 894 (5th Cir. 1981); *Boeing v. United States*, 650 F.2d. 493 (8th Cir. 1981), rev’g 493 F. Supp. 665 (E.,D. Mo. 1980); *Doyle v. United States*, 358 F. Supp. 300 (E.D. Pa 1973); *Pennsylvania Bank & Trust Co. v. United States*, 451 F. Supp. 1296 (W.D. Pa. 1978), aff’d 597 F.2d 382 (3rd Cir. 1979); Rev. Rul. 75-350, 1975-2 C.B. 366 (marital deduction allowed for power of appointment marital trust, even though surviving spouse was mentally ill from the time of first spouse’s death until time of surviving spouse’s death, and under applicable state law, incapable of exercising the power); Rev. Rul.75-351, 1975-2 C.B. 368 (minor had a general testamentary power of appointment even though, under applicable state law, minor was legally incompetent to execute a will at the time of death). But, see also *Finley v. United States*, 404 F. Supp. 200 (S.D. Fla., 1975) vacated on jurisdictional grounds, 612 F.2d 166 (5th Cir. 1980) (decedent, from time of devise of general power of appointment until her death lacked legal capacity to exercise general testamentary power of appointment, and so did not “possess” a general power of appointment for estate tax purposes).

6. Decedent Need not Know of Power’s Existence

a) Generally

There appear to be no cases directly on point, but as a decedent who lacks the legal ability to understand the power of appointment is deemed to possess it for estate tax purposes, then a competent decedent who simply is unaware of the power’s existence should be deemed to possess it. See *Estate of Freeman v. Comm’r*, 67 TC. 202 (1976) (power holder never saw the trust instrument and never knew he had a power of appointment). The only question should be whether the grant of the power is legally effective under state law, when the donee of the power is unaware of the transfer.

Also, the IRS may not want to argue that a general power of appointment is not taxable unless the powerholder knows of its existence. This argument may be useful to it in dealing with POASTs, but it could be turned against the IRS in many cases in which a holder of a power of appointment wishes not to have the subject property included in his or her gross estate; the lack of knowledge is easy to assert and often difficult to disprove.

b) Trustee’s Obligation to Inform Powerholder
(1) The Uniform Trust Code

The trustee may not be required to inform a competent adult powerholder of the power’s existence in a state in which the Uniform Trust Code has been adopted.

(a) Duty to Inform

Uniform Trust Code § 813(a) requires a trustee to “keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests.”

(b) Powerholders are Beneficiaries

Uniform Trust Code § 103(3) states that a beneficiary is any person who has either a present or future beneficial interest in a trust, or a power of appointment over trust property. The Comments to this section explain that:

“While the holder of a power of appointment is not considered a trust beneficiary under the common law of trusts, holders of powers are classified as beneficiaries under the Uniform Trust Code. Holders of powers are included on the assumption that their interests are significant enough that they should be afforded the rights of beneficiaries.”

(c) Powerholders May be Qualified Beneficiaries

Qualified beneficiaries include “a distributee or permissible distributee of trust income or principal,” someone who would be such a distributee “if the interests of the distributees . . . terminated on that date without causing the trust to terminate,” and someone who “would be a distributee or permissible distributee of trust income or principal if the trust terminated on that date.” Uniform Trust Code § 103(13). Under the Uniform Trust Code, therefore, a powerholder who is a discretionary beneficiary is clearly a qualified beneficiary entitled to notice of the trust’s terms, while one who has no beneficial interest is not a qualified beneficiary and the trustee has no obligation to give him or her notice of the trust and its terms.

(d) Waiver of Notice by the Trust Instrument

Uniform Trust Code § 103(b)(8) states that the duty of the trustee to notify qualified beneficiaries of an irrevocable trust who have reached 25 years of age of the trust’s existence, the identity of the trustee, and of their right to request trustee’s reports, cannot be waived by the trust instrument.

(2) Common Law

The trustee is less likely to be required to inform a competent adult powerholder of the power’s existence in a state in which the Uniform Trust Code has not been adopted. The comments to Uniform Trust Code § 103 note that treating holders of powers of appointment as beneficiaries is a departure from the common law of trusts, but that the Uniform Trust Code changes this rule.
Restatement (Third) of Trusts § 82 (2007) provides that the trustee of an irrevocable trust, unless the instrument provides otherwise, must inform fairly representative beneficiaries of the trust’s existence, their status as beneficiaries, and their right to obtain other information regarding the trust and the trustee, and under this section “[o]ccasionally . . . the trustee’s duty to provide information about a trust will extend also to a donee of a power of appointment . . .” Oddly, the Restatement (Third) of Trusts does not state what those conditions might be, but the fact that a power would cause assets to be included in the gross estate of the powerholder would seem a compelling reason to require a trustee to inform the powerholder of its existence. See also George G. Bogert & George T. Bogert, The Law of Trusts and Trustees § 961 (rev. 2d ed. 1983) (“the trustee must inform the beneficiary of all material facts affecting the beneficiary’s interest that the trustee knows the beneficiary does not know, but that the beneficiary needs to know to protect the beneficiary’s interest in dealing with a third party.”)

(3) Possible Analogy to Crummey Powers

(a) Rev. Rul. 81-7 Requires Notice -- Sort Of

In Rev. Rul. 81-7, 1981-1 C.B. 474, the IRS stated that a withdrawal power does not create a present interest unless the beneficiary is aware of its existence and of any gift against which it may be exercised. Absent such knowledge, the IRS views such a withdrawal power as illusory and inadequate to create a present interest. In that ruling, however, G created a trust giving to A, the beneficiary, a Crummey power that lapsed at the end of the year. G made a gift to the trust on December 29. No notice was given to A. The IRS stated that the gift tax annual exclusion was not available for these gifts, because

“[i]n failing to communicate the existence of the demand right and in narrowly restricting the time for its exercise, G did not give A a reasonable opportunity to learn of and to exercise the demand right before it lapsed. G’s conduct made the demand right illusory and effectively deprived A of the power.”

The use of the conjunctive “and” in the quoted material, however, suggests that only the combination of (1) the failure to give notice and (2) the lack of a reasonable amount of time within which to exercise the withdrawal rights justified denial of the annual exclusion. This interpretation suggests that failure to give notice, alone, does not deprive the donor of the annual exclusion and, by analogy, and does not impair the effectiveness of a power of appointment to produce a basis adjustment at the powerholder’s death.

(b) IRS Requires Notice; Tax Court Does Not

The Tax Court has repeatedly rejected the requirement of notice for a Crummey power. Estate of Turner v. Comm’r, T.C. Memo. 2011-209; Estate of Cristofani v. Comm’r, supra. In fact, notice was not given to the beneficiary in Crummey v. Comm’r, 397 F.2d 82, 86–87 (9th Cir. 1968), aff’g in part and rev’g in part T.C. Memo. 1966-144, but in that case the beneficiary was a minor. Thus, the IRS view that notice of a power to appoint to oneself or, by extension, to others, is required in order to make the power effective for income and transfer tax purposes is without much legal support.
Nonetheless, a practical practitioner may deem it appropriate to give the power-holder notice of the power and his or her right to exercise it, to minimize the chances of a challenge to the validity of the power as a tool for increasing the basis of the subject property. Of course, this brings one back to the most difficult issue – finding an upstream powerholder who will not, either voluntarily or involuntarily, divert the funds from the natural objects of the donor’s affection, and minimizing the risk that one’s choice turns out to be less reliable than one hoped.

7. Avoiding Voluntary Diversion by the Exercise of the Power

One can minimize the risk of diversion of the subject property by requiring that the power be exercised only with the consent of a nonadverse party. Reg. § 20.2041-3(c).

a) “Nonadverse party” defined

(1) Generally

Reg. § 20.2041-3(c) does not refer to a “nonadverse party, but states that a power of appointment is not a general power if it is exercisable only in conjunction with the creator or “with the consent or joinder of a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the decedent, his estate, his creditors, or the creditors of his estate.” Thus, a nonadverse party is anyone who does not have a substantial interest in the subject property and whose interest in the subject property is not adverse to the exercise of the power in favor of the powerholder, his or her estate, the powerholder’s creditors, or the creditors of the powerholder’s estate.

(2) Substantiality of the Interest

Reg. § 20.2041-3(c) states that an interest is substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, these interests are to be valued actuarially. Unfortunately, the regulations do not define “insignificant.”

(3) Adverse Nature of the Interest

Reg. § 20.2041-3(c) states also that a taker in default has an adverse interest, but a coholder of the power does not, unless the coholder obtains the power after the holder’s death and can then exercise it in favor of himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate. One example in the regulations states that a sole remainder beneficiary who is entitled to the subject property after the death of both the powerholder and another person has a substantial adverse interest. Reg. § 20.2041-3(c), Ex. 1. Another example demonstrates that a discretionary beneficiary to whom the trust principal may be distributed has a substantial adverse interest. Reg. § 20.2041-3(c), Ex. 2. On the other hand, a third example shows that a beneficiary who is entitled to trust income during his or her lifetime does not have an interest adverse to a power to appoint the trust funds at the beneficiary’s death. Reg. § 20.2041-3(c), Ex. 3.

(4) Drafting

One of the more difficult problems is finding a nonadverse party who is willing to risk being sued by the unhappy holder of a power of appointment. There are several ways to approach this.
First, one could name an independent trustee as the nonadverse party. The trustee has a fiduciary duty to protect the interests of the beneficiaries named in the instrument, and so is less likely to consent to a different exercise of the power than would be an uninvolved person. The trustee’s fiduciary duty also gives the trustee a better litigating position if the powerholder does sue. Also, the trust can provide that the cost of the defense of such a suit should be borne by the trust assets, rather than the trustee’s personal resources.

Second, one could seek out that family member who exists in most families, who never agrees with anyone on anything. Such persons are uniquely well-suited to the role as consenting nonadverse person, and they are used to having disputes with family members. Again, however, the trust should provide that the cost of defense of any such suit will be borne by the trust assets.

Third, one could require that the local court serve as the nonadverse party. A local court has no financial interest in the trust, and is clearly a nonadverse party. The time required to obtain the consent of the court means that the powerholder cannot effective act rashly, and the local court is likely to require that all financially-interested persons be notified of the suit and have an opportunity to make their views known. This protects the trustee and slows down the process to minimize the risk of a rash exercise of the power of appointment.

Also, the required consent of a nonadverse party could be imposed in all cases or only where the holder attempts to exercise the power in favor of someone other than the donor or the natural objects of the donor’s bounty. The latter group could be described, for example, as “the descendants of the donor’s grandparents, and all charitable organizations”. A key difficulty with this approach is finding a non-adverse party whom the donor trusts implicitly and who is willing to be the possible target of abuse from the holder of the power or his or her intended appointees who disagree with the decision of the nonadverse party to reject the proposed appointment.

b)  **Limit Appointees to Powerholder’s Creditors**

Some practitioners believe that allowing the powerholder to appoint only to his or her creditors will be restrain diversion, while still creating a general power of appointment. In reality, it does not restrain the powerholder very much, because he or she can merely borrow money to spend or give away, and then appoint the trust assets to the lender in satisfaction of the debt. It does force the powerholder to take this additional step, rather than just to appoint the property to his or her estate, but it is hardly a significant restraint on diversion. Also, while the authors disagree, some practitioners are concerned that a power exercisable in favor of one’s creditors (or the creditors of one’s estate) could be interpreted as general only to the extent that there are actual creditors. This seems inconsistent with the point just made, that the holder of the power has the ability to borrow money and thus expand the appointive property.

8.  **Rights of the Powerholder’s Creditors**

a)  **Generally**

Property subject to a nongeneral power of appointment is not usually subject to the claims of the donee’s creditors, but property subject to a general testamentary power of appointment may be subject to the claims of the creditors of the powerholder’s estate.
b) **Uniform Trust Code**

The Uniform Trust Code does not address creditor issues with respect to property subject to a testamentary general power of appointment. The comments to Uniform Trust Code § 505 refer to *Restatement (Second) of Property: Donative Transfers* §§ 13.1 to 13.7 (1986), discussed below.

c) **Restatement (Second) of Property: Donative Transfers**

Traditionally, property subject to an exercised general testamentary power of appointment could be subjected to the payment of claims against the powerholder’s estate. *Restatement (Second) of Property* § 13.4 (1986). The idea is that until the powerholder exercises the power, he or she has not accepted sufficient control over the subject property to be treated as if it were owned outright.

d) **Restatement (Third) of Property: Donative Transfers**

The more modern rule is reflected in *Restatement (Third) of Trusts* § 56, Comments (2007), which states that property subject to a testamentary general power of appointment is subject to the claims of the creditors of the powerholder’s estate, whether or not the power is exercised, because the power alone is equivalent to outright ownership. The subject property is subject to the claims of the powerholder’s creditors to the extent the powerholder’s estate is insufficient satisfy the claims of those creditors. Property subject to a general testamentary power of appointment does not enable the powerholder’s creditors to reach the trust assets during his or her lifetime. California, Michigan and New York all have specific statutory provisions following the pattern of the Restatement (Third).

e) **Uniform Power of Appointment Act**

Section 502 of the Uniform Power of Appointment Act (2013) follows *Restatement (Third) of Trusts* and permits the creditors of the estate of the powerholder to reach the subject property, to the extent the estate’s other property is insufficient to meet all claims. This right is subject to the powerholder’s right to direct the source from which liabilities are paid.

f) **Bankruptcy Act**

The U.S. Bankruptcy Code states that the trustee in bankruptcy “stands in the shoes” of the debtor and so may be able to exercise the general power on behalf of the debtor/powerholder and in favor of the bankrupt estate. 11 U.S.C. § 541(b)(1); *In re Behan*, 506 B.R. 8 (Bankr. D. Mass. 2014); *In re Gilroy*, 235 B.R. 512 (Bankr. D. Mass. 1999); see also Bove, *Using the Power of Appointment to Protect Assets – More Power than You Ever Imagined*, 346 ACTEC L. J. 333, 338 (Fall 2010).

g) **Planning Considerations**

(1) **Requiring Solvency**

One could precondition the valid exercise of the power in favor of the powerholder’s estate upon the solvency of the powerholder’s estate. Reg. § 20.2041-3(b), while not expressly authorizing such conditions, seems to presume their viability, when it provides that “a power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death.” However, the Tax Court’s decision in *Kurz v. Comm'r*, *supra*., could pose a problem. The powerholder can always incur new debts, so *Kurz* could cause an insolvent powerholder’s gross estate to include the full value of the maximum assets that could have been subject to the power had
the powerholder died solvent. Kurz was just a tax case, but a state court could apply this same analysis to the rights of the powerholder’s creditors, and permit creditors of an insolvent powerholder’s estate to reach the power, even though it was not, by its terms, exercisable.

2) Careful Selection of Powerholder

The best solution to the risk that the powerholder’s creditors may seek to attach the trust assets that are subject to the powerholder’s general power of appointment is to grant such powers only to persons who have no significant debts and who are unlikely to incur significant debts. This sounds easier than it is, of course, because the fortunes of an individual can change. One way to minimize the risk is to grant the power of appointment only to individuals who are quite elderly and, therefore, unlikely to live long enough to create substantial new debts. Unfortunately, most people do not come with a “use by” date tattooed on their forehead, so that one must rely upon an educated guess as to the donee’s life expectancy.

3) Use a Limited Power of Appointment

One could give the powerholder only a limited power of appointment, which could then be exercised to trigger the Delaware Tax Trap under Section 2041(a)(3), by appointing the property in trust for the benefit of the desired beneficiaries, giving them a currently exercisable general power of appointment. In states that permit one to trigger the Delaware Tax Trap, this should result in inclusion of the subject property in the upstream powerholder’s gross estate, with the desired income tax basis adjustment, without subjecting the assets to the claims of the creditors of the powerholder. Of course, the Delaware Tax Trap does cause the assets to become subject to the claims of the appointees’ beneficiaries, because a presently exercisable power to appoint trust assets to oneself is treated as equivalent to outright ownership for most state law purposes, including creditors’ rights.

4) Requiring Consent of Nonadverse Party

Generally, property subject to a general power of appointment that is exercisable only after a condition is met is not subject to the claims of the powerholder’s creditors until that condition has been met, because the powerholder’s creditors cannot reach assets that the powerholder cannot personally appoint. Peter Spero, Asset Protection: Legal Planning, Strategies and Forms ¶ 13.10 (Thomson Reuters/Tax & Accounting, 2001 & Supp. 2018-2); Bove, Using the Power of Appointment to Protect Assets – More Power than You Ever Imagined, 346 ACTEC L. J. 333, 337-338 (Fall 2010). Thus, creditors ought not to be able to reach assets that can be appointed only with the consent of a nonadverse party, unless they can prove that there was a prearrangement under which the nonadverse party would always consent to whatever appointment the powerholder made.

9. GST Tax Issues

a) Generally

An upstream general power of appointment should not cause GST tax problems, but it does effect a series of changes in the GST status of the trust and it does require that the upstream person holding the general power of appointment allocate or be deemed to have allocated GST exemption to the trust at his or her death.

b) New Transferor
If property is subject to estate tax in a decedent’s estate, the decedent becomes the transferor of that property for GST tax purposes. Reg. § 26.2652-1(a)(2). Thus, the death of the upstream powerholder causes the powerholder to be substituted as the transferor of the property that was the subject of the power of appointment, whether it was exercised or lapsed. This is particularly problematic because the upstream powerholder is, by definition, likely to be assigned to an even higher generation than the original transferor, so that individuals who were previously not skip-persons may become skip-persons with respect to this portion of the trust.

c) Loss of Original GST Exemption Allocation

The change in the identity of the transferor, because the trust is subject to estate taxation in the upstream person’s estate, results in a determination of a new inclusion ratio. Thus, a new transferor for a trust results in the loss of any further benefit from the GST exemption previously allocated to the trust. This is not stated directly in the statute. This result follows from the rule in IRC § 2631(a) that only the transferor can allocate the GST exemption to a trust or transfer. See C. Harrington, L.L. Plaine, J. Miraglia Kwon, & H. Zaritsky, *Generation-Skipping Transfer Tax* ¶ 4.06[4][g] (Thomson Reuters/Tax & Accounting, 2d ed. 2001 & 2018 Cum. Supp. No. 2).

d) New Allocation of GST Exemption Required

(1) Generally

It is easy to use up one’s applicable exclusion amount without using an equal amount of GST exemption, merely by making gifts to nonskip persons. Large generation-skipping transfers, however, always utilize applicable exclusion amount. (Annual exclusion gifts, however, may require GST exemption allocation but not exhaust the donor’s applicable exclusion amount.) Taxable gifts Thus, the upstream person should usually have at least as much unused GST exemption as his or her unused applicable exclusion amount. The upstream person should then allocate (or be deemed to have allocated) his or her GST exemption to the trust, preserving or creating a zero inclusion ratio.

(2) Automatic Trust Division

When different persons make transfers to the same trust, the trust must recalculate its inclusion ratio, and the trust is automatically treated like two separate trusts for GST tax purposes. IRC § 2654(b); Reg. § 26.2654-1(a)(2)(i). Treatment of a single trust as separate trusts under this rule is solely for purposes of calculating the GST tax; it does not mean that the trust files two income tax returns. Reg. § 26.2654-1(a)(2)(i). Because the two trusts should both have zero inclusion ratios (one based on the allocation of GST exemption by the original transferor and the other based on the allocation of GST exemption by the upstream person).

(3) Automatic Deemed Allocations

Obviously, the estate of the upstream person can file an estate tax return and allocate GST exemption to the trust. IRC § 2632(a). The unused GST exemption of a deceased upstream person will be automatically allocated to the trust, after allocation to any direct skip transfers, because the trust individual is a transferor and taxable distribution or a taxable termination might occur from the trust at or after such individual’s death. IRC § 2632(e).

e) Don’t Allocate GST Exemption – Wait for Upstream Powerholder to Pass
One way to avoid the issue of wasting the original donor’s GST exemption is simply for the original donor to opt-out of being his/her GST exemption. Thus, when the upstream powerholder dies, such upstream powerholder’s GST exemption is allocated to the trust. However, care must be given when giving the upstream powerholder an unlimited general power of appointment, because if the assets to which the power is given exceeds the donee/upstream beneficiary’s unused lifetime exclusion amount or GST exemption, there could be estate or GST tax implications.

10. Limiting the Power of Appointment

If the upstream beneficiary is given a testamentary general power of appointment over the POAST, at the time of such upstream beneficiary’s death, the entire value of the POAST would be included in his/her gross estate. This could cause unintended consequences (i.e., it may cause a Federal estate tax, where one was not anticipated).

To eliminate this contingency, the upstream beneficiary’s testamentary general power of appointment should be structured as a contingent testamentary general power of appointment. Using a contingent general power of appointment is not a new concept. It has been used for over 30 years (i.e., since the inception of the 1986 version of the GST tax) to minimize the impact of such tax. The drafter should be careful in structuring the contingent general power of appointment to minimize risking the IRS raising the step transaction / implied agreement doctrine, however.

a) Limiting to the Upstream Beneficiary’s Otherwise Unused Applicable Exclusion Amount

Limiting the contingent general power of appointment to the upstream beneficiary’s otherwise unused applicable exclusion amount avoids the imposition of any estate tax when the upstream beneficiary dies. If the assets in the POAST exceed the upstream beneficiary’s otherwise unused applicable exclusion amount, and there is no limit on the general power of appointment, then the upstream beneficiary would have a taxable estate with an estate tax liability.

For example, if the upstream beneficiary, G1, never made taxable gifts in his lifetime and had a gross estate of $2.18 million, and the POAST had assets of $10 million, the basic exclusion amount at the time of death was $11.18 million, and G1 has an unlimited general power of appointment, then there would be an estate tax due on $1 million (i.e., $2.18 million + $10 million - $11.18 million = $1 million). Thus, even though there would be a basis adjustment on all of the assets, there would now be an estate tax of $400,000 (assuming a 40% estate tax rate).

Thus, the contingent general power of appointment should be limited to the upstream beneficiary’s otherwise unused applicable exclusion amount.

From a planning perspective, we suggest that the contingent general power of appointment should be limited to an amount equal to the upstream beneficiary’s otherwise unused applicable exclusion amount less $10,000. The reason for this is that the gross estate of the upstream beneficiary will be less than the threshold for filing an estate tax return. Thus, you get all of the benefits of a basis adjustment without having to file an estate tax return!

b) Limiting to the Upstream Beneficiary’s Otherwise Unused GST Exemption

The upstream beneficiary’s contingent general power of appointment should also be limited to his/her otherwise unused GST Exemption, because if it is not, then it is entirely possible that there could be a taxable termination at the upstream beneficiary’s death, which would cause a GST tax to be imposed.
For example, let’s assume that the upstream beneficiary (G1) made significant annual exclusion gifts to GST trusts where he used $5.18 million of his GST exemption, but had never used any of his applicable exclusion amount. Let’s assume that at the time of his death G1 had a gross estate of $1.18 million and had an unlimited general power of appointment over a POAST worth $10 million at the time of his death. Assume that he dies in 2018 when the basic exclusion amount and GST exemption is $11.18 million. Assume further that the trust was created by upstream beneficiary’s son, G2, where G1 had a discretionary income interest for support and G2’s children (i.e., G1’s grandchildren) were also discretionary beneficiaries. And upon G1’s death, the trust is for G3 (i.e., G1’s grandchildren) and their descendants.

As a result of G1’s death, there will be no estate tax, because the gross estate (i.e., $1.18 million + $10 million = $11.18 million) is equal to G1’s applicable exclusion amount (of $11.18 million), thus, there is no estate tax. However, because G1 only had $6 million of GST Exemption remaining (having used $5.18 million of his $11.18 million during his life), $4 million of the POAST will not be GST exempt. And, because G1 becomes the ‘transferor’ for GST tax purposes as a result of including the POAST in G1’s estate for estate tax purposes, and because the only beneficiaries are G3 and their descendants, who are skip persons as to G1, there is now a taxable termination and $1.6 million of GST tax due (assuming a 40% GST tax rate).

To avoid the unintended incursion of estate tax or GST tax liability, the upstream beneficiary should be given a contingent general power of appointment limited to the lesser of (a) the upstream beneficiary’s otherwise unused applicable exclusion amount (reduced by $10,000), or (b) the upstream beneficiary’s otherwise unused GST Exemption (reduced by $10,000).

By limiting the general power of appointment, you not only avoid the possibility of the imposition of the estate and/or GST tax liability, but also eliminate the need to file an estate tax return for the upstream beneficiary, while at the same time obtaining a basis adjustment for the assets. And, this can all be accomplished by using a POAST!

11. Interaction of an Upstream General Power of Appointment and a Crummey Power

There is no case or ruling on point, but a testamentary general power that gives the upstream person the power to appoint all or some part of a gift that is still subject to the donee’s Crummey withdrawal power could disqualify the gift for the annual exclusion, because the beneficiary’s withdrawal right is not absolute. Furthermore, a testamentary general power that gives the upstream person the power to appoint all or some part of a gift that is still subject to the donee’s hanging Crummey withdrawal rights could be deemed to cause those rights to lapse in excess of the five percent or $5,000 limitation, thereby causing a taxable gift. To avoid this, the upstream power of appointment should expressly not apply to any portion of the trust that is subject to a beneficiary’s Crummey withdrawal right.

One astute author has noted that:

“Ironically, any power to appoint trust assets that can only be made to a trust which keeps the existing Crummey withdrawal right intact is not a general power as to that portion (as it cannot be appointed to the power holder, his/her creditors, estate, or creditors of estate). [citation omitted] However, because any such appointive trust would have a presently exercisable general power of appointment (a Crummey power is a presently exercisable power of appointment), the exercise of the limited power of appointment would trigger the Delaware Tax Trap under most every state law. [citation omitted] Thus, the appointment of any portion subject to Crummey rights would trigger inclusion under §2041(a)(3) and the appointment of the remaining portion would trigger inclusion under §2041(a)(2).”
12. **Death of Upstream Powerholder within One Year of Gift to Trust -- IRC §1014(e)**

a) **Generally**

If the powerholder dies within one year of the gift funding the trust, a step up in basis should not be denied under IRC § 1014(e), even if the same assets return to the donor by appointment or in default of a valid appointment. IRC § 1014(e)(1) denies a basis adjustment only for “appreciated property . . . acquired by the decedent by gift during the 1-year period ending on the date of the decedent’s death . . . .” This rule requires a transfer of property, and the grant of a general power of appointment is not a transfer of property; it is a transfer of the ability to dispose of property that the transferee (powerholder) does not possess. There are no cases or rulings on this point, and the IRS may take a different position. One should caution the client that there is always a chance that this type of trust will not provide the desired basis adjustment unless the powerholder lives for at least one year.

b) **The Gift and Sale Approach**

(1) **Generally**

Some practitioners suggest that the trust be funded with cash or unappreciated assets, and that the grantor then sell appreciated property to the trust for a promissory note. The theory is that the sale is not a gift for purposes of IRC § 1014(e), and the original gift was not of appreciated property, so that this rule should not apply.

(2) **The Step Transaction Doctrine Rears its Ugly Head**

The problem with this analysis is that the step transaction doctrine is likely to cause the gift and sale to be treated as part of an integrated transaction, to which IRC § 1014(e) may apply.

(a) **Using Older Powerholders Increases Step Transaction Problems**

This is particularly true because one tends to use the upstream power of appointment with an elderly powerholder, so that there may be relatively little time between the grant of the power and its lapse or exercise. The proximity of the two steps is, admittedly, only one factor in determining the application of the step transaction doctrine, but it is one of the most important.

(b) **Planning to Avoid the Step Transaction Doctrine on a Gift and Sale Transaction**

The planner must take steps to treat the initial gift as transaction from the later sale to the trust.

(i) **Time is Not on Your Side**

This may be as simple as waiting a substantial time between the initial gift and the sale, but as noted above, one may not have a long time to wait between the transactions. Also, there is no bright line test for time. The longer the time between steps, the less likely it is that the steps will be treated as part of a single
integrated transaction. Compare, however, Henricksen v. Braicks, 137 F.2d 632 (9th Cir. 1943) (transactions one-half hour apart were independent); and Comm’r v. Ashland Oil & Refining Co., 99 F.2d 588 (6th Cir. 1938), cert. denied, 306 U.S. 661 (1939) (steps six years apart were part of a single integrated transaction).

(ii) Do Not Document the Multiple Steps

The planner should not explain in writing that the gift of cash or unappreciated assets will be followed by a sale for appreciated assets. Even privileged communications have a nasty habit of turning up in IRS files. Instead, the planning memo should describe the creation of the trust and the cash or unappreciated property gift. The trustee should then invest the cash, rather than keeping it in its present form. The memo should also state that, after a reasonable time, the grantor and the trustee should meet with the planner to discuss further investment options for the trust. After that meeting, the planner can document the sale to the trust.

13. Grantor Trust Status After the Powerholder’s Death

A trust is a grantor trust if the grantor retains (or a nonadverse person holds) the delineated powers and interests described in IRC §§ 673-677. The grantor does not own any portion of the trust attributable to a transfer by someone else, unless the grantor holds a withdrawal power described in IRC § 678. The death of the powerholder constitutes a constructive addition to the trust for grantor trust purposes only if the powerholder exercises the power in favor of the trust; the lapse of the power does not constitute a constructive addition to the trust. See Reg. §§ 1.671-2(e)(5), 1671-2(e)(6), Ex. 9. Thus, if the trust is a grantor trust and the grantor wants it to remain a grantor trust, the powerholder should allow the general power of appointment to lapse, rather than exercise it.

14. Exercising an Upstream General Power to Appoint Assets in Trust for the Grantor’s Benefit

a) Generally

A grantor who retains beneficial enjoyment or the power to alter beneficial enjoyment of a trust fund may have the trust assets included in his or her gross estate under IRC §§ 2036 or 2038. The law is unclear, but there is a good chance that the same result may occur if an upstream powerholder exercises his or her general power of appointment in further trust for the benefit of the grantor.

b) Does the General Power of Appointment Negate the Original Transfer by the Grantor for Estate Tax Purposes?

(1) IRC § 2036 – Not Usually a Problem

IRC § 2036(a) includes in a decedent’s gross estate property transferred by the decedent during his or her lifetime (except for a bona fide sale for an adequate and full consideration in money or money’s worth), and as to which the decedent retains a lifetime right to income or enjoyment of the property or a right to designate who shall enjoy the beneficial enjoyment of the property. The requirement that the interest or power be “retained” renders it difficult to apply IRC § 2036(a)
to an interest that is granted the donor by the exercise of an upstream testamentary power of appointment.

IRC § 2036(a) could apply, however, if there is an understanding or agreement between the donor and the upstream powerholder that the latter will exercise the power in a manner that bestows an interest or power to the former. In such a situation, the interest could be deemed retained. For this reason, the upstream powerholder should have separate counsel draft the will that exercises his or her power of appointment; use of the same counsel who prepared the trust instrument could raise a suggestion that there was an understanding or agreement to benefit the donor.

(2) IRC § 2038, However, is Another Matter Entirely

(a) Generally

IRC § 2038(a)(1) includes in a decedent’s gross estate property transferred by the decedent during his or her lifetime (except for a bona fide sale for an adequate and full consideration in money or money's worth), and the decedent possessed on the date of death a power to alter, amend, revoke, or terminate. IRC § 2038(a)(1) does not require that the decedent have retained this power; it requires only that it exist on the date of the decedent’s death. See Rev. Rul. 70-348, 1970-2 C.B. 193 (property included in estate of decedent who became custodian of gift to minor on death of original custodian).

Therefore, on its face, IRC § 2038(a)(1) should apply if the upstream powerholder exercises a general power to appoint the subject assets in further trust, either for the beneficial enjoyment of the original grantor (such as a right to invade principal or income) or for the beneficial enjoyment of others in the discretion of the original grantor. See Seasonsgood v. United States, 331 F. Supp. 486 (S.D. Ohio 1971). A grantor’s right to distribute trust assets subject to an external ascertainable standard, however, does not fall under IRC § 2038(a)(1). Estate of Ford v. Comm’r, 53 T.C. 114 (1969), acq. in part, nonacq. in part recommended, AOD, 1970 WL 22802 (May 13, 1970), 1978 WL 194691 (Dec. 31, 1978), aff’d per curiam, 450 F.2d 878 (2d Cir. 1971).

(b) Is the Upstream Powerholder the True Transferor?

One might argue that the inclusion of the subject assets in the powerholder’s gross estate under IRC § 2041 should cause the powerholder to replace the original grantor as the transferor of the subject property for purposes of IRC § 2038. Unfortunately, there appears to be no authority to support this analysis.

(i) Point Against

IRC § 2038(a)(1) states that it applies "without regard to when or from what source the decedent acquired such power." This
would appear to undercut the argument that the upstream powerholder should supplant the original grantor for purposes of IRC § 2038.

(ii) **Comparison with IRC § 2044**

A contrary rule applies where property is included in the gross estate of a donee-spouse under IRC § 2044. In such cases, the donee-spouse is treated as the transferor for estate and GST tax purposes and can create a trust for the original grantor without the application of IRC §§ 2036 or 2038. This, however, is because of a specific statutory direction that a deceased spouse be treated as the transferor of any property includible in his or her gross estate because of a lifetime QTIP election. IRC § 2044(c).

(iii) **Comparison with Grantor Trust Rules**

In determining who is the grantor of a trust for grantor trust purposes, Reg. § 1.671-2(e)(5) states that:

> “If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.”

This, however, is an income tax rule, and there is no authority for adopting a similar rule for estate tax purposes.

15. **Combining a POAST with a Domestic Asset Protection Trust**

The only reason why a general power of appointment might not be appropriately granted to an upstream person with respect to a trust created for the grantor’s lifetime benefit under a domestic asset protection trust statute, would be that it could expose the trust assets to the claims of the powerholder’s creditors. There appears to be no inconsistency between the rules for an upstream general power of appointment and those for a domestic asset protection trust.

16. **Other Innovative Planning Opportunities with POASTs**

One of the major goals of the POAST is to utilize the upstream beneficiary’s otherwise unused applicable exclusion amount and GST exemption, by causing part or all of the assets in the POAST to be included in G1’s gross estate. A goal, not explicitly stated before, is to try to fund the POAST
with assets, but to do so without using too much of the donor’s (i.e., the lower generation’s) applicable exclusion amount.

For purposes of this section, we call the upstream beneficiary, G1, the donor, G2 and the donor’s other beneficiaries (e.g., his descendants), G3.

Funding by using G2’s annual exclusion amounts accomplishes that goal; however, it is limited to the amount of G1s and G3s. But, there are other ways to fund the POAST.

a) The Pour-Over GRAT Approach

Using zeroed-out GRATs are generally a good planning tool in low interest rate environments, because they are very little of G2’s applicable exclusion amount. However, they are not good tools from a GST tax perspective (because of the so-called “ETIP” rules). With successful GRATs, assets remaining in the GRAT could pour-over into the POAST.

Remember, we do not suggest allocating G2’s GST exemption to the POAST. We wait until G1 dies and uses his otherwise unused GST exemption and allocates it to the POAST. This way, you get the benefit of the GRAT (i.e., passing assets gift/estate tax free) as to G2, and the allocation of G1’s GST exemption, and a basis adjustment at G1’s death.

b) The Pour-Over CLAT Approach

CLATs, like GRATs, are also good, low-interest rate estate planning tools. Like GRATs, if the CLAT is successful, the remainder generally passes to non-charitable beneficiaries. And, like GRATs, the ETIP rules apply. To get the same benefits as using a “pour-over GRAT”, if there is a POAST, consider leaving the remainder of the CLAT to the POAST.

c) The Convertible POAST

Consider converting an otherwise irrevocable, dynastic trust to a POAST. Many irrevocable, dynastic grantor trusts have trust protectors with the power to add a beneficiary (i.e., often to achieve grantor trust status under IRC § 674(c)). If the trust has such a provision, simply add G1 as a beneficiary and give G1 a contingent testamentary general power of appointment.

If there is no trust protector, consider judicial modification. For instance, the grantor, beneficiaries and trustee could petition a court to add G1 as a discretionary income and principal beneficiary, and also provide G1 with a contingent testamentary general power of appointment.

Alternatively, if the state law permits, it may be possible to accomplish the same (i.e., adding G1 as a beneficiary with a contingent testamentary general power of appointment) through non-judicial modification.

d) Insuring G1’s Life

Another efficient way to leverage the POAST is to purchase life insurance on G1’s life, if it is financially feasible.

e) The Sale to a POAST

To add value to the POAST, consider the “sale to the intentionally defective grantor trust” approach. Since the POAST is structured as a grantor trust for income tax purposes, consider the sale of discounted assets to the POAST, where G2 would take back a promissory note with a favorable interest rate. If the assets outperform the interest rate on the promissory note, the appreciation will increase the net value of the POAST.
17. Premature Death of the Donor

It is entirely possible that the donor (G2) predeceases the upstream beneficiary (G1). If this is the case, the basis of the transferred assets into the POAST will not get a basis adjustment at G2’s premature death (i.e., the opposite result had G2 done nothing). So, one may think that the planning did not succeed. That is not accurate. Let’s put things into perspective.

If G2’s death was foreseeable (i.e., G2 was ill at the time of the planning), the POAST should not have been a suggested planning tool. Conversely, if death was not foreseeable, the statistical likelihood of G2 predeceasing G1 would have been small, and thus likely ignored.

Remember, premature death simply delays the income tax benefit of the basis adjustment (unless you take the position that the basis can be adjusted at G1’s death).

However, because the POAST was a grantor trust, it is likely that there would be a ‘swap power’ under IRC § 675(4)(C), which could have allowed G2 to swap some higher basis assets into the POAST and lower basis assets back into G2’s estate before death to reduce the impact of waiting for the lower-basis assets to be adjusted when G1 dies.

Finally, it is important to remember the income tax benefit (i.e., basis adjustment) is only one of the benefits, the other benefits include the allocation of G1’s otherwise unused GST exemption, the basis adjustment when G1 dies, and the ability to care financially for G1, should the need arise.

18. The SLAT-POAST

The so-called, Spousal Lifetime Access Trust, or SLAT, became a highly-touted estate planning tool in the early 2000s. The idea behind the SLAT was to create a trust for the benefit of one’s spouse and descendants, and, assuming a happy marriage (or a relatively happy marriage, or a so-so marriage, but one that will likely end with death of one spouse), the donor and spouse get to effectively use the assets for their benefit, even though the assets have been moved out of the donor’s estate for estate tax purposes.

The POAST can be structured as a SLAT. In other words, if the donor is (happily, relatively happily, etc.) married, he/she could consider creating a SLAT, and adding an upstream beneficiary as a discretionary beneficiary (for support) and giving the upstream beneficiary a contingent testamentary general power of appointment.

This combines the benefits (and burdens) of the SLAT with the benefits (and burdens) of a POAST ... The “SLAT-POAST.”
XIII. BASIS PLANNING: POST-FORMATION TECHNIQUES TO CREATE BASIS IN AN IRREVOCABLE TRUST AT THE GRANTOR’S DEATH – HARDER THAN IT OUGHT TO BE

A. The Problem Explained

The 2017 Tax Act continues a recent history of legislative significant increases in the applicable exclusion amount. Many grantors will find that they now have more applicable exclusion amount than they require, and that their prior gifts to irrevocable trusts will now provide no estate tax savings. Yet, these gifts did remove property from the grantor’s gross estate and so will deprive those assets of a basis adjustment at the grantor’s death. The grantor has, in essence, foregone a basis increase at death in exchange for no actual estate tax savings. Such grantors will often wish to cause their irrevocable trusts to be included in the grantor’s gross estate, either entirely or in part.

The regulations state that an individual cannot retain to himself or herself a general power of appointment, for estate tax purposes. Reg. § 20.2041-1(a)(2) (“For purposes of §§20.2041-1 to 20.2041-3, the term ‘power of appointment’ does not include powers reserved by the decedent to himself within the concept of sections 2036 through 2038.”) Where such a power was not “reserved” by the decedent, however, one could arguably be granted later. Nonetheless, there is no real precedent on this issue, and one might find it useful to evaluate the addition of a power in the grantor to appoint the trust assets under IRC §§ 2036 and 2038, rather than under § 2041.

B. Gross Estate Inclusion under Section 2036

1. Generally

It is difficult to cause the grantor’s estate to include trust assets under IRC § 2036, because that section applies only to interests and powers that are retained by the grantor. One could, perhaps, argue that the grantor retained this interest or power by not expressly negating the power of the trustee and beneficiaries to decant or reform the trust, though there is no authority in support of this analysis.

2. Grantor Cannot Assert Substance Over Form

IRC § 2036 applies to a power or interest in a trust that is retained by an express or implied agreement or understanding, even if it is not expressed in the trust instrument. Skinner v. United States, 316 F.2d 517 (3d Cir. 1963); Estate of Linderme v. Comm’r, 52 T.C. 305 (1969); Estate of Kerdolff v. Comm’r, 57 T.C. 643 (1972); Rev. Rul. 70-155, 1970-1 C.B. 189; Rev. Rul. 78-409, 1978-2 CB 234.

A grantor may, therefore, assert that such an interest or power was retained by an agreement with the trustees that was not expressed in the trust instrument. For example, a grantor who creates a QPRT and outlives the reserved use term could then continue to use the residence without paying adequate rent. Such continued use of the property would normally be deemed a retained beneficial enjoyment, if it were anticipated from the creation of the trust.

The courts and the IRS, however, have held that the taxpayer cannot argue substance over form, because the taxpayer selects the form of the transaction and cannot thereafter challenge it. City of New York v. Comm’r, 103 T.C. 481 (1994), aff’d, 70 F.3d 142 (D.C. Cir. 1995) (“To freely allow taxpayers to argue for alternative tax treatment of a transaction upon the examination of the returns would be tantamount to administering the tax laws based on a policy that tax consequences flow from the ‘transaction taxpayers have chosen or from any other form [of transaction] they might have chosen, whichever is … [more favorable]’”); Estate of Durkin v. Comm’r, 99 T.C. 561, 571-573 (1992); Comm’r v. Danielson, 378 F.2d 771 (3d Cir. 1967), rev’g 44 T.C. 549 (1965); Coleman v. Comm’r, 87 T.C. 178 (1986), aff’d without op. 833 F.2d 303 (3d Cir. 1987); Howell v. Comm’r,
T.C. Memo. 2012-303. See also, CCA 201121020; FSAs 199921002, 199909018, 200004011, and 200242004; and TAMs 9515003, 200334001, and 200418008.

The Ninth Circuit explained this in *In re Steen v. United States*, 509 F.2d 1398, 1402-1403 fn. 4 (9th Cir.1975), in which it stated:

“"The rule [that the government may bind a taxpayer to the form in which he has factually cast a transaction] exists because to permit a taxpayer at will to challenge his own forms in favor of what he subsequently asserts to be true substance would encourage post-transactional tax planning and unwarranted litigation on the part of many taxpayers and raise a monumental administrative burden and substantial problems of proof on the part of the government.""

* * *

"In a case such as this one, where the documentary form of the transaction is ambiguous, the government's assertion of the rule will normally render the taxpayer's factual characterization of the transaction on his income tax return conclusive against his conflicting and subjective testimony.""

C. Gross Estate Inclusion under Section 2038

1. Generally

A grantor may be able to cause trust assets to be included in his or her gross estate by obtaining a power to alter, amend, revoke, or terminate the beneficial enjoyment of those assets. IRC § 2038(a)(1) applies to such a power as long as it is held by the grantor on the date of his or her death (or released within three years of the date of his or her death) "without regard to when or from what source the decedent acquired such power." This suggests that gross estate inclusion should be possible by granting the grantor a power to control the beneficial enjoyment of all or specific trust assets, whether the grantor obtains this power by decanting, judicial reformation, or nonjudicial reformation. Unfortunately, the law is not quite that simple.

2. *Skifter* and the Origin of the Power

Under a line of cases, an IRC § 2038(a)(1) power cannot exist unless its creation was reasonably anticipated by the grantor when the trust was created.

a) *Estate of Skifter*

(1) Facts

In *Estate of Skifter v. Comm’r*, 468 F.2d 699 (2d Cir. 1972), aff’g 56 T.C. 1190 (1971), *nonacq. recommended* AOD (Dec. 22, 1971), *acq*. 1978-2 C.B. 1, Hector Skifter gave his wife an insurance policy he owned on his own life. Hector lived more than three years, but unfortunately, his wife predeceased him, leaving the

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policy to a trust of which he was trustee. As trustee, Hector had the right to change the policy beneficiaries, though he could not benefit himself by so doing.

(2) **Government Argument**

The IRS contended that Hector held incidents of ownership over the policy, notwithstanding that his exercise of those incidents was circumscribed by his fiduciary duties.

(3) **Courts Treat Life Insurance Policy Like Other Assets are Treated Under IRC §§ 2036 - 2038 and 2041**

The Tax Court and the Second Circuit both held for Hector’s estate, that he might have incidents of ownership, but that he should not be taxed on the policy proceeds under IRC §2042. The courts stated that life insurance is supposed to be treated under IRC §2042 like other property is treated under IRC §§2036 and 2038. In this situation, the courts held, Hector had obtained the power to control the policy’s beneficial enjoyment from an unexpected and uncontrolled source – his late wife’s death. The Second Circuit explained:

“This type of power would fall under both §2036 and §2038. The former provision is clearly not triggered in this case because it only applies to a power retained by the grantor over the income from property when he transferred it to another. Thus, for purposes of §2036, it would not matter that the decedent effectively had the power to deprive later income beneficiaries of the income from the corpus in favor of an earlier income beneficiary. However, the latter provision, §2038, would apply because decedent had the power “to alter, amend . . ., or terminate” the trust. The Commissioner has pointed to many cases holding that such a power would result in the property interest over which the power could be exercised being included in the estate of the holder of the power. [citations omitted] Therefore, he argues, this power must be an incident of ownership for §2042 purposes also.

But the Commissioner’s reliance on §2038 cases exposes the fatal flaw in his position. The cases he cites dealt with powers that were retained by the transferor or settlor of a trust. That is not what we have here; the power the decedent had was given to him long after he had divested himself of all interest in the policies-it was not reserved by him at the time of the transfer. This difference between powers retained by a decedent and powers that devolved upon him at a time subsequent to the assignment is not merely formal, but has considerable substance. A taxpayer planning the disposition of his estate can select the powers that he reserves and those that he transfers in order to implement an overall scheme of testamentary disposition; however, a trustee, unless there is agreement by the settlor and/or beneficiaries, can only act within the powers he is granted. When the decedent is the transferee of such a power and holds it in a fiduciary capacity, with no beneficial interest therein, it is difficult to construe this arrangement as a substitute for a testamentary disposition by the decedent. [citations omitted]”
b) Split in the Circuits

The Sixth and Eighth Circuits followed Skifter. See Hunter v. United States, 474 F. Supp. 763, 764-65 (W.D.Mo.1979), aff’d, 624 F.2d 833 (8th Cir. 1980); and Estate of Fruehauf v. Comm’r, 427 F.2d 80 (6th Cir. 1970). See also Estate of Reed v. United States, 36 AFTR 75-6413 (S.D. Fl. 1974), stating that IRC § 2038 applies only

“where the transferor-decedent himself sets the machinery in motion that purposefully allows fiduciary powers over the property interest to subsequenly return to him.”

The Fifth Circuit, however, twice rejected the Second Circuit’s analysis, because it did not believe that the legislative history of IRC § 2038 was relevant to analysis of life insurance policies under IRC § 2042. Terriberry v. United States, 517 F.2d 286 (5th Cir. 1975), cert. denied, 424 U.S. 977 (1976); and Rose v. United States, 511 F.2d 259 (5th Cir. 1975).

c) IRS Fudges and then Acquiesces -- Rev. Rul. 84-179

The IRS nonacquiesced in Skifter, but then acquiesced and adopted its analysis in Rev. Rul. 84-179, 1984-2 C.B. 195, in which it excluded the proceeds of a life insurance policy from an insured decedent’s gross estate, if the policy was held in a fiduciary capacity, the incidents could not be exercised for the decedent’s personal benefit, and:

“the decedent did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and the devolution of the powers on decedent was not part of a prearranged plan involving the participation of decedent.”

See Folk, Fiduciary Powers and Life Insurance: Putting Rev. Rul. 84-179 Into Perspective, 63 Taxes 417 (1985). This, albeit indirectly, appears to accept the concept that IRC § 2041 and, by analogy, IRC § 2038, cannot apply unless the grantor initiates the transfer that results in his or her possession of a power to alter, amend, revoke, or terminate beneficial enjoyment.

a) Analysis

(1) Skifter Seems Correct

Skifter poses a distinct obstacle in using IRC § 2038 to cause an irrevocable trust to be included in a grantor’s gross estate. The legislative history of various tax acts suggests that the court in Skifter was correct, and that IRC § 2038 requires that the grantor’s actions ultimately produce the right to alter, amend, revoke, or terminate. See discussion in Blattmachr, Zeydel, and Gans, The World’s Greatest Gift Tax Mystery, Solved, Tax Notes 61 (April 27, 2007). Thus, one may reasonably expect the IRS to contest the use of a trust reformation or decanting to give the grantor an IRC § 2038.

(2) Level of Grantor Involvement Required

It is not clear what the Skifter analysis actually requires. Logically, it ought not to require that the power be retained by the grantor, because the Code was quite clear in imposing this requirement in IRC § 2036(a) and the plain language that was used there is missing from IRC § 2038. This may be a logical inference, but it is not necessarily legally required. See Kirtsaeng v. John Wiley & Sons, Inc.,
568 U.S. 519 (2013) (No canon of interpretation forbids interpreting different words used in different parts of the same statute to mean roughly the same thing.)

The Skifter analysis appears to require that the grantor take some affirmative action to obtain the power in question, and that he or she not merely sit passively while the power is granted to him or her. Thus, a decanting by the trustee that gives the grantor a power to appoint the trust assets would not seem to satisfy the Skifter requirements, though if the trustee’s decision to decant was prompted by a letter from the grantor stating that the grantor had unused applicable exclusion amount and that the trustee ought to take steps to cause the assets to be included in the grantor’s gross estate, Skifter might be satisfied. A trust reformation initiated by the grantor, either alone or together with the trustee and beneficiaries, to give the grantor such a power would certainly seem to satisfy the Skifter requirements.

Uniform Trust Code § 411(a) states, in part, that:

“(a) [A noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust.] [If, upon petition, the court finds that the settlor and all beneficiaries consent to the modification or termination of a noncharitable irrevocable trust, the court shall approve the modification or termination even if the modification or termination is inconsistent with a material purpose of the trust.] A settlor’s power to consent to a trust’s modification or termination may be exercised by an agent under a power of attorney only to the extent expressly authorized by the power of attorney or the terms of the trust; by the settlor’s [conservator] with the approval of the court supervising the [conservatorship] if an agent is not so authorized; or by the settlor’s [guardian] with the approval of the court supervising the [guardianship] if an agent is not so authorized and a conservator has not been appointed.


For those states that did not adopt UTC’s version of section 411, such as Florida, perhaps using non-judicial modification provisions under UTC section 411 (Fl. Stat. § 736.0111) or using the modification to achieve the settlor’s tax objectives under UTC 416 (Fl. Stat. § 736.0416) may be another way to accomplish this. Note, however, the settlor would have to be a party to the non-judicial modification under section 111 and/or join in the court proceeding under section 416.

States that permit a reformation but have not adopted the Uniform Trust Code may still permit the grantor to file the petition for reformation.

The courts have not provided details on what actions by a grantor are sufficient to cause gross estate inclusion under IRC § 2038 after the trust has been created, but it seems reasonable that such a suit to reform would suffice. In any event, this is the most promising avenue for causing IRC § 2038 to apply to an irrevocable trust
in which the grantor originally retained no power to alter, amend, revoke or terminate.
XIV. BASIS PLANNING: DOUBLE BASIS INCREASE -- THE TAX BASIS REVOCABLE TRUST AND THE JEST

A. Using a General Power of Appointment to Obtain a Basis Increase

Property subject to a general power of appointment held by a decedent is included in his or her gross estate for federal estate tax purposes under IRC § 2041, and that property included in a decedent’s gross estate for federal estate tax purposes obtains a new basis equal to its estate tax value. In a technical advice memorandum and several private letter rulings, the IRS has taken the position that the mere fact that property is subject to a deceased spouse’s general power of appointment does not assure that it will receive a basis step-up, and that IRC § 1014(e) will avoid such a step-up if the surviving spouse who granted the power of appointment had the right to revoke the transfers to the trust during the year prior to the first deceased spouse’s death. These rulings form the basic authority on so-called “tax basis revocable trusts” and “joint estate step-up trusts (JESTs).”

B. TAM 9308002 and the Tax Basis Revocable Trust

This technique, its rejection, and the possibility that the IRS is incorrect, can best be understood in the context of the various rulings on this transaction, now known as the tax basis revocable trust. The first such ruling was TAM 9308002.

1. Community Property Tax Treatment in a Common Law State?

H and W, who were U.S. citizens living in the common-law state of X, created a joint revocable trust one month before W’s death. They placed all property held by them, most of which had been held as joint tenants, into the trust. The trustees were directed to distribute the net income from the trust property to or for the benefit of the grantors in quarter-annual or more frequent installments, and to distribute as much of the principal of the trust property as the trustees determined necessary for the grantors' health, education, support, and maintenance so that the grantors could continue their accustomed manner of living.

Either grantor, acting alone and without the consent of the other grantor, could have revoked the trust during the grantors’ joint lifetimes, in which case an undivided one-half interest in the trust property would have been distributed free of the trust to each grantor. Neither grantor exercised the power to revoke the trust.

At the date of death of the first grantor to die, the trust provided that the decedent's one-half interest in the property passed to the surviving grantor outright and free of trust.

Each grantor had the power to compel the trustee by an inter vivos instrument to pay the taxes, debts, and expenses of that grantor from any assets in the trust. The other grantor's right to revoke the trust is not affected during the lifetime of the grantor making the request, but if a grantor makes the request and the other grantor has not elected to revoke the trust prior to the requesting grantor's death, then at the time of the requesting grantor’s death, the surviving grantor's powers to amend, revoke and withdraw are subject and subordinate to the trustee's duties to pay the taxes, debts, and expenses of the decedent grantor. At the date of W’s death, neither of the grantors had notified the trustee that the trustee was to make such payments.

W’s personal representative included the entire trust fund in her gross estate, including one-half of the trust fund under IRC § 2038, because of the right to revoke, and the other half under IRC § 2041, because of the power of appointment.

2. IRS Analysis and Conclusions

The IRS concluded that IRC § 1014(e) applied and no basis step-up was available for the surviving spouse’s one-half of the trust assets included in the first deceased spouse’s gross estate under IRC
§ 2041. The IRS explained that the legislative history of IRC § 1014(e) expresses Congress' concern that under the pre-1982 rules, an individual could transfer appreciated property to a family member immediately prior to the family member's death, anticipating that on the family member's death the individual would receive the property back (through bequest or devise) and obtain a step-up in basis. Under such circumstances, there is little substance to the initial transfer to the decedent, because of the short period of time between the two transfers. Further, the IRS stated, Congress recognized that the allowance of an unlimited marital deduction and the increase in the unified credit provided an even greater incentive for persons to plan such death-time transfers of appreciated property, since in many cases, the provisions eliminated any estate and gift tax consequences with respect to the transfers. See H. Rep. No. 201, 97th Cong. 1st Sess. 188 (1981), characterizing the step-up in basis in such circumstances as “unintended and inappropriate.” IRC § 1014(e) applies, the IRS stated, unless the deceased donor relinquished actual dominion and control over the property for a full year prior to death. The IRS explained that

“In the instant case, the surviving spouse (i.e., donor) held dominion and control over the property throughout the year prior to the decedent's death, since he could revoke the trust at any time. It was only at the decedent's death that the power to revoke the trust became ineffective. Because the donor never relinquished dominion and control over the property (and the property reverted back to the donor at the spouse's death) the property was not acquired from the decedent under section 1014(a) and (e), notwithstanding that it is includible in the decedent's gross estate. Taxpayer's position in this case would produce the "unintended and inappropriate" tax benefit Congress expressly eliminated in enacting section 1014(e).”

C. Later Private Rulings

The IRS issued several further private rulings involving similar transactions, and in each one concluded that the portion of the trust contributed by the surviving spouse was includible in the first deceased spouse’s gross estate under IRC § 2041, but that no basis adjustment was allowed for that portion of the trust fund under IRC § 1014(e).

1. PLR 200101021

   a) Facts

   In PLR 200101021, the grantors, a married couple, proposed to create a joint trust and fund it with assets that they owned as tenants by the entirety. The trustee would apply trust income and principal as the trustee deemed advisable for the comfort, support, maintenance, health, and general welfare of the grantors. Either grantor could terminate the trust by notice to the other grantor. The trustee would, upon termination of the trust, deliver the trust property to the grantors in their joint names as tenants in common.

   Either grantor also could amend the trust while both grantors were living, by delivering to the other grantor the amendment in writing at least 90 days before the effective date of the amendment.

   The trust also granted the first grantor to die a testamentary general power of appointment, exercisable alone and in all events, to appoint part or all of the assets of the trust to the deceased grantor’s estate or any other person.

   In default of the valid exercise of this power of appointment, the trust fund to which the power relates would be divided into marital and nonmarital shares. The marital share would be paid outright to the surviving spouse, and the nonmarital share held in a trust for the benefit of the surviving spouse, for his or her support and maintenance, and to the couple’s descendants, for their maintenance, support, and education.
b) IRS Conclusions

The IRS ruled, without significant analysis, that:

- The transfer of joint property to the trust would not be a completed gift for gift tax purposes, because each grantor would retain the power to terminate the trust by written notice to the other grantor, and upon such termination, the trustee would deliver the trust property to the grantors in both their names as tenants in common;

- Distributions of trust property to either of the grantors during their joint lives would constitute a gift by the other grantor to the extent of one half of the value of the trust assets distributed, but the gift would qualify for the gift tax marital deduction under IRC § 2523;

- The first grantor to die would possess a general power of appointment over the portion of the trust fund contributed by the other grantor and a power to revoke the trust over the portion of the trust he or she had personally contributed, causing the entire trust fund to be included in the deceased grantor’s gross estate;

- On the death of the first grantor to die, the surviving grantor would be treated as relinquishing his or her dominion and control over the surviving grantor’s one-half interest in the trust, and the surviving grantor would make a completed gift for gift tax purposes of the surviving grantor’s entire interest in the trust, and this gift will qualify for the marital deduction under IRC § 2523; and

- IRC § 1014(e) would apply to any trust property includible in the estate of the first grantor to die that is attributable to the surviving grantor’s contribution to the trust and that is acquired by the surviving grantor, either directly or indirectly, pursuant to the deceased grantor’s exercise, or failure to exercise, the general power of appointment.

2. Other Rulings

See also PLR 200403094 and PLR 200604028, reaffirming the same points as PLR 200101021, but not addressing IRC § 1014(e).

D. The Joint Estate Step-Up Trust (JEST)


1. Structure of the JEST

A JEST is a joint revocable trust created by a married couple who reside in a non-community property state. Each spouse owns a separate share of the trust. Each spouse has the power to terminate the trust during their joint lives, when each spouse’s share will be distributed to him or her individually. The JEST becomes irrevocable when the first spouse dies. Both powers to revoke terminate. The first spouse to die is given a testamentary power to appoint the entire trust fund. On the death of the first spouse to die, the assets of his or her share of the trust are divided into a credit shelter trust A, for the benefit of the surviving spouse and descendants. If the first spouse’s estate exceeds his or her applicable exclusion amount, the excess is held in a QTIP trust for the surviving spouse. If the share of the first spouse to die is less than his or her applicable exclusion amount, then the assets over which he or she holds a general power of appointment are used to fund credit-shelter
trust B, for the benefit of other family members and excluding the surviving spouse as a beneficiary. It is suggested that the surviving spouse may be added as a beneficiary by a trust protector at some later date.

2. Analysis of the JEST

The JEST has one noteworthy advantage over the tax-basis revocable trust, in that the assets contributed by the surviving spouse do not typically pass back to the surviving spouse at the first spouse’s death. The assets passing subject to the power of appointment will, except to the extent appointed otherwise, pass to a trust for other family members. This should make application of IRC § 1014(e) extremely difficult.

E. Analysis of the IRS Position on the Tax Basis Revocable Trust (and, by Extension, on the JEST)

1. Gift at Moment Before Death

a) Generally

TAM 9308002 states that IRC § 1014(e) applies to property acquired by the decedent by gift unless, at least one year before death, the donor relinquishes “actual dominion and control over the property.” Property is “acquired from the decedent by gift” under IRC § 1014(a) only upon such cessation of dominion and control. This is a reasonable interpretation of the requirement of IRC § 1014(e) that the property be acquired by gift within one year of death.

b) Moment Before Death and Basis

The concept is that the surviving spouse made a revocable gift to the first spouse to die that became a completed gift at the moment before the first spouse’s death. This presupposes that the completion of the gift occurs before the first spouse dies. An interpretation that the gift was completed after death would mean that no transfer was made before the first spouse’s death.

c) Moment Before Death and Marital Deduction

PLR 200101021 states that on the death of the first grantor to die, the surviving grantor would be treated as relinquishing his or her dominion and control over the surviving grantor’s one-half interest in the trust, and the surviving grantor would make a completed gift for gift tax purposes of the surviving grantor’s entire interest in the trust, and this gift will qualify for the marital deduction under IRC § 2523. If the gift were deemed to have been made at the moment after the spouse’s death, which seems equally tenable in theory, the gift could not be made to the spouse while he or she was married to the transferor; it would be made to the beneficiaries of the deceased spouse’s estate, and it would not qualify for the estate tax marital deduction. Some commentators believe that this interpretation is at least as valid as the one adopted by the IRS. See Blattmachr, Bramwell & Gans, Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do In The Interim?, 42 Real Prop. Prob. & Tr. J. 413 (Fall, 2007). If the IRS took this position, however, the basis adjustment would have to be allowed, because the property would not pass back to the donor spouse.

d) What Was Transferred within One Year of Death?

(1) The Surviving Spouse’s Contributed Property

TAM 9308002 and the various private rulings do not actually state whether, within one year of death the surviving spouse transferred to the deceased spouse
the assets contributed by the surviving spouse or the power of appointment over those assets. TAM 9308002 speaks of relinquishing dominion and control “over the property” within one year of death. PLR 200101021 refers to the release of dominion and control over “the Trust property.”

(2) The Power of Appointment

Several commentators have interpreted the IRS as having treated the power of appointment as having been transferred within one year of death. See, e.g., Blattmachr, Bramwell & Gans, Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do In The Interim?, 42 Real Prop. Prob. & Tr. J. 413, 421 (Fall, 2007); and Fletcher, Drafting Revocable Trusts to Facilitate a Stepped-Up Basis, 22 Est. Plan. 100, 105 (March/April 1995). This would seem to stretch IRC § 1014(e) well beyond its statutory language, because the power of appointment is not itself property, but a power to control the disposition of property. In reality, however, the IRS focused on the fact that the surviving spouse transferred property to the trust upon the lapse of the power to revoke immediately before the first spouse’s death. The fact that the property was also subject to a general power of appointment was apparently insufficient to override the operation of IRC § 1014(e). The IRS viewed the failure under IRC § 1014(e) to trump the inclusion of the property in the first spouse’s gross estate under IRC § 2041.

2. Existence of a General Power of Appointment

The use of a tax-basis revocable trust or JEST to make the surviving spouse’s assets available to take advantage of the first spouse’s applicable exclusion amount depends upon the existence of a general power of appointment. The IRS appears not to have objected in the actual rulings to treating the powers of appointment as general powers of appointment, though it is understood that the IRS addressed this issue in the negotiations over TAM 9308002, though it did not address it in the final version of the TAM.

a) Exercise with Consent of the Creator

The attorney whose planning was the subject of TAM 9308002 has written that the IRS estate tax examiner in the TAM argued that the power of appointment was a limited power because it was exercisable solely in conjunction with its creator. The agent noted that W could exercise the power only by giving notice to the trustees (including H) and that H would then be able to revoke the trust and withdraw his share of the trust assets. As H had given W her power of appointment, the agent argued that this had the effect of requiring W to exercise the power together with its creator. The IRS National Office ruled that W’s power of appointment was a general power of appointment. This is consistent with several cases which have held that a donor’s right to dispose of the property to which a power of appointment relates after the exercise of that power is not equivalent to a requirement that the power be exercised jointly with the creator. Johnstone v. Comm’r, 76 F.2d 55 (9th Cir. 1935), cert. denied, 296 U.S. 578 (1935), aff’g 29 B.T.A. 957 (1934); Keeter v. United States, 461 F.2d 714 (5th Cir. 1972), rev’g 323 F. Supp. 1093 (N.D. Fl. 1971); GCM 37428 (1981). See discussion in Fletcher, Drafting Revocable Trusts to Facilitate a Stepped-Up Basis, 22 Est. Plan. 100, 105 (March/April 1995).

b) Requirement of Notice

The requirement that notice must be given to the other spouse before exercise of an inter vivos power of appointment is insufficient to preclude the existence of the general power of appointment even if notice must be given to the creator of the power, acting as trustee. IRC § 2041(a)(2); Reg. § 20.2041-3(b).
3. Exclusion of Property from Surviving Spouse’s Gross Estate

One article suggests that the weakest element in the IRS analysis is that, any portion of the assets contributed by the surviving spouse that are included in the first spouse’s gross estate under IRC § 2041 and that pass to a nonmarital trust of which the surviving spouse is a beneficiary, could be includible in the surviving spouse’s gross estate. This article suggests that, under the step transaction doctrine, the transfer of property to the revocable trust by the surviving spouse could be combined with their passage to a nonmarital trust, to cause the nonmarital trust to be treated as self-settled by the surviving spouse for estate tax purposes. Blattmachr, Bramwell & Gans, *Estate Tax Exemption Portability: What Should The IRS Do? And What Should Planners Do In The Interim?*, 42 Real Prop. Prob. & Tr. J. 413, 430-434 (Fall, 2007). This argument seems to be very fact-sensitive; the longer the property remains in trust before the first spouse’s death, and the broader the powers granted the first spouse to appoint the trust to someone other than the surviving spouse, the less appropriate it would be to apply the step transaction doctrine.

4. Taxable Gift by the Trust Beneficiaries

As is the case where any beneficiary consents to a modification of a trust, has the beneficiary made a transfer that would be considered a gift for gift tax purposes? Depending upon the facts, it may be a taxable gift, or not.

5. Representation of the Trustee and Beneficiaries

The ethical question arises, should the trustee and the beneficiaries have separate representation? These should also be addressed, in the course of the planning.
XV. BASIS PLANNING: THE GRANTOR RETAINED INTEREST STEP-UP TRUST (“GRISUT”)

A. Generally

In an article in *Journal of Taxation*, Austin W. Bramwell, Brad Dillon, and Leah Socash described a series of ingenious trusts that seek to adjust the traditional qualified personal residence trust (QPRT), grantor retained annuity trust (GRAT), or grantor retained unitrust (GRUT), in order to assure that there is a basis adjustment for the trust assets when the first spouse dies, regardless of which spouse dies first or how title to the property is held before it is transferred to the trust. Austin W. Bramwell, Brad Dillon, and Leah Socash, *The New Estate Planning Lexicon: Sugrits and Other Grantor- Retained Interest Step-Up Trusts*, 123 J. Tax’n 196 (Nov. 2015). The following is this pair of authors’ explanation of these techniques.

Any errors are solely our responsibility. Messrs. Bramwell and Dillon and Ms. Socash share none of the responsibility for our mistakes. Their work was excellent. Ours is yet to be judged.

B. The Step-Up Personal Residence Trust (“SUPRT”)

1. Generally

Clients who have an appreciated personal residence and who no longer need significant estate tax savings can modify the traditional qualified personal residence trust to provide a basis step-up for the residence at the death of whichever spouse dies first. This basis step-up would not be available merely by holding the property as joint tenants, tenants in common, or tenants by the entirety. IRC § 2040.

2. Structure of the SUPRT

A SUPRT is a qualified personal residence trust (QPRT) created by one spouse (the donor-spouse), that provides a reserved use period that continues until the death of the first to die of the donor-spouse and the other spouse (the donee-spouse). If the donor-spouse dies first, the trust assets pass to the donee-spouse or his or her estate. If the donee-spouse dies first, his or her will or revocable trust disposes of the assets of the trust. It is presumed that the donee-spouse leaves these assets to or in trust for the donor-spouse, though there should be no clear prearrangement for a retransfer. For more on the rules for an ordinary QPRT, see R. Aucutt & H. Zaritsky, *Structuring Estate Freezes After Chapter 14*, ¶ 3.04, ¶ 10.05 (Thomson Reuters/Tax & Accounting, 2d ed.1997 & Supp. 2018-2); H. Zaritsky, *Tax Planning for Family Wealth Transfers During Life*, ¶ 10.09 (Thomson Reuters/Tax & Accounting, 5th ed. 2013 & Supp. 2018-3).

3. Tax Results of the SUPRT

a) Residence Included in First Deceased Spouse’s Gross Estate

If the donor-spouse dies first, the trust assets are included in his or her gross estate under IRC § 2036(a), because the donor-spouse will have retained the rent-free use of the property for a term that does not end before his or her death.

If the donee-spouse dies first, the trust ends and the residence passes to the donee-spouse’s estate. Thus, the value of the residence will be included in his or her gross estate under IRC § 2033.

(1) No Estate Tax Savings

There is no estate tax savings from the SUPRT, because the property merely passes from one spouse to the other. The point of this trust is to assure a full basis adjustment up to the fair market value of the residence at the first spouse’s death, regardless of which spouse dies first.
(2) Estate Tax Marital Deduction

When the first spouse dies and the property is included in his or her gross estate under IRC § 2033 (donee-spouse dies first) or IRC § 2036 (donor-spouse dies first), the property passing outright to the surviving spouse should qualify for the estate tax marital deduction.

b) No Taxable Gift

(1) Completed Gift to Donee-Spouse

The donor-spouse’s gift on the creation of the trust is the value of the donee-spouse’s remainder interest, which is possessory upon the death of the earlier of the two spouses to die. This can be determined under the standard IRS actuarial tables. See Publication 1457 at p.8, www.irs.gov/pub/irs-pdf/p1457.pdf. The present value of the donee-spouse’s remainder interest is the value of the trust assets, less the value of the grantor’s lifetime reserved interest. IRC § 2702 permits the subtraction of the value of the donor-spouse’s lifetime personal use interest in the trust because the trust holds only an interest in a personal residence and meets the other requirements of a QPRT. The fact that the reserved use term is not a fixed number of years does not disqualify the trust as a QPRT – it merely changes the value of the remainder interest.

(2) Gift Qualifies for the Gift Tax Marital Deduction

The taxable gift, however, is zero, because the gift of the remainder interest to the donee-spouse or his or her estate qualifies for the gift tax marital deduction. See Rev. Rul. 54-470, 1954-2 C.B. 320 (A gift of a vested indefeasible remainder interest such as would be includible in the gross estate of the donee spouse at death under the 1939 predecessor to IRC § 2033 qualifies for the gift tax marital deduction.).

c) Probable Basis Adjustment at Each Spouse’s Death under IRC § 1014

(1) Generally

The value of the residence and other assets of the SUPRT should receive a basis adjustment up to the fair market value of the property on the date of the first spouse’s death, under IRC §§ 1014(a), 1014(b)(1), and 1014(b)(9). The trust assets then pass to the surviving spouse, either under the trust instrument or the first spouse’s will, so they should, if retained by the surviving spouse until his or her later death, receive another basis adjustment at that time.

(2) Basis Adjustment May be Lost if Donee-Spouse Dies Within One Year of Gift of Remainder Interest

If the donee-spouse dies within one year of the gift of the remainder interest to him or her, IRC § 1014(e) should apply and deny the basis increase. This rule should not apply, however, if the donor-spouse dies within one year of having given the spouse the remainder interest, because there is no gift from the surviving spouse to the first deceased spouse, as required under IRC § 1014(e).

IRC § 1014(e) would not apply, however, if the donee-spouse leaves the property to someone other than the donor-spouse, at the former’s death within one year of
the funding of the trust. Leaving the property in trust for the donor-spouse, however, even if there are other beneficiaries, may result in the loss of all or part of the basis increase. See discussion at IV, E, 3, above.

C. The Step-Up Grantor Retained Income Trust (“SUGRIT”)

1. Generally

A donor who has sufficient applicable exclusion amount to assure that current gifts and the assets of his or her estate will not be subject to gift or estate taxes may want to consider a variation on the SUPRT that may hold diverse investment assets, rather than being restricted to holding the grantor’s personal residence. Such a variation is the step-up grantor retained income trust, or SUGRIT, which resembles the SUPRT except that; (a) it is not restricted to a personal residence – it may hold various types of investment or tangible assets; and (b) the gift of the remainder interest is likely to be a taxable gift.

2. Structure of the SUGRIT

A SUGRIT is an irrevocable trust created by the donor-spouse that provides a reserved income interest for a period that continues until the first spouse’s death. If the donor-spouse dies first, the trust assets pass to the surviving donee-spouse or his or her estate. If the donee-spouse dies first, his or her last will leaves his or her interest in the trust to or in trust for the donor-spouse.

3. Tax Results of the SUGRIT

a) Assets Included in First Deceased Spouse’s Gross Estate

As with a SUPRT, if the donor-spouse dies first, the trust assets are included in his or her gross estate under IRC § 2036(a), because the donor-spouse will have retained the right to the income from the trust assets for a term that does not end before his or her death.

If the donee-spouse dies first, the trust ends and the assets pass to the donee-spouse’s estate. Thus, the value of the assets will be included in his or her gross estate under IRC § 2033.

(1) No Estate Tax Savings

There is no estate tax savings from the SUGRIT, because the trust assets merely pass from one spouse to the other. The point of this trust, like the SUPRT, is to assure a full basis adjustment up to the fair market value of the trust assets at the first spouse’s death, regardless of which spouse dies first.

(2) Estate Tax Marital Deduction

When the first spouse dies and the property is included in his or her gross estate under IRC § 2033 (donee-spouse dies first) or IRC § 2036 (donor-spouse dies first), the property passing outright to the surviving spouse should qualify for the estate tax marital deduction.

b) Substantial Taxable Gift under IRC § 2702

(1) Gift to Donee-Spouse Enlarged Under IRC § 2702

The donor-spouse’s gift on the creation of the trust is the value of the donee-spouse’s remainder interest, which is possessory upon the death of the earlier of the two spouses to die. Under IRC § 2702(a), however, the gift tax value of this transfer must be determined without subtracting the present value of the donor-
spouse’s reserved income interest. The exceptions for trusts holding only a personal residence and for reserved qualified interests (annuities and unitrust interest) do not apply. The value of the gift, therefore, is the entire value of the transferred assets.

(2) Not All of the Gift Qualifies for the Gift Tax Marital Deduction

IRC § 2702(a)(1) applies “Solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), . . .” The increase in the value of the gift appears not to be reflected in the calculation of the gift tax marital deduction. Therefore, the taxable gift is the full value of the transferred assets, reduced only by the actuarial value of the donee-spouse’s remainder interest.

(3) Gift Tax Limits, But Does Not Eliminate, the Appeal of the SUGRIT

The fact that IRC § 2702 produces a taxable gift on the creation of a SUGRIT only means that this technique should be reserved to couples who are unlikely to utilize all of their applicable exclusion amount. The goal of the SUGRIT is to obtain a full basis adjustment on the trust assets at the death of each spouse; it is not to reduce wealth transfer taxes.

Note, however, that if the donor-spouse dies first, his or her gift to the SUGRIT is not part of his or her lifetime adjusted taxable gifts, and so his or her applicable exclusion amount is adjusted for estate tax purposes, to recover the prior taxable gift. IRC § 2001(b) defines “adjusted taxable gifts” for estate tax purposes as “the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent.” This clearly excludes from the adjusted taxable gifts the donor-spouse’s transfers to the SUGRIT. The real cost of the additional taxable gift under IRC § 2702, therefore, occurs only if the donee-spouse dies first.

There is also a fair argument that the donor-spouse’s applicable exclusion amount should be restored even if the donee-spouse dies first, if the donee-spouse transfers the trust assets to the donor-spouse. The above-quoted portion of IRC § 2001(b) excludes from a decedent’s “adjusted taxable gifts” transfers that are “includible in the gross estate of the decedent.” One could construe this as including the transfer to the SUGRIT if it is returned to the donor-spouse’s gross estate by a subsequent transfer from the donee-spouse’s estate. There is, however, no authority supporting this interpretation at this time.

c) Probable Basis Adjustment at Each Spouse’s Death under IRC § 1014

(1) Generally

The value of the assets of the SUGRIT should receive a basis adjustment up to their fair market value on the date of the first spouse’s death, under IRC §§ 1014(a), 1014(b)(1), and 1014(b)(9). The trust assets then pass to the surviving spouse, either under the trust instrument or the first spouse’s will, so they should, if retained by the surviving spouse until his or her later death, receive another basis adjustment at that time.

(2) Basis Adjustment May be Lost if Donee-Spouse Dies Within One Year of Gift of Remainder Interest

As with the SUPRT, if the donee-spouse dies within one year of the gift of the remainder interest to him or her, IRC § 1014(e) should apply and deny the basis
increase. Again, this rule should not apply if the donor-spouse dies within one year of having given the spouse the remainder interest, because there is no gift from the surviving spouse to the first deceased spouse, as required under IRC § 1014(e). Leaving the property in trust for the donor-spouse, however, even if there are other beneficiaries, may result in the loss of all or part of the basis increase. See discussion at IV, E, 3, above.

D. The Tangibles SUGRIT

1. Generally

Yet another possibility is to create a SUGRIT and fund it entirely with non-depreciable tangible property. This transaction has the potential of achieving both income and wealth transfer tax benefits.

2. Structure

A Tangibles SUGRIT, like a regular SUGRIT, is an irrevocable trust created by the grantor-spouse that provides a reserved income interest for a period that continues until the first spouse’s death. If the donor-spouse dies first, the trust assets pass to the surviving donee-spouse or his or her estate. If the donee-spouse dies first, his or her last will leaves his or her interest in the trust to or in trust for the donor-spouse. The Tangibles SUGRIT differs from the regular SUGRIT in that; (a) it holds only non-depreciable tangible property; and (b) the gift of the remainder interest should not be a taxable gift.

3. Regulations’ Exception for Tangibles Trusts

a) Generally

Reg. § 25.2702-2(c)(2)(i) states, in part, that the valuation rules of IRC § 2702 does not apply to a transfer in trust of tangible property:

“(A) For which no deduction for depreciation or depletion would be allowable if the property were used in a trade or business or held for the production of income; and

(B) As to which the failure to exercise any rights under the term interest would not increase the value of the property passing at the end of the term interest.”

Non-depreciable tangible property could include artwork, antiques, jewelry, or unimproved land.

b) Establishing Gift Tax Value

IRC § 2702 does not apply to a transfer in trust of tangible property, so the value of the gift is determined by conventional gift tax rules. Reg. § 25.2702-2(c)(2)(ii), however, states that the best evidence of the value of a transfer to a Tangibles SUGRIT:

“is actual sales or rentals that are comparable both as to the nature and character of the property and the duration of the term interest. Little weight is accorded appraisals in the absence of such evidence. Amounts determined under section 7520 are not evidence of what a willing buyer would pay a willing seller for the interest.”
As with other assets for which there is no established market, the practitioner will need to secure expert appraisals to establish the fair rental value of assets transferred to a Tangibles SUGRIT.

The regulations recognize that it is often impractical to transfer such nondepreciable assets without also transferring a small amount of depreciable property that has been added as an improvement. This is particularly true of ranch or farm land, which will almost always include a certain amount of fencing and other minor improvements. Thus, the regulations provide that a Tangibles SUGRIT will not be disqualified merely because there is also held by the trust depreciable improvements on otherwise acceptable nondepreciable tangible property, as long as the improvements do not increase the fair market value of the nondepreciable property by more than 5 percent. Reg. § 25.2702-2(c)(2)(ii).


4. **Tax Results of the Tangibles SUGRIT**

   a) **Assets Included in First Deceased Spouse’s Gross Estate**

      As with a SUGRIT or SUPRT, if the donor-spouse dies first, the assets of a Tangibles SUGRIT are included in his or her gross estate under IRC § 2036(a), because the donor-spouse will have retained the right to the income from the trust assets for a term that does not end before his or her death.

      If the donee-spouse dies first, the trust ends and the assets pass to the donee-spouse’s estate. Thus, the value of the assets of the Tangibles SUGRIT will be included in his or her gross estate under IRC § 2033.

      (1) **No Estate Tax Savings**

         There is no estate tax savings from the Tangibles SUGRIT, because the tangibles merely pass from one spouse to the other. The point of this trust is to assure a full basis adjustment up to the fair market value of the trust assets at the first spouse’s death, regardless of which spouse dies first.

      (2) **Estate Tax Marital Deduction**

         When the first spouse dies and the property of the Tangibles SUGRIT is included in his or her gross estate under IRC § 2033 (donee-spouse dies first) or IRC § 2036 (donor-spouse dies first), the property passing outright to the surviving spouse should qualify for the estate tax marital deduction, as with a SUPRT or a SUGRIT.

   b) **No Taxable Gift**

      (1) **Completed Gift to Donee-Spouse**

         The donor-spouse’s gift on the creation of a Tangibles SUGRIT is the value of the donee-spouse’s remainder interest, which is possessory upon the death of the earlier of the two spouses to die. Unlike a SUPRT, however, the value of the reserved use interest in a Tangibles SUGRIT is not determined under the IRS actuarial tables. Reg. § 25.2702-2(c)(1).
The regulations state that the best evidence of the value of a term interest in a Tangibles SUGRIT is actual sales or rentals of property that is comparable “both as to the nature and character of the property and the duration of the term interest” and that little weight will be given to appraisals that do not include evidence of actual comparable sales or rentals. Reg. § 25.2702-2(c)(3). This means that the grantor must search for rentals of comparable property, consider the length of the lease, and determine whether the lessee is required to pay the maintenance expenses on such leases. Then, the overall value of the leased property can be compared with the rents to determine the actual return on investment from the use of such assets.

Then, the present value of the donee-spouse’s remainder interest, after subtracting the value of the grantor’s lifetime reserved interest. IRC § 2702 permits the subtraction of the value of the donor-spouse’s lifetime personal use interest in the trust because the trust holds only an interest in a personal residence and meets the other requirements of a Tangibles GRIT under the regulations. The fact that the reserved use term is not a fixed number of years does not disqualify the trust as a Tangibles GRIT – it merely changes the value of the remainder interest.

(2) Gift Qualifies for the Gift Tax Marital Deduction – But at What Value?

As with a SUPRT or SUGRIT, the value of the remainder interest given to the donee-spouse or his or her estate qualifies for the gift tax marital deduction. See Rev. Rul. 54-470, 1954-2 C.B. 320. As with a SUGRIT, however, there appears to be a difference between the gift tax value of the remainder interest (based on comparable rentals) and the marital deduction value (based on the actuarial tables under IRC § 7520. For a Tangibles SUGRIT, however, it is not clear whether the remainder interest under the actuarial tables will be worth more or less than that valued on the basis of comparable rentals. If the comparable rentals value is at equal to or greater than the value based on the IRS actuarial tables, there should be no taxable gift.

c) Probable Basis Adjustment at Each Spouse’s Death under IRC § 1014

(1) Generally

The value of the assets of a Tangibles SUGRIT should receive a basis adjustment up to the fair market value of the property on the date of the first spouse’s death, under IRC §§ 1014(a), 1014(b)(1), and 1014(b)(9). The trust assets then pass to the surviving spouse, either under the trust instrument or the first spouse’s will, so they should, if retained by the surviving spouse until his or her later death, receive another basis adjustment at that time.

(2) Basis Adjustment May Be Lost if Donee-Spouse Dies Within One Year of Gift of Remainder Interest

As with a SUPRT or SUGRIT, if the donee-spouse dies within one year of the gift of the remainder interest to him or her, IRC § 1014(e) should apply and deny the basis increase. This rule should not apply, however, if the donor-spouse dies within one year of having given the spouse the remainder interest, because there is no gift from the surviving spouse to the first deceased spouse, as required under IRC § 1014(e).

IRC § 1014(e) would not apply, however, if the donee-spouse leaves the property to someone other than the donor-spouse, at the former’s death within one year of
the funding of the trust. Leaving the property in trust for the donor-spouse, however, even if there are other beneficiaries, may result in the loss of all or part of the basis increase. See discussion at IV, E, 3, above.

E. Step-Up Grantor Retained Annuity Trust ("SUGRAT") or Unitrust ("SU-GRUT")

1. Generally

A SUGRAT or SUGRUT is a qualified grantor retained annuity or unitrust created by the donor-spouse, that provides a reserved annuity or unitrust interest use period that continues until the death of the first to die of the donor spouse and the donee-spouse. If the donor-spouse dies first, the trust assets pass to the surviving donee-spouse or his or her estate. If the donee-spouse dies first, his or her last will leaves his or her interest in the trust to or in trust for the donor-spouse. For more on the rules for GRATs and GRUTs generally, see also R. Aucutt & H. Zaritsky, Structuring Estate Freezes After Chapter 14, ¶ 3.03, ch. 11 (Thomson Reuters/Tax & Accounting, 2d ed.1997 & Supp. 2018-2); H. Zaritsky, Tax Planning for Family Wealth Transfers During Life, ¶ 12.06 (Thomson Reuters/Tax & Accounting, 5th ed. 2013 & Supp. 2018-3).

The rules and treatment of a SUGRAT or SUGRUT would be similar to that of a SUPRT, except that: (a) there would be no restriction on the type of assets that a SUGRAT or SUGRUT may hold; and (b) the interest retained by the donor-spouse would be either an annuity or unitrust interest, rather than the personal use of the asset; and (c) in some situations, the entire trust fund might not be included in the donor-grantor’s gross estate if he or she dies first.

Unfortunately, the SUGRAT or SUGRUT does not appear to work under the present regulations, though some believe that there are legitimate arguments in their favor. The key problem is that Regulation Section 25.2702-3(d)(4) states:

(4) Term of the annuity or unitrust interest. The governing instrument must fix the term of the annuity or unitrust and the term of the interest must be fixed and ascertainable at the creation of the trust. The term must be for the life of the holder, for a specified term of years, or for the shorter (but not the longer) of those periods. Successive term interests for the benefit of the same individual are treated as the same term interest. (emphasis supplied)

Clearly, a SUGRAT or SUGRUT uses a term that is not the life of the holder, a specified term of years, or the shorter of the two. It is, rather, the shorter of the lives of the holder and the holder’s spouse. Reading the regulations literally, they unambiguously appear to preclude this approach.

There is no logical policy reason why the regulations would not permit a SUGRAT or SUGRUT. The retained interest in a SUGRAT or SUGRUT would certainly be fixed and ascertainable at the time the trust is created. Nonetheless, there appears to be no logical way to construe the regulations as permitting a SUGRAT or SUGRUT.

F. Reciprocal GRISUTS

1. Generally

Spouses may each own assets that they desire to have included in the estate of the first spouse to die, in order to obtain a basis adjustment. This, of course, raises questions under the reciprocal trust doctrine, in which the Supreme Court stated that reciprocal trusts would be treated as created by their respective beneficiaries, rather than their respective settlors, “if they are interrelated, and that
the arrangement, to the extent of mutual value, leaves the settlors in approximately the same eco-
nomic position as they would have been in had they created trusts naming themselves as life bene-

2. The Reciprocal Trust Doctrine

The Supreme Court’s decision in Estate of Grace involved estate taxation, which would seem to render it applicable to determining what portion of the trust assets are includible in the gross estate of the first spouse to die. For those who would argue that the real issue is income taxation, rather than estate taxation, it is noteworthy that the Tax Court and the Sixth Circuit have applied the reciprocal trust doctrine for income tax purposes, as well. See Krause v. Comm’r, 57 T.C. 890 (1973), aff’d, 497 F.2d 1109 (6th Cir. 1974), cert. denied, 419 U.S. 1108 (1975). Other courts applied the pre—Estate of Grace version of the doctrine to income tax cases, as well. See Estate of Newberry v. Comm’r, 17 T.C. 597 (1951), rev’d, 201 F.2d 874 (3d Cir. 1953); Tobin v. Comm’r, 11 T.C. 928 (1948), rev’d in part, 183 F.2d 919 (5th Cir. 1950); Haldeman v. Comm’r, 6 T.C. 345 (1946); Wieboldt v. Comm’r, 5 T.C. 946 (1945); Whiteley v. Comm’r, 42 BTA 316 (1940), aff’d, 120 F.2d 782 (3d Cir. 1941), cert. denied, 314 U.S. 657 (1941).

3. Results of Reciprocal Trust Doctrine Application to GRISUTs

If spouses create reciprocal GRISUTs, the doctrine could result in the inclusion of the trust fund only in the gross estate of the donor-spouse, because the donor would be treated as if he or she had retained the remainder interest in his or her own trust.

It should be noted, however, that while the reciprocal trust doctrine has been used to cause inclusion of a trust in an individual’s gross estate, it has never been used to cause exclusion of a trust fund from an individual’s gross estate. Nonetheless, there is no reason why it could not be so used. See also See Slade, The Evolution of the Reciprocal Trust Doctrine Since Grace and Its Current Application in Estate Planning, 17 Tax Mgmt. Est. Gifts & Tr. J. 71 (1992).

4. Avoiding the Reciprocal Trust Doctrine

There is no bright-line test for what makes trusts reciprocal. The standard established in Estate of Grace is merely that the reciprocity “leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.” United States v. Estate of Grace, 395 U.S. 316, 324 (1969). Thus, one must take as many steps as possible to avoid leaving the two spouses in such reciprocal situations. The following steps are suggested:

- **Different retained interests.** Spouses should attempt not to create the same types of trusts for each other. For example, one spouse could create a SUPRT for the other spouse, and the other spouse could create a Tangible SUGRIT for the first spouse. This leaves each with reciprocal value (to the extent of equivalent value), but arguably not comparable economic positions.

- **Different creation dates.** It is helpful if the trusts are not created within a relatively close period of time. In Estate of Lueders v. Commissioner, 164 F.2d 128 (3d Cir. 1947), for example, the court held that the doctrine did not apply to similar trusts established by a spouse under instruments created 15 months apart. The court noted there was no evidence of any agreement, express or implied, or even an “understanding” to make reciprocal transfers of property at the time the husband’s trust was created. See also PLR 9735025 (reciprocal trust doctrine does not apply when one trust was modified to become reciprocal 26 years after the other was created, and then only because the taxpayer’s brother resigned as trustee.
Different trustees. The trusts should have different trustees. This may not avoid having equivalent economic benefits, but it does avoid the argument that there are reciprocal powers. Compare *Bischoff v. Comm'r*, 69 T.C. 32 (1977) (reciprocal powers created estate taxation); with *Estate of Green v. United States*, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine does not apply to reciprocal powers, because they do not create an identical economic interest).

Different wills. One element of differentiation may be for the donee-spouses to make different dispositions of the trust funds if the donee-spouse dies first. One spouse could leave assets outright to the other, and the other spouse leave assets to a QTIP or other marital trust. This can be further enhanced if one spouse leaves his or her GRISUT assets to other family members, which will eliminate the estate tax marital deduction for this disposition but will also negate the possible application of IRC § 1015(e).
XVI. BASIS PLANNING: DOUBLE BASIS INCREASE -- ALASKA, SOUTH DAKOTA, AND TENNESSEE
COMMUNITY PROPERTY TRUSTS

A. Generally

Alaska, South Dakota, and Tennessee currently provide that property acquired by a married couple is separate property, unless the couple elect to treat it as community property, in contrast with the general rule in most community property states that all property acquired by a married couple is presumed to be community property, unless they have clearly provided to the contrary. Alaska permits the creation of a trust to hold property as community property and treat the assets of such trusts as community property, even if the couple creating the trust do not reside within the state. AS §§ 34.77.010 to 34.77.995. South Dakota and Tennessee provide that holding property in trust is the only way in which to create community property in those states. S.D. Cent. Code §§ 55-17-1 to 55-17-14; Tenn. Code §§ 35-17-101 to 35-17-108. See Asher, Blattmachr & Zaritsky, Tax Planning with Consensual Community Property: Alaska’s New Community Property Law, 33 Real Prop. Prob. & Tr. J. 615 (Winter 1999); Shaftel & Greer, Alaska Enacts an Optional Community Property System Which Can Be Elected by Both Residents and Nonresidents, SD 36 ALI-ABA 1, 12–13 (1999); Singleton, Yes, Virginia, Tax Loopholes Still Exist: An Examination of the Tennessee Community Property Trust Act of 2010, 42 U. Mem. L. Rev. 369 (Winter 2011); Ware, Section 1014(b)(6) and the Boundaries of Community Property, 5 Nev. L.J. 704 (Spring 2005).

1. Early Opt-In State


2. Alaska


3. Tennessee


4. South Dakota


B. The Community Property Trust

Alaska, South Dakota, and Tennessee permit residents and nonresidents to create trusts with their situs in the opt-in state, and to have in-state trustees hold those assets for the grantors as community property.

1. Alaska

a) Mandatory Requirements of an Alaska Community Property Trust

The Alaska Community Property Act states that property held in a trust is community property if:

● One or both spouses transfer property to the trust. AS § 34.77.100(a);

● The trust expressly declares that some or all the property transferred is community property under Title 34, Chapter 77 of the Alaska Statutes. AS § 34.77.100(a);
At least one trustee is a “qualified person,” defined as (a) an individual who, except for brief intervals, military service, attendance at an educational or training institution, or absences for good cause shown, resides in Alaska, whose true and permanent home is in Alaska, who does not have a present intention of moving from Alaska, and who intends to return to Alaska when away; (b) a trust company that is organized under Alaska law and that has its principal place of business in Alaska; or (c) a bank that is organized under Alaska law or a national banking association that is organized under federal banking law, if the bank or national banking association possesses and exercises trust powers and has its principal place of business in Alaska. AS § 34.77.100(a);

The powers of the qualified person who is a trustee include or are limited to (a) maintaining records for the trust on an exclusive or a nonexclusive basis; and (b) preparing or arranging for the preparation of, on an exclusive or a nonexclusive basis, any income tax returns that must be filed by the trust. AS § 34.77.100(a);

The trust is signed by both spouses. AS § 34.77.100(a); and

The trust contains, at the beginning of the trust and in capital letters, the following declaration:

“The consequences of this trust may be very extensive, including, but not limited to, your rights with respect to creditors and other third parties, and your rights with your spouse both during the course of your marriage and at the time of a divorce. Accordingly, this agreement should only be signed after careful consideration. If you have any questions about this agreement, you should seek competent advice.”

AS § 34.77.100(b).

b) Optional Features of an Alaska Community Property Trust

The statute states that an Alaska community property trust may also include the following provisions:

- The rights and obligations in the property transferred to the trust, regardless of when and where the property was acquired or located. AS § 34.77.100(d)(1);
- The management and control of the property transferred to the trust. AS § 34.77.100(d)(2);
- The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event. AS § 34.77.100(d)(3);
- The choice of law governing the interpretation of the trust. AS § 34.77.100(d)(4);
- Any other matter affecting the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty. AS § 34.77.100(d)(5);
- Provisions respecting the right to amend or revoke. AS § 34.77.100(e). An Alaska community property trust may not be amended or revoked unless the
agreement itself provides for amendment or revocation, or unless amended or re-
voked by a later community property trust (which need not actually declare that it holds any community property). An amended trust or the revocation of a trust is enforceable without consideration. Unless a community property trust expressly provides otherwise, at any time after the death of the first spouse the surviving spouse may amend the community property trust with regard to the surviving spouse's property to be disposed of at the surviving spouse's death. In this subsec-
tion, "surviving spouse's property" means the property that consists of the surviv-
ing spouse's separate property and the surviving spouse's share of the community property determined as of the date of the first spouse's death. Id.

c) Trustees

The Alaska statute also provides that either or both spouses may be trustees, but it does not require that either spouse be a trustee. AS § 34.77.100(a). Thus, the management rights of the spouses over community property owned outright can be changed by the transfer of that property to an Alaska community property trust. The trustee of a community property trust shall maintain records that identify which property held by the trust is community property and which property held by the trust is not community property. AS § 34.77.100(h).

d) Conditions of Enforcement

An Alaska community property trust is not enforceable if the spouse against whom en-
forcement is sought proves that:

- The trust was unconscionable when made. AS § 34.77.100(f). Whether or not a community property trust is unconscionable is deter-
mined by a court as a matter of law. AS § 34.77.100(g);

- The spouse against whom enforcement is sought did not execute the community property trust agreement voluntarily; or

- Before execution of the community property trust agreement, the spouse against whom enforcement is sought (a) was not given a fair and reasonable disclosure of the property and financial obligations of the other spouse; (b) did not voluntarily sign a written waiver expressly waiving right to disclosure of the property and financial obligations of the other spouse beyond the disclosure provided; and (c) did not have notice of the property or financial obligations of the other spouse.

2. South Dakota

a) Mandatory Requirements of an South Dakota Special Spousal (Community Property) Trust

The South Dakota Special Spousal Trust permits the use of a trust to opt in to a community property system. S.D. Cent. Code § 55-17-1. Property held in a trust is South Dakota Special Spousal Trust if:

- One or both spouses transfer property to a trust. S.D. Cent. Code § 55-17-1;

- The trust expressly declares that some or all the property transferred is South Da-
  kota special spousal property as provided in S.D. Cent. Code §§ 55-17-1 to 55-17-14;

- At least one trustee is a “qualified person.” S.D. Cent. Code § 55-17-1. A “qual-
  ified person” means
● An individual who, except for brief intervals, military service, attendance at an educational or training institution, or for absences for good cause shown, resides in South Dakota, whose true and permanent home is in South Dakota, who does not have a present intention of moving from South Dakota, and who has the intention of returning to South Dakota when away. S.D. Cent. Code §§ 55-3-41(1) and 55-16-3;

● A trust company that is organized under South Dakota or federal law and that has its principal place of business in South Dakota. S.D. Cent. Code §§ 55-3-41(2) and 55-16-3; or

● A bank or savings association that possesses and exercises trust powers, has its principal place of business in South Dakota, and the deposits of which are insured by the Federal Deposit Insurance Corporation. S.D. Cent. Code §§ 55-3-41(3) and 55-16-3;

● Some or all of the trust assets are deposited in South Dakota or physical evidence of such assets is held in the state and the trust is being administered by a qualified person S.D. Cent. Code §§ 55-3-39(1) and 55-16-3;

● The qualified person must be designated as a trustee under the governing instrument, a successor trusteeship, or designated by a court having jurisdiction over the trust. S.D. Cent. Code §§ 55-3-39(2) and 55-16-3;

● The administration of the trust must be wholly or partly in South Dakota. S.D. Cent. Code §§ 55-3-39(3) and 55-16-3;

● The instrument expressly declares that the property is community property. S.D. Cent. Code § 55-17-3; and

● The trust contains, at the beginning and in capital letters, the following declaration:

"THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING YOUR RIGHTS WITH RESPECT TO CREDITORS AND OTHER THIRD PARTIES, AND YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE, AT THE TIME OF A DIVORCE, AND AT THE DEATH OF YOU OR YOUR SPOUSE. ACCORDINGLY, THIS TRUST AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS TRUST AGREEMENT, YOU SHOULD SEEK INDEPENDENT LEGAL ADVICE."


b) Optional Features of an South Dakota Special Spousal (Community Property) Trust

● A South Dakota Special Spousal Trust is enforceable without consideration. S.D. Cent. Code § 55-17-1;

● The trust may be revocable or irrevocable. S.D. Cent. Code § 55-17-1;
A South Dakota Special Spousal Trust may not be amended or revoked unless the trust agreement provides for amendment or revocation, or unless the trust agreement is amended or revoked by a later South Dakota Special Spousal Trust. S.D. Cent. Code § 55-17-4;

To amend or revoke the trust, a later South Dakota Special Spousal Trust need not declare any property held by the trustee as special spousal property (community property). The amended trust or the revocation is enforceable without consideration. S.D. Cent. Code § 55-17-4;

Unless a South Dakota Special Spousal Trust expressly provides otherwise, after the first spouse's death, the surviving spouse can amend the trust with regard to his or her property to be disposed of at his or her death. S.D. Cent. Code § 55-17-4;

The spouses may also include in a South Dakota Special Spousal Trust their agreements on the following:

- The rights and obligations in the property transferred to the trust, notwithstanding when and where the property is acquired or located;
- The management and control of the property transferred to the trust;
- The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event;
- The choice of law governing the interpretation of the trust; and
- Any other matter that affects the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty. S.D. Cent. Code § 55-17-9;

A South Dakota Special Spousal Trust can also be a self-settled spendthrift trust, which South Dakota law refers to as a qualified disposition in trust. S.D. Cent. Code § 55-17-11(1). Nonetheless, a South Dakota Special Spousal Trust may not adversely affect the right of a child to support. S.D. Cent. Code § 55-17-10;

No provision of a revocable South Dakota Special Spousal Property Trust can adversely affect the interest of a creditor unless the creditor has actual knowledge of the trust when the obligation to the creditor is incurred. S.D. Cent. Code § 55-17-11(1);

The South Dakota law also expressly permits the creation of community property by a transfer at death. It states that, in addition to other transfers of property to a South Dakota Special Spousal Trust, property is considered transferred to such a trust if it is subject to a nonprobate transfer on death under an insurance policy, contract of employment, bond, mortgage, promissory note, certificated or uncertificated security, account agreement, custodial agreement, deposit agreement, compensation plan, pension plan, individual retirement plan, employee benefit plan, trust, conveyance, deed of gift, marital property agreement, or other written instrument of a similar nature and the South Dakota special spousal trust is designated as a beneficiary to receive the property under the transfer. The property is considered the surviving spouse's property that is not South Dakota special spousal property. S.D. Cent. Code § 55-17-7;

A spouse is required to act in good faith with respect to the other spouse in matters involving South Dakota special spousal property. This is one of the provisions
that cannot be varied by the express terms of a South Dakota Special Spousal Property Trust. S.D. Cent. Code § 55-17-11;

- The South Dakota statute also provides protections for a bona fide purchaser who buys property from a South Dakota Special Spousal Property Trust. First, it provides that notice of the existence of a South Dakota Special Spousal Property Trust, a marriage, or the termination of a marriage does not affect the status of a purchaser as a bona fide purchaser. S.D. Cent. Code § 55-17-12(1). Second, it provides that community property bought by a bona fide purchaser from a spouse having the right to manage and control the property is acquired free of any claim of the other spouse. The effect of this subsection may not be varied by a South Dakota Special Spousal Property Trust. S.D. Cent. Code § 55-17-12(2);

- A South Dakota Special Spousal Trust executed during marriage is not enforceable if the spouse against whom enforcement is sought proves the following:
  - The trust was unconscionable when made;
  - The spouse against whom enforcement is sought did not execute the trust agreement voluntarily; or
  - Before execution of the trust, the spouse against whom enforcement is sought:
    - Was not given a fair and reasonable disclosure of the property and financial obligations of the other spouse;
    - Did not voluntarily sign a written waiver expressly waiving right to disclosure of the property and financial obligations of the other spouse beyond the disclosure provided; and
    - Did not have notice of the property or financial obligations of the other spouse.


3. Tennessee

Tennessee provide for the ownership of community property in Tennessee, but only if the property is held in a Tennessee Community Property Trust. Tenn. Code § 37-15-105(a).

a) Mandatory Requirements of a Tennessee Community Property Trust

Property held in a trust is Tennessee community property is community property, if:

- One or both spouses transfer property to the trust. Tenn. Code § 37-15-103;

- At least one trustee is a “qualified trustee,” defined as (a) a natural person who is a resident of Tennessee; or (b) a company authorized to act as a fiduciary in Tennessee. Tenn. Code §§ 37-15-103(2), 37-15-102(6);

- The powers of the qualified trustee include or are limited to (a) maintaining records for the trust on an exclusive or a nonexclusive basis; and (b) preparing or arranging for the preparation of, on an exclusive or a nonexclusive basis, any income tax returns that must be filed by the trust. Tenn. Code § 37-15-103(2);

- The trust is signed by both spouses. Tenn. Code § 37-15-103(2); and
The trust contains, at the beginning of the trust and in capital letters, the following declaration:

"THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE."


b) Optional Features of a Tennessee Community Property Trust

A Tennessee community property trust may also include the following provisions

- The rights and obligations in the property transferred to the trust, notwithstanding when and where the property is acquired or located. Tenn. Code § 37-15-104(a)(1);
- The management and control of the property transferred to the trust. Tenn. Code § 37-15-104(a)(2);
- The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event. Tenn. Code § 37-15-104(a)(3);
- The choice of law governing the interpretation of the trust. Tenn. Code § 37-15-104(a)(4);
- Any other matter that affects the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty. Tenn. Code § 37-15-104(a)(5);
- The right to manage and control the trust property. Tenn. Code § 37-15-104(d);
- Either spouse may amend a Tennessee community property trust regarding the disposition of that spouse's one-half share of the community property in the occurrence of that spouse's death. Except as provided in such a provision, a Tennessee community property trust may not be amended or revoked unless the agreement itself provides for amendment or revocation. Tenn. Code § 37-15-104(b).

c) Character of Property

(1) Distributed Property

Property distributed from a Tennessee community property trust ceases to be community property. Tenn. Code § 37-15-105(e).

(2) Death of First Spouse

On the death of a spouse, one-half of the property owned by a Tennessee community property trust is treated as the surviving spouse’s community property interest. Tenn. Code § 35-17-107.
d) **Distributions in Kind**

Unless the trust agreement provides to the contrary, the trustee can distribute trust assets in divided or undivided interests and adjust resulting differences in valuation. A distribution in kind may be made on the basis of a non-pro rata division of the aggregate value of the trust assets, on the basis of a pro rata division of each individual asset, or by using both methods. Tenn. Code § 35-17-107.

e) **Divorce**

The trust terminates upon the dissolution of the grantors’ marriage. On termination, the trustee distribute one-half of the trust assets to each spouse, unless otherwise agreed to in writing by both spouses. Tenn. Code § 35-17-108.

C. **Legal Efficacy of the Alaska, South Dakota, or Tennessee Community Property Trust**

1. Choice of law issues

a) **Generally**

The rules by which the state that should assume jurisdiction over various aspects of trust administration, construction, and the rights of beneficiaries, depend upon whether the trust corpus is real or personal property. Generally, the intent of the grantor determines the jurisdiction for a trust holding personal property, while the sites of the real property is determinative with respect to a trust on real property. Issues of the administration of a trust holding personal property (whether tangible or intangible) are determined under the jurisdiction in which the trust is otherwise administered, which itself is determined on the basis of the intent of the grantor, as disclosed in the governing instrument. Absent an express declaration in the instrument as to the place of administration, the grantor’s intent is usually assumed to be that the trustee shall administer the trust at the trustee’s principal place of business or domicile. A grantor who names two or more trustees who are domiciled in different states may manifest an intention that the trust should be administered at the domicile or place of business of one of them. Therefore, if the grantor names one or more trustees situated in Alaska or Tennessee, as is required by the two state statutes, it may be assumed that the trust should be administered in the state of the trustee and that it should be supervised by the courts of that state.

b) **Application of Choice of Law Rules to Alaska, South Dakota, and Tennessee Community Property Trusts**

The requirements for an Alaska Community Property Trust, a South Dakota Special Spousal Trust, or a Tennessee Community Property Trust include the designation of at least one in-state trustee and refer repeatedly to the construction of the rights of the parties in the property under that state’s law. Under the general rule, therefore, the courts of the state in which the trusts are created should have jurisdiction over matters involving the administration of the trust even though they might lack jurisdiction over some or all of the beneficiaries. See Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950).

(1) **Personal Property**

(a) **Situs for Construction**

Questions relating to the construction of an *inter vivos* trust holding personal property and the rights of the various beneficiaries will be based on the law of the state designated in the instrument, or in the absence of
such a designation, the law of the place of administration, if the issue relates to trust administration, or otherwise the jurisdiction that the grantor would probably have desired to apply. *Restatement (Second) Conflicts of Law* § 268. A state need have no connection with the trust in order to use its law in construing the trust instrument, if the grantor has selected that particular state’s law. *Hughes v. Comm'r*, 104 F.2d 144 (9th Cir. 1939); *Noble v. Rogan*, 49 F. Supp. 370 (s.D.Cal. 1943); *Application of Eyre*, 133 N.Y.S.2d 511 (1954); *Matter of Grant-Suttie*, 205 Misc. 940, 129 N.Y.S.2d 572 (1954); *Matter of Carter*, 13 Misc.2d 1040, 178 N.Y.S.2d 569 (1958).

(b) **Situs for Validity**

A similar rule applies in determining the overall validity of a trust of personal property. The validity of the trust is determined under the law of the state designated by the grantor, as long as that state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which the trust has its most significant relationship. *Restatement (Second) Conflicts of Law* § 270. A state has a substantial relation to a trust if the grantor designates that the trust is to be administered there, or if any trustee has its principal place of business or domicile in that state when the trust is created, or if the trust is administered in that state, or if it is the domicile of the beneficiaries.

(2) **Real Property**

(a) **Generally**

As to trusts of interests in land, however, the law of the situs of the land becomes more important.

(b) **Situs for Administration and Validity**

The administration and validity of a trust in land is determined according to the law of the state in which the land is situated, even if the trustees are situated elsewhere. *Restatement (Second) Conflicts of Law* § 276. A court of a state other than that in which the property is situated may still exercise jurisdiction over the administration of the trust, if this does not unduly interfere with the control by the courts of the situs. *Fuller v. McKim*, 187 Mich. 667, 154 N.W. 55 (1915); *Knox v. Jones*, 47 N.Y. 389 (1872); *Matter of Osborn*, 151 Misc. 52, 270 N.Y.S. 616 (1934); *In re Sandford's Will*, 81 N.Y.S.2d 377 (1948); *In re Fagan's Estate*, 84 N.Y.S.2d 558 (1948); *In re Piazza's Estate*, 130 N.Y.S.2d 244 (1954); *In re Master's Will*, 136 N.Y.S.2d 907 (1954); *In re Warburg’s Estate*, 237 N.Y.S.2d 557 (1963).

(c) **Situs for Construction**

Issues of construction of the trust instrument, however, have not always been construed according to the situs. Some courts apply the law of the situs. *Bowen v. Frank*, 179 Ark. 1004, 18 S.W.2d 1037 (1929); *Veach v. Veach*, 205 Ga. 185, 53 S.E.2d 98 (1949); *Peet v. Peet*, 229 Ill. 341, 82 N.E. 376 (1907); *Scofield v. Hadden*, 206 Iowa 597, 220 N.W. 1 (1928); *Thompson v. Penn*, 149 Ky. 158, 148 S.W. 33 (1912); *In re Estate of Hencke*, 220 Minn. 414, 19 N.W.2d 718 (1945); *Minot v. Minot*, 17 App.Div. 521, 45 N.Y.S. 554 (1st Dep't 1897); *Matter of Good*, 304 N.Y.

(d) **Enforceability in Domicile State**

Generally, the couple can select the law to govern particular property. In Stein-Sapir v. Stein-Sapir, 382 N.Y.S.2d 799 (N.Y. App. Div. 1976), for example, a couple domiciled in New York married in Mexico, and elected under Mexican law to have their future assets be held as community property. They later divorced in New York and the New York court held that the community property election was valid, and that the wife owned one-half of the property earned by the husband. Restatement (Second) of Conflicts of Laws § 258, cmt. (b) states that a couple can choose the law of a state other than their domicile to govern their property, and such a choice will apply unless it is “outweighed . . . by the intensity of the interest of another state . . . in having its own rules applied.”

(3) **Caveat: Huber v. Huber**

Despite the rules set out in the Restatement (Second) Conflicts of Law and various cases, the courts sometimes look at things in a different manner. In re Huber v. Huber, 493 B.R. 798 (Bankr. W.D. Wash. 2013), a U.S. district court applied the law of the state in which the settlor and his creditors resided and refused to apply the law of the state under whose law a domestic asset protection trust was allegedly created and permitted a trustee in bankruptcy to set aside transfers made to the trust as both actually and constructively fraudulent.

(a) **Facts**

Donald Huber was a real estate developer and manager and a lifelong resident of the state of Washington. When Donald realized that many of his real estate projects were about to fail and be foreclosed upon, that he would become personally liable as guarantor on several loans, and that he would be sued, he transferred substantially all of his assets to the Donald Huber Family Trust, an irrevocable trust, for his own benefit and that of his descendants and stepchildren.

The trust was prepared by a Washington attorney, and the trust instrument stated that Alaska law would apply. An Alaska corporation was the trustee.

It was shown that Donald created the trust for both estate planning purposes and to protect at least part of his assets from the claims of his creditors.

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The trust was funded with interests in an Alaska limited liability company established for that purpose, and to which Donald had transferred substantially all of his assets. These assets were all situated in Washington, except for one $10,000 certificate of deposit that was situated in Alaska.

Donald did not expressly retain the right to direct how or if distributions were made from the trust, but substantially all of his requests for distributions were granted and there was a record of only one refusal. The only party to review the requests was Donald's son, with whom he was in business.

(b) Bankruptcy

Donald filed for Chapter 11 bankruptcy protection in 2011. The trustee in bankruptcy moved for summary judgment that the transfers to the trust were void under applicable state law and should be set aside for purposes of the bankruptcy action. The trustee contended that the trust should be invalidated under Washington state law and federal bankruptcy law, despite the trust instrument's own designation of itself as an Alaska trust.

(c) Held: Trust Controlled by Washington Law, Not Alaska Law

(i) Generally

The bankruptcy judge (Judge Snyder) for the Western District of Washington granted a summary judgment to the trustee, finding that the trust did not protect its assets from the claims of Donald’s creditors and should be set aside on three separate bases.

(ii) Conflict Between Two State Laws

The court held that the trust was not protected from the claims of the settlor’s creditors by the provisions of Alaska law that expressly recognize the validity of self-settled asset protection trusts, but instead were invalid under the provisions of Washington state law that reject self-settled spendthrift trusts. Compare AS § 34.40.110 and Rev. Codes of Wash. § 19.36.020. The court stated that the conflict between the laws of the two states must be settled under federal choice of law rules, rather than state choice of law rules. Citing Lindsay v. Beneficial Reinsurance Co. (In re Lindsay), 59 F.3d 942, 948 (9th Cir. 1995).

(iii) Ninth Circuit Applies Restatement (Second) Conflicts

The Ninth Circuit, to which the case would be appealed, applies the choice of law rules set forth in of the Restatement (Second) of Conflict of Laws (1971), which states at section 270, that a provision in the instrument governing an inter vivos trust of personal property that declares the validity of the trust will be controlled by the law of a specific state, will be followed only if:

- the state declared in the instrument as controlling has a substantial relation to the trust, and
the application of its local law does not violate a strong public policy of the state with which as to the matter at issue the trust has its most significant relationship. *Liberty Tool & Mfg. v. Vortex Fishing Sys., Inc. (In re Vortex Fishing Sys., Inc.)*, 277 F.3d 1057, 1069 (9th Cir. 2002).

(iv) **Most Significant Relationship**

Comment 6 to this section of the *Restatement (Second) of Conflict of Laws* also states that the state with the most significant relationship is determined by the following factors:

- the needs of the interstate and international systems;
- the relevant policies of the forum;
- the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue;
- the protection of justified expectations;
- the basic policies underlying the particular field of law;
- certainty, predictability and uniformity of result; and
- ease in the determination and application of the law to be applied.

(v) **Substantial State Relation to the Trust**

The comment also provides that a state has a substantial relation to a trust if

- The settlor designated it as the state in which the trust is to be administered;
- It is the trustee’s place of business or domicile at the time of the trust’s creation;
- It is the trust assets’ location at the time of the trust’s creation;
- It is the settlor’s domicile at the time of the trust’s creation; or
- It is the beneficiaries’ domicile at the time of the trust’s creation.

The court stated that Alaska law would apply only if Alaska had a substantial relation to the trust. *Restatement (Second) of Conflict of Laws* § 270, cmt. b (1971).
(vi) **Searching for a Substantial Relationship**

When Donald created his trust, neither he nor the beneficiaries were domiciled in Alaska and the trust assets were not located in Alaska. The trust's only connection with Alaska was the location of the trustee and the administration of the trust in Alaska.

On the other hand, at that time, Donald and the trust beneficiaries all resided in Washington, the trust assets (other than a certificate of deposit) were transferred from Washington, Donald's creditors were located in Washington, and the drafting attorney was located in Washington. When the trust was created, therefore, Alaska had only a minimal relation to the trust, but Washington had a substantial relation to the trust.

(vii) **Strong Washington Public Policy**

Washington, however, had a strong public policy against self-settled asset protection trusts; its statutes declare them void against both existing and future creditors. Revenue Codes of Wash., § 19.36.020; *Carroll v. Carroll*, 18 Wash. 2d 171, 175, 138 P.2d 653 (1943); *Rigby v. Mastro (In re Mastro)*, 465 B.R. 576, 611 (Bankr. W.D. Wash. 2011). Therefore, as the trust was a self-settled trust, Donald's transfers of assets into the trust were void, and the trustee was entitled to summary judgment voiding the transfers.

(viii) **Fraudulent Transfer**

The court also held that the transfers to the trust were fraudulent under Section 548(e)(1) of the Bankruptcy Code.

2. **Application of Community Property Basis Rules**

The major tax advantage of creating an Alaska, South Dakota, or Tennessee community property trust is to enable residents of non-community property states to take advantage of IRC § 1014(b)(6), which states that, upon the death of either spouse, the basis of the entire community property asset (and not just one-half of the asset) becomes equal to the estate tax value of the asset. IRC § 1014(b)(6) does not distinguish between property that is held as community property under automatic (opt out) state laws or under elective (opt in) state laws. Furthermore, significant authority strongly suggests that community property under an (opt in) law, such as that adopted in Alaska, South Dakota, or Tennessee, would be eligible for the basis adjustment at death under IRC § 1014(b)(6), as long as the state statute created property rights that are generally the same as those created by other state community property laws.

a) **Harmon**

In *Comm’r v. Harmon*, 323 U.S. 44 (1944), the U.S. Supreme Court held that the taxpayers in an opt-in community property state could not split their community property income for U.S. income tax purposes.

(1) **Facts**

In 1939, Oklahoma passed a community property law that applied only if married Oklahoma residents opted into the system. 32 Ok. Stat. of 1941 §§ 51 et seq. The Harmon’s elected under the statute to opt into the community property system.
Thereafter, each reported one-half of the community property income for federal income tax purposes, in order to use two sets of rate brackets (this was before the enactment of joint tax returns).

(2) Supreme Court Analysis

(a) Court Recognizes Two Styles of Community Property

The Court stated that community property systems

“are of two sorts--consensual and legal. A consensual community arises out of contract. It does not significantly differ in origin or nature from such a status as was in question in Lucas v. Earl, where by contract future income of the spouses was to vest in them as joint tenants. In Poe v. Seaborn, supra., the court was not dealing with a consensual community but one made an incident of marriage by the inveterate policy of the State.”


(b) Opt-In Community Property Cannot Assign Incidence of Income Tax

The Court held that the Oklahoma community property "does not significantly differ in origin or nature from such a status as was in question in Lucas v. Earl, where by contract future income of the spouses was to vest in them as joint tenants." 323 U.S. 44, at 46 (1944).” The Court noted that, under Lucas v. Earl, 281 U.S. 111 (1930), the spouses could not use community property to split income, under the anticipatory assignment of income doctrine.

(c) Analysis of Harmon

(i) One View

Some commentators focus on this holding to conclude that the modern opt-in community property cannot qualify for the basis adjustment under IRC § 1014(b)(6). D. Westfall & G. P. Mair, Estate Planning Law & Taxation, § 4.01(1) (4th ed. 2001 & Supp. 2017) (arguing that an elective community property system such as adopted by Alaska will not be effective under Harmon); and Roberts, A Cautionary Tale -- Community Property Trusts, 47 Tenn. Bar J. 24 (July 2011).

(ii) Another View

The Court in Harmon stated that it assumed “that, once established, the community property status of Oklahoma spouses is at least equal to that of man and wife in any community property State . . .” 323 U.S. 44, at 47 (1944). Thus, the Court recognized that the property was community property, but determined that the spouse who earned Oklahoma consensual community property income must report it under the assignment of income doctrine. Cf. United States v. Robbins, 269 U.S. 315 (1926) (couple's income was community property, but
wife could not report any part of it for federal income tax purposes because her interest had not vested). In discussing the history of the case, the Court stated:

“[The lower courts] overruled the [Commissioner's] contention that, as the [Oklahoma] statute permits voluntary action which effects a transfer of rights of the husband and wife, the case is governed by Lucas v. Earl and other decisions of like import. We hold that the [Commissioner's] view is the right one.”


One can, therefore, read Harmon to say that consensual or opt-in community property is community property under the community property laws of a state, and therefore, IRC § 1014(b)(6) should determine the basis of the surviving spouse's one-half interest. Harmon predates IRC § 1014(b)(6), however, and thus may not be controlling.

(3) Opt In vs. Opt Out

Voluntary or consensual conversion of separate property into community property under the laws of a traditional community property state, such as California or Texas, creates community property under IRC § 1014(b)(6). It seems odd to suggest that opt out rules are recognized but opt in rules are not.

(4) Justice Douglas’ Dissent

Justice Douglas (joined by Justice Black) dissented in Harmon, noting that

“One dubious decision does not of course justify another. But if Texas can reduce the husband's income tax by creating in his wife a 'vested' interest in half his salary and other income, I fail to see why its neighbor, Oklahoma, may not do the same thing. The Court now concedes that once established, the community property status of Oklahoma spouses is at least equal to that of man and wife in any community property state. How then can Oklahoma be denied the same privilege which other community property states enjoy?

* * *

But it is said that the filing of a written election under the Oklahoma statute is an 'anticipatory arrangement' for the disposition of income under the rule of Lucas v. Earl; that a 'consensual' community will not be recognized for federal income tax purposes but that a 'legal' community will. As the Tax Court, however, pointed out (1 T.C. 40, 49) such a distinction will not stand scrutiny. Community property created by marriage is the effect of a contract. [footnote omitted] It is the result of a consensual act. The same is true where husband and wife agree to leave Oklahoma and establish their domicile in Texas so as to gain the advantages of a community property system. I can see no difference in substance whether the state puts its community property system in effect by one kind of contract or
another. One is as much ‘legal’ as another. The agreement to marry or the agreement to move from Oklahoma to Texas is as ‘consensual’ as the act of filing a written election under the Oklahoma statute.”


The dissent also stated that maintaining any meaningful distinction between consensual community property under a mandatory community property system and consensual community property under a consensual community property system may be impracticable.

b) McCollum

A lower court decision in McCollum v. United States, 1958 WL 10206 (N.D. Okla. 1958), is also instructive.

(1) Facts

A married couple elected in 1943 to treat their assets as community property under Oklahoma’s opt-in statute. In 1945, after Harmon, Oklahoma adopted a mandatory community property regime, under which all property that a husband and wife acquired after enactment of the 1945 law or after their marriage, if later, would be community property, subject to certain exceptions. See generally Kane v. Comm’r, 11 T.C. 74 (1948) (providing a brief history of Oklahoma’s experiment with community property). The 1945 law also declared that assets designated by couples as community property under its 1939 opt-in law were community property.

Mr. McCollum died after the 1939 Code predecessor to IRC § 1014(b)(6) became effective. His wife succeeded to his community property interest in a particular piece of land they acquired after electing the Oklahoma community property regime. Mrs. McCollum took the position that the basis of her one-half interest in the property changed upon his death under the predecessor to IRC § 1014(b)(6).

(2) District Court Allows Basis Adjustment

The U.S. District Court agreed that the predecessor to IRC § 1014(b)(6) applied. Oklahoma had a mandatory or opt-out community property system by the time Mr. McCollum died, but the decision seems consistent with the notion that IRC § 1014(b)(6) applies to consensual or opt-in community property, because the property in question was acquired before 1945, when it would have been community property only under the opt-in law. Logically, the Alaska, and possibly the Tennessee and South Dakota, opt-in community property systems should produce the same result; community property under those statutes is community property "under the community property laws of [a] State."

c) Rev. Rul. 77-359

Rev. Rul. 77-359, 1977-2 C.B. 24 also supports the notion that the basis of opt-in community property should be determined under IRC § 1014(b)(6).

(1) Facts

In Rev. Rul. 77-359, Husband and Wife were residents of Washington state. In 1975, the taxpayers agreed in writing that all presently-owned separate property and all thereafter acquired property would be community property.
Conversion of Property Recognized

The Service stated that such an agreement changes the status of presently owned separate property and subsequently acquired separate property into community property under applicable state law, and should, therefore, be respected for federal tax purposes.

Analysis

State Law Allows Contractual Creation of Community Property

The Service noted that the Washington Supreme Court had held that a written agreement between spouses that property then-owned and thereafter acquired would be community property was legally effective under applicable state law. *Volz v. Zang*, 113 Wash. 378, 194 P. 409 (1920). The court held that the agreement was a valid contract and operated converted separate real property into community property, because state law gave spouses the right to deal in every possible manner with their property, and that the couple could change the status of separate property to community property. See also *Estate of Shea*, 60 Wash. 2d 810, 376 P.2d 147 (1962); *Neeley v. Lockton*, 63 Wash. 2d 929, 389 P.2d 909 (1964); *Estate of Verbeek*, 2 Wash. App. 144, 467 P.2d 178 (1970); and *Merriman v. Curl*, 8 Wash. App. 894, 509 F.2d 765 (1973).

Harmon Applied

To the extent that the agreement affects the income from separate property and not the separate property itself, the Service stated that it would not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns. Citing Comm’r v. Harmon, *supra*. Thus, the IRS stated that the property was community property, but that it did not split income because it was created by an election. The clear implication is that property that becomes community by election may still be community property, even if it does not, under *Harmon*, shift the incidence of taxable income.

PLR 199917025

See also PLR 199917025, in which separate property that was converted into community property by an agreement between the spouses, which agreement was enforceable under applicable state law, became community property for tax purposes. See, also Randall, *Estate Planning and Community Property*, 28 Idaho L. Rev. 807, 815 (1991/1992); Rasmussen, *Divorce Provisions in Opt-In Marital Property Agreements*, 67 Wis. Law. 15 (April 1994); Smith, *The Unique Agreements: Premarital and Marital Agreements, Their Impact Upon Estate Planning, and Proposed Solutions to Problems Arising at Death*, 28 Idaho L. Rev. 833, 873-74 (1991/1992); Treacy, Jr., *Planning to Preserve the Advantages of Community Property*, 23 Est. Plan. 24, 26, 29 (1996).

Language of IRC § 1014(b)(6)

It should also be noted that IRC § 1014(b)(6) only requires that the property be community property under the laws of any State (or possession or foreign country). If nonresident married persons transfer property to an Alaska, South Dakota, or Tennessee Community
Property Trust, the property will be community property under the law of that state, and so should literally fall under the basis adjustment rules of IRC § 1014(b)(6).

e) Caveat: Alaska vs. Tennessee and South Dakota

The Alaska Community Property Act closely mirrors the Uniform Marital Property Act, which Wisconsin adopted and which the IRS has ruled creates valid community property. Rev. Rul. 87-13, 1987-1 CB 20. The only significant difference is that the Alaska rules are opt in, rather than default. In particular, the Uniform Marital Property Act details the rights of the parties to manage and control the property and to dispose of it at death. South Dakota’s community property statute merely states that assets in a South Dakota Special Spousal Trust are community property. It does not address management, control, or disposition at death. Tennessee’s statute addresses dispositions at death and some issues of rights during lifetime, but it does not address management and control. These distinctions between the Tennessee and South Dakota statutes and both the common law rules and the Uniform Marital Property Act may give the IRS a basis for denying a basis adjustment for the entire property held in such state community property trusts. See also analysis in Angerhofer v. Comm'r, 87 T.C. 814 (1986) (German law creating a “Community of Aggregated Gains” did not create community property.

D. Drafting and Planning

1. Generally

The Alaska, South Dakota, and Tennessee community property trusts have not been tested in any court opinion, but as discussed above, at least the Alaska trusts should work well under the existing law, and the South Dakota and Tennessee trusts have a good argument for working well under existing law.

2. Situs Issues

All three states make it quite easy for a trust to adopt those states as the relevant situs, but the importance of assuring that the chosen state’s laws apply suggests that practitioners should urge their clients to do more than the minimum required to create an Alaska, South Dakota, or Tennessee community property trust. In particular, it is suggested that taxpayers do the following:

- Give the situs (Alaska, South Dakota, or Tennessee) trustee actual possession and control over the trust assets, rather than over a portion of the trust assets. If securities are held in certificate form, the trustee should hold the certificate. Otherwise, the brokerage account should be opened with a brokerage that has an office in the situs state. Tangible assets should be held in the situs state or held by an LLC or corporation created under the laws of the situs state.

- The situs trustee should have all duties with respect to management and administration of the trust assets. Distribution authority may be held by a co-trustee.

- The governing instrument should not only declare that the situs law applies but should prevent the trustee from changing the trust’s situs until the first spouse has died.

3. Integrating the Community Property Trust into the Estate Plan

The easiest way to integrate the community property trust into the parties’ estate plan is to provide that, when the first spouse dies or, if earlier, the §share to the husband’s separate revocable trust (or, if there is none, to the husband or the personal representative of his estate), and one share to the wife’s separate revocable trust (or to her or the personal representative of her estate). See Zaritsky,
4. What Does the Uniform Disposition of Community Property Rights at Death Act (UDCPRDA) have to do with Double Basis Adjustment

a) General Overview

The Uniform Disposition of Community Property Rights at Death Act (“UDCPRDA”) was drafted by the National Conference of Commissioners of Uniform State Law in 1971 and sent to the American Bar Association, who approved it on February 7, 1972.


b) NCCUSL’s Explanation of the Proposed Statute

In most cases when uniform laws are promulgated, there are prefatory notes, which generally give the purpose and intent of the proposed law. UDCPRDA is no exception; its prefatory note states as follows:

“Frequently spouses, who have been domiciled in a jurisdiction which has a type of community property regime, move to a jurisdiction which has no such system of marital rights. As a matter of policy, and probably as a matter of constitutional law, the move should not be deemed (in and of itself) to deprive the spouses of any preexisting property rights. A common law state may, of course, prescribe the dispositive rights of its domiciliaries both as to personal property and real property located in the state. California’s development of its “quasicommunity property” laws illustrates the distinction.

The common law states, as contrasted to California, have not developed a statutory pattern for disposition of estates consisting of both separate property of spouses and property which was community property (or derived from community property) in which both spouses have an interest. In these states there have been relatively few reported cases (although the number has been increasing in recent years); the decisions to date show no consistent pattern and the increasing importance of the questions posed suggests the desirability of uniform legislation to minimize potential litigation and to facilitate the planning of estates.

This Act has a very limited scope. If enacted by a common law state, it will only define the dispositive rights, at death, of a married person as to his interests at death in property “subject to the Act” and is limited to real property, located in the enacting state, and personal property of a person domiciled in the enacting state. The purpose of the Act is to preserve the rights of each spouse in property which was community property prior to change of domicile, as well as in property substituted therefor where the spouses have not indicated an intention to sever or alter their “community” rights. It thus follows the typical pattern of community property which permits the deceased spouse to dispose of “his
half’ of the community property, while confirming the title of the surviving spouse in ‘her half.’

It is intended to have no effect on the rights of creditors who became such before the death of a spouse; neither does it affect the rights of spouses or other persons prior to the death of a spouse. While problems may arise prior to the death of a spouse they are believed to be of relatively less importance than the delineation of dispositive rights (and the correlative effect on planning of estates). The prescription of uniform treatment in other contexts poses somewhat greater difficulties; thus this act is designed solely to cover dispositive rights at death, as an initial step.

The key operative section of the Act is Section 3 which sets forth the dispositive rights in that property defined in Section 1, which is subject to the Act. Section 2 follows Section 1’s definition of covered property and is designed to provide aid, through a limited number of rebuttable presumptions in determining whether property is subject to the Act.

No negative implications were intended to be raised by lack of inclusion of other presumptions in Section 2; areas not covered were simply left to the normal process of ascertainment of rights in property.

The first three sections form the heart of the Act; the succeeding sections might almost be described as precatory and have been added to clarify situations which would probably follow from the first three sections but which might raise questions. Thus, Section 8 makes it clear that nothing in the Act prevents the spouses from severing any interest in community property or creating any other form of ownership of property during their joint lives; and, such action on their part will effectively remove any property from classification as property subject to this Act. Similarly, Section 9 makes it clear that the Act confers no rights upon a spouse where, by virtue of the property interests existing during the joint lives of the spouses, that spouse had no right to dispose of such property at death. By way of illustration, in at least one community property jurisdiction, the wife has no right to dispose of any part of the community property if she predeceases her husband. If the law of that jurisdiction is construed so as to treat this as a rule of property, then the move to the common law state should not alter the “property interest” of the spouses by conferring a right on the wife which she did not previously possess. On the other hand, if the provision is treated as simply establishing a pattern of dispositive rights on death of a wife who predeceases her husband, rather than a property right, the common law state of new domicile could prescribe an alternative pattern of dispositive rights. The Act does not resolve this question; rather it simply makes clear that it does not affect existing “property rights,” leaving to the courts the interpretation of the effect of the community property state’s law.”

(1) Observations on NCCUSL’s Comments

In reviewing the prefatory note, it is interesting that nowhere does it mention that a purpose of this provision had anything to do with income taxes, tax basis or any similar provision. Rather, the purpose of this law was to provide upon the death of the first spouse to die of a couple who once lived in a community property state and owned community property, assuming that the couple did nothing to affirmatively destroy any property rights that they may have had in their “community property”, that the surviving spouse will have certain community property
“rights” with respect to such property. What is more interesting is that the uniform law does not state that the property continues to be community property (the act is silent), rather the uniform act focuses on the surviving spouse’s “rights” in the property. The goal of the statute is to provide certain rights to the surviving spouse in the property that such would be akin to what the survivor would have received had the property been community property. Thus, the subtlety of the statute is the focus on the survivor’s rights, and not defining the property as “community property” or some other type of property.

(2) States Implementing UDCPRDA

There are sixteen common law states that have adopted UDCPRDA. Interestingly, even though Alaska has the Community Property Trust act, they have also kept their version of UDCPRDA. With respect to opt-in community property states, keeping the UDCPRDA would be relevant for those who choose not to opt into the community property system.

c) Does the Survivor’s Interest in Property Covered Under UDCPRDA obtain a Date of Death Basis Adjustment Under IRC § 1014(b)(6)?

(1) Careful Reading of IRC §1014(b)(6)

This is the big question. We have to look at the IRC § 1014(b)(6) carefully, once again. The statute reads as follows:

“(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse’s one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent’s gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939 … “

(2) Analysis of IRC § 1014(b)(6)

We see that this statue applies only to “community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country.”

The question then becomes, if a decedent dies a resident of a non-community property state, can that decedent own “community property”? This situation arises where a couple live in a community property state, acquire community property assets, move to a non-community property state and one spouse dies while a resident of the non-community property state.

The key question is whether the state in which the decedent spouse was a resident at the time of death recognized property as “community property” at the time of the decedent spouse’s death. One may have a knee-jerk reaction and say, for those states that adopted UDCPRDA certainly would have jurisprudence to categorize property as community property.

We caution the reader that this is not necessarily the case. The title to the statute gives the reader a key to this. The statute is called the Uniform Disposition of Community Property Rights at Death Act (emphasis supplied). The statute is not
a uniform statute on the disposition of “Community Property”, rather it is a statute that is designed to address community property “rights”. Nowhere in the statute does it say that the property is “community property”, it simply provides certain presumptions, how the property will be distributed at death, how title is perfected by the surviving spouse and the decedent’s fiduciary, heirs, or devisee, how to deal with purchasers for value and creditors and certain other aspects and rights with respect to the property that was once community property when the decedent lived in a community property state. Significantly, the statute does not characterize the property as community property.

Understanding the purposes and limitations of UDCPRDA, the planner must determine whether, if UDCPRDA was adopted in a state, would property be characterized as community property, or whether the property is not community property. If the property is community property “under the community property laws of any State …” then so long as one-half (½) of such property was included in the decedent spouse’s gross estate for federal estate tax purposes, the basis of such property will obtain a basis adjustment under IRC § 1014(b)(6). If however, the state does not categorize the property as community property, then there should be no basis adjustment.

d) Florida’s Case Law and Analysis

(1) Considering New Legislation

Currently the Real Property Probate and Trust Law section of the Florida Bar is considering whether to introduce legislation similar to the Community Property Trust law as there exists in Alaska, Tennessee and/or South Dakota.

The Florida Bar has looked to what North Carolina is doing, since they too are looking at introducing this legislation.

(2) Does Florida have Community Property Jurisprudence?

For some, the answer is clearly “No” and for others, they debate that answer. We examine the jurisprudence below.

Most cite to the case of Quintana v. Ordono, 195 So. 2d 577 (Fla. 3rd DCA 1967) as the case that determines that Florida has community property jurisprudence. Interestingly, what the Supreme Court never came to the conclusion that the property was community property. What they held was that the decedent spouse was hold the property in a “resulting trust” for the survivor, and the survivor had rights to those assets held in trust. Faced with the issue, it appears that the justices found a remedy under Florida law (i.e., resulting trust) for the interest in the property in question.

The Florida Supreme Court did not hold that the property was community property. Rather, like the UDOCPRDA, they gave the survivor rights in the property.

(3) Conclusions on Florida’s Law

In light of the fact that there is disagreement among many who have studied this issue, what is clear it that it is unclear in Florida. What is clear is if you have jurisprudence in a state where the property “is” community property and not that the surviving spouse has “rights” in property that was at one time community property, then the property can be adjusted under IRC § 1014(b)(6). If the property is not community property under the laws of Florida, then there can be no adjustment. There is currently no case that has litigated this issue.
A. Generally

A part-sale/part-gift is a bargain sale, usually between family members or a donor and a charity. A bargain sale involves the transfer of property by one family member to another for less than full and adequate consideration in money or money’s worth. The buyer may pay all cash or give the seller an installment note, in which case any gain on the sales portion of the bargain sale may be reported under the installment sales rules.

B. Two, Two Transactions in One

A bargain sale is actually two transactions for tax purposes—a taxable gift and a sale.

1. Gift Portion

A bargain sale is a taxable gift to the extent that the fair market value of the property sold exceeds the consideration received. Reg. § 1.1001-1(e).

2. Sale Portion

a) Gain Transaction

A bargain sale is a sale to the extent that the consideration received exceeds the transferor’s adjusted basis in the property. Reg. § 1.1001-1(e).

Example XVII-1

Son wishes to buy Mom’s closely held stock that has a fair market value of $200,000. However, Son has only $150,000 to spend. Mom agrees to sell the stock to Son for $150,000. Mom’s adjusted basis in the stock is $50,000.

The transfer is a $50,000 taxable gift, determined by the difference between the stock’s fair market value and the amount of consideration paid by Son ($200,000 - $150,000 = $50,000).

The transfer is also a sale on which Mom recognizes a $100,000 gain, determined by the difference between the purchase price and Parent’s adjusted basis ($150,000 - $50,000 = $100,000).

See Example XVI-3 below to determine how basis is determined in Son’s hands.

b) No Loss - Loss Transaction

In a bargain sale transaction, the regulations provide that no loss is sustained in a sale to the extent that the consideration is less than the adjusted basis. Reg. § 1.1001-1(e).

Example XVII-2

Daughter wishes to buy Dad’s closely held stock that has a fair market value of $300,000. However, Child has only $150,000 to spend. Dad agrees to sell the stock to Child for $150,000. Dad’s adjusted basis in the stock is $200,000.

The transfer is a $150,000 taxable gift, determined by the difference between the stock’s fair market value and the amount of consideration paid by Daughter ($300,000 - $150,000 = $150,000).
Even though the adjusted basis (of $200,000) was greater than the consideration received, there will be no loss because of Reg. § 1.1001-1(e).

See Example XVII-4 below to determine how basis is determined in Daughter’s hands.

3. Basis in a Non-Charitable Bargain Sale

The transferor’s adjusted basis in a non-charitable bargain sale property is allocated entirely to the sales portion of the transaction. Reg. § 1.1001-1(e)(1).

The transferee’s basis in the bargain sale property is the greater of:

- the consideration paid by the transferee (i.e., the donee); or
- the transferor’s adjusted basis at the time of the transfer, plus any gift taxes paid on gift.

Reg. §1.1015-4.

Example XVII-3

This is the same fact pattern as Example XVII-1, except here we discuss Son’s basis in the stock. Recall that Son purchased the stock with a fair market value of $200,000 and adjusted basis in Mom’s hands of $50,000 for $150,000. Son’s basis would be $150,000, calculated as follows:

Greater of:

<table>
<thead>
<tr>
<th>Consideration paid by Son</th>
<th>$150,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>or</td>
<td></td>
</tr>
<tr>
<td>Mom’s basis, plus gift taxes paid</td>
<td>50,000</td>
</tr>
</tbody>
</table>

Son’s basis $150,000

Example XVII-4

This is the same fact pattern as Example XVII-2, except here we discuss Daughter’s basis in the stock. Recall that Daughter purchased the stock with a fair market value of $300,000 and adjusted basis in Dad’s hands of $200,000 for $150,000. Daughter’s basis would be $200,000, calculated as follows:

Greater of:

<table>
<thead>
<tr>
<th>Consideration paid by Daughter</th>
<th>$150,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>or</td>
<td></td>
</tr>
<tr>
<td>Dad’s basis, plus gift taxes paid</td>
<td>200,000</td>
</tr>
</tbody>
</table>

Daughter’s basis $ 200,000
4. Holding Period in non-charitable transaction

As discussed above, even though there are two separate transactions, the holding period of the entire basis of the property will be tacked under the theory that the language “in whole or in part” under IRC § 1223(2) would apply. See, Citizens Nat’l Bank of Waco v. United States, 417 F.2d 675 (5th Cir. 1969).

Thus, in each of the four examples, the donee (i.e., Son in Examples XVII-1 and XVII-3, and Daughter in Examples XVII-2 and XVII-4) will tack the donor’s holding period.

C. Basis in a Charitable Bargain Sale

1. Charitable Bargain Sale Defined

A charitable bargain sale is a bargain sale in which all or part of the gift portion is deductible for income tax purposes under IRC § 170. IRC § 1011(b); Reg. § 1.1011-2(a)(1).

2. Apportionment of Basis

For purposes of determining gain on a charitable bargain sale, the adjusted basis of the transferred property that is deemed to have been sold or exchanged is that portion of the adjusted basis of the entire property that bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the entire property. Reg. § 1.1011-2(b). See also generally Lichter, The Federal Tax Rules and Theory of Bargain Sale Gifts to Charity, 12 Tax Mgmt. Est., Gifts & Tr. J. 172 (1987) and 13 Tax Mgmt. Est., Gifts & Tr. J. 23 (1988); Weber & Stevenson, Charitable Bargain Sales and the Allowability Test—A Tax Trap, 56 Taxes 101 (1978).

Example XVII-5

Donor sells to Church certain publicly-traded stock that Donor has held for more than one year, and so qualifies as long-term capital gain property. Church pays Donor $400,000. The fair market value of the stock is $1 million. Donor’s adjusted basis in the stock is $300,000. Donor’s adjusted basis for determining gain on the bargain sale is $120,000, determined as follows:

\[
\text{Adjusted basis} = \frac{\text{Amount realized}}{\text{Fair market value}} \times \text{Adjusted basis}
\]

Donor realizes a long-term capital gain of $280,000 ($400,000 amount realized - $120,000 adjusted basis) on the bargain sale. See Reg. § 1.1011-2(c), Ex. 1.

3. Encumbered Property

The tax effects of a charitable gift of encumbered property are identical to those of a traditional bargain sale to a charity for cash. The amount of the debt assumed or taken subject to by the charity is included in the transferor-donor’s amount realized for purposes of determining the transferor-donor’s gain recognized on the transfer. Thus, the donor recognizes gain if the amount of the debt exceeds the share of his or her adjusted income tax basis allocated to the sale portion of the transfer. The excess of the value of the property over the amount of the encumbrance is deductible as a charitable contribution. Reg. § 1.1011-2(a)(3); see also Rev. Rul. 75-194, 1975-1 C.B. 80; and Rev. Rul. 81-163, 1981-1 CB 433. The part-sale result occurs even if there is no purchase, but rather the transfer of property that is subject to a non recourse mortgage. Ebben v. Comm’r, 783 F.2d 906 (9th Cir. 1986); Guest v. Comm’r, 77 T.C. 9 (1981). See also Woodburn, Jr., Handling Charitable Gifts of Debt-Encumbered Property, 21 Est. Plan. 287 (Sept./Oct. 1994).
4. Income Tax Deduction

With respect to the gift part, the excess of the allocable value of the property over the amount received is a deductible gift to the charity. IRC § 1011(b).

a) Reduction for Non-Long-Term Capital Gain

Under IRC § 170(e)(1)(A), the deductible amount of a gift of appreciated ordinary income property is reduced by that part of the gain that would not qualify as long-term capital gain upon the sale of the property.

b) Bullard and the Charitable Bargain Sale

IRS previously stated that when the charitable contribution arises from a bargain sale, the non-long-term capital gain inherent in the entire property reduces the charitable deduction, and not just the non-long-term capital gain allocable to the charitable gift portion. The Tax Court rejected this position in Estate of Bullard v. Comm’r, 87 T.C. 261 (1986).

c) Regulations Revised

After Bullard, the IRS amended the regulations to state that only the non-long-term capital gain inherent in the portion of the property contributed to charity reduces the deduction for the charitable gift. Reg. §§ 1.170A-4(c), 1.1011-2, as amended by T.D. 8176, 53 Fed. Reg. 5568 (Feb. 25, 1988).
XVIII. PROBLEM BASIS SITUATIONS: BASIS OF PARTNERSHIP (AND LLC INTERESTS) AND THE SECTION 754 ELECTION

A. Background on Partnership Taxation

1. In general

Limited partnerships (LPs) and limited liability companies (LLCs) are used extensively today in estate planning. The choice of entity is primarily determined by the client’s needs and goals, the practitioner and the state in which the entity is to be formed.

For federal income tax purposes, LPs are generally taxed as partnerships under Subchapter K of the Internal Revenue Code. LLCs, by comparison may choose to be taxed as corporations (whether C or S), partnerships (if there are two or more members) or disregarded entities (where there is a single member). See generally, Reg. § 301.7701-1; -2; -3 and -4.

For purposes of this paper, we will discuss those LPs and LLCs that choose to be taxed as partnerships under Subchapter K, and often will refer to LLCs and LPs as “partnerships”. This part of the paper is designed to be an overview of partnership law as it affects basis inside and outside of the partnership. For comprehensive treatise on partnership tax, see, W.S. McKee, W.F. Nelson & R.L. Whitmire, Federal Taxation of Partnership and Partners (Thomson Reuters/Tax & Accounting, 4th Ed. 2007 & Supp. through 2018-1).

2. Underlying Theories for Subchapter K

In general, federal partnership tax law wrestles with two underlying theories that set the stage for its taxation: Aggregate Theory and Entity Theory.

a) Aggregate Theory

Under the aggregate theory, one would basically look through the partnership and tax the partner with respect to his/her ratable share of partnership items. According to Professors McKee, Nelson and Whitmire, if subchapter K was based only on aggregate theory, subchapter K would be generally unnecessary, because other sections of the Code would be able to adequately tax the partnership and its partners.

b) Entity Theory

The entity concept treats the partnership as a separate entity, and thus transactions between the partnership and third parties, as well as transactions between the partnership and its partners are at arm’s length.


c) Which Theory Applies?

The simple answer is – both.

Both theories apply in partnership tax, and as it applies to basis, we generally understand that a partner has a basis in his partnership interest, sometimes called “outside basis”) separate and apart from the partnership’s basis in the assets that it holds, sometimes called “inside basis”), thus, with regard to basis, it appears that an entity approach is adopted.
However, as with most of the partnership tax law, there is often a blending of the aggregate and entity theory.

The 754 Election (discussed in section XVIII.J below) is a perfect example. On the one hand the basis of assets inside the partnership is generally determined on an entity theory, but when there is a shift in ownership of the partner’s interests, that inside basis may be adjusted because of an outside basis shift.

From time to time, the tax lawyer tries to take advantage of some of the nuances and gaps that arise because of the application of one theory or the other to a particular partnership tax provision. When this happens, generally the issue is brought to light and then there are revenue rulings, regulatory and/or statutory changes that address the particular issue. These rulings and changes generally leads more of a blending of the aggregate and entity theories underpinning the existing partnership tax law, which could then further the complication and lead to more confusion.

B. Initial Basis

Generally, a partner’s initial basis is established when a person (defined broadly to include individuals, trusts, estates, corporations, etc.,): (a) contributes assets into a partnership in exchange for a partnership interest, (b) purchases a partnership interest from an existing partner, or (c) a combination (a) and (b).

1. Contributions

In general, most contributions are non-recognition events, however, there are some that cause gain to be recognized on contribution. Note: Losses are never recognized on contribution.

a) Tax Free Contributions – General Rule

(1) No Gain Recognition

When partners contribute assets to the partnership in exchange for partnership interests, generally neither the partnership nor its partners recognize gain. IRC §721(a).

(a) Inside Basis - Basis of Partnership’s Assets

When there is no gain recognition, the partnership’s basis of the assets transferred to the partnership (i.e., the “inside basis”) will be a transferred basis. IRC § 723; Reg. § 1.723-1

(b) Outside Basis – The Partner’s Basis in its Partnership Interest

When there is no gain recognition, the partner’s basis in the partnership interest (i.e., the “outside basis”) is equal to the basis of the property contributed to the partnership. IRC § 722; Reg. § 1.722-1

Example XVIII-1

Richard owns Blackacre (raw land) which he purchased for $100,000 in 2001. George owns Whiteacre (raw land) that abuts Blackacre. George purchased Whiteacre for $200,000 in 2004. In January 2015, each of Blackacre and Whiteacre has a fair market value of $500,000, on the day that Richard and George enter a partnership by contributing Blackacre and Whiteacre in exchange for a 50% interest in RGLP. Richard
will be the general partner and George will be the silent limited partner.

Richard’s outside basis will be $100,000 (i.e., the basis of Blackacre before contribution).

George’s outside basis will be $200,000 (i.e., the basis of Whiteacre before contribution).

RGLP’s inside basis will be $100,000 for Blackacre and $200,000 for Whiteacre.

(2) Holding Period

(a) For the Partnership

If no gain is recognized, the holding period of the property received by the partnership would be a tacked holding period. IRC § 1223(2); Reg. § 1.723-1.

(b) For the Partner

(i) The Rules

Unlike the holding period for the partnership, the holding period for the partner is a bit more complicated. If no gain is recognized, then for purposes of determining the holding period, one looks to the assets contributed to determine the holding period.

If the contributed assets are capital and IRC § 1231 type assets, then the holding period is a tacked holding period. IRC § 1223(1).

If the contributed assets are cash, a non-capital asset or non-$1231$ type of asset, then the holding period begins on the date of contribution. IRC § 1223(1); Reg. § 1.1223-1(a).

If there is a mix of assets contributed (e.g., some cash, some capital assets), then, only for purposes of holding period, the partnership interest is bifurcated, and the rules (i.e., tacking and date of contribution) would apply pro-rata based on the fair market values of the assets contributed. Reg. §1.1223-3(b)(1). For an example, see also Reg. § 1.1223-3(f) Example 1.

(ii) The Aberration – Subsequent Contributions

In light of the bifurcation rule set forth in Reg. § 1.1223-3(b)(1), it should be noted that every time a partner makes a contribution of cash, a non-capital asset, or a non-$1231$ type asset to the partnership, the holding period for the outside basis has to be bifurcated. That bifurcation lasts for only one year and a day (because after that one year and a day period, any gain from the sale or exchange would be a capital asset).
As a practical matter, this only comes into play when there are cash calls and a sale or exchange will occur within a year of such cash call.

Example XVIII-2

Assume the same facts as Example XVIII-1, and that both Blackacre and Whiteacre are capital assets.

As to Richard’s outside basis, he would have a tacked holding period back to 2001.

As to George’s outside basis, he would have a tacked holding period back to 2004.

As to RGLP’s inside basis, Blackacre’s holding period would be 2001 and Whiteacre’s holding period would be 2004.

Example XVII-3

Assume the same facts as Example XVIII-1, except that Richard contributed cash of $500,000 instead of Blackacre, and that Whiteacre is a capital asset.

As to Richard’s outside basis, he would have a new holding period as of the date of contribution.

As to George’s outside basis, he would have a tacked holding period back to 2004.

As to RGLP’s inside basis, the cash will have a date of contribution holding period and Whiteacre’s holding period would be 2004.

Example XVII-4

Assume the same facts as Example XVIII-1, except that Richard contributed cash of $200,000 and Greenacre (which had a FVM of $300,000 and a $100,000 adjusted basis and was bought in 2001), instead of Blackacre, and that both Greenacre and Whiteacre are capital assets.

As to Richard’s outside basis, he would have a bifurcated basis for holding period purposes. As to two-fifths (2/5), his holding period would be a new holding period as of the date of contribution (i.e., related to the cash) and as to three-fifths (3/5), he would have a tacked holding period going back to 2001 (i.e., related to Greenacre).

As to George’s outside basis, he would have a tacked holding period back to 2004.

As to RGLP’s inside basis, the cash will have a date of contribution holding period, Greenacre’s holding period would be 2001, and Whiteacre’s holding period would be 2004.
b) Taxable Contributions – The Exceptions

In general, gain could be recognized when “boot” is received by the partner and gain is recognized when an “investment partnership” is formed.

(1) Receipt of Boot

“Boot” comes in various forms. It could occur when a partner receives cash or other property in conjunction with the partnership interest in exchange for the assets given up, or it could be that the partnership assumed debt or took assets subject to debt from the partner.

IRC § 721(a) is silent on how to treat receipt of boot by the partner (which is in stark contrast to the formation rules for corporations under IRC § 351). However, the regulations provide that the assumption of debt would be treated as a constructive distribution and the rules under IRC § 731 would apply. If the net assumed debt exceeds the partner’s basis in the property given up, then gain will be recognized under IRC § 731(a).

(2) Investment Partnerships

Unlike the statutory gap for receipt of boot, IRC § 721(b) provides that a partnership recognizes gain (and not loss) if the contributions would be considered made to a partnership that, if it had been incorporated, it would be treated as an investment company, as such term is defined in IRC § 351(e) (hereinafter, “investment partnerships”).

(3) Basis - Gain is Recognized

(a) Outside Basis

When gain is recognized on the contribution, the partner’s outside basis is equal to the sum of (1) amount of cash contributed, (2) the adjusted basis of the other assets contributed, and (3) the gain recognized on the transfer. IRC § 722; Reg. §§ 1.722-1 and 721-1(b).

(b) Inside Basis

Further, in determining the partnership’s inside basis, such basis is equal to the basis of the assets in the hand of the partner (immediately before the transfer), plus any gain recognized by the partner. IRC § 723; Reg. § 1.723-1.

(c) Holding Period

The holding period rules discussed in section XVIII.B.1.a.2 above would apply equally in this situation.

c) Assumption of Liabilities/Relief of Debt – And Basis

When assets are contributed to a partnership and the partnership assumes the debt or the contributed assets are subject to the debt, there are three transactions that occur:

- First, the contributing partner is being relieved of debt.
- Second, the partnership assumes the debt.
Third, the assumed debt by the partnership is deemed to be assumed by all of the partners based on their pro rata shares.

A partner’s basis increases by the amount of such partner’s share of the partnership’s debt or the amount of any partnership liability that such partner assumes. IRC § 722; Reg. §§ 1.722-1 and 1.752-1. The assumption of debt is treated as a contribution by the partner to the partnership.

Conversely, a partner’s basis decreases by the amount such partner’s share of the debt that is relieved or that such partner assumes. IRC § 722; Reg. §§ 1.722-1 and 1.752-1.

**d) Basis of Partner’s Contribution of Partner’s Own Note**

**1) To a Partnership**

If a partner contributes his/her own note in exchange for a partnership interest, the partnership basis is not increased by the face amount of the note. This is true whether the note is a recourse or non-recourse note. The basis of the note is zero and the basis in the partnership interest exchanged for the note is also zero. See *Vision Software LLC v. Comm’r*, T.C. Memo 2014-182; *Dakotah Hills Offices Ltd. P’ship v. Comm’r*, T.C. Memo 1998-134; *Gemini Twin Fund III v. Comm’r*, T.C. Memo 119-315; *Oden v. Comm’r*, 679 F.2d 885 (4th Cir. 1983), aff’d, T.C. Memo 1981-184; and Rev. Rul. 80-235, 1980-2 C.B. 229.

As the notes are paid off, then the basis is increased by the note payments. Thus, if the note is never paid off, then the partner would not have any basis in the partnership with regard to that note. *Vision Software, LLC v. Comm’r*, supra.

**2) To a Subchapter C Corporation – A Different Rule**

It should be noted that in *Peracchi v. Comm’r*, 143 F.3d, 487 (9th Cir. 1998) in the context of subchapter C corporations, the Tax Court held that the taxpayer Donald Peracchi had a basis equal to the face value of his note (in this case, $1.06 million), and on contribution, the basis in the stock he received in exchange for such note would be equal to that amount. It is interesting to note in Footnote 16 that the court was mindful of the difference between pass through entities, such as S corporation and partnerships) and said that in such a context, the note would have a zero basis. In a similar case, instead of holding that the note had a value equal to its face value, the Second Circuit held that the note had a zero value, but on contribution to a corporation, the basis of the stock in the hands of the shareholder was equal to the face value of the note (i.e., creating basis upon contribution). *Lessinger v. Comm’r*, 872 F.2d 519 (2nd Cir. 1989).

The troubling part of these cases is that if the taxpayer did nothing, the note would have a zero basis (based on existing case law other than in the subchapter C corporation context), and by contributing to a subchapter C corporation the note had a basis immediately before contribution (*Peracchi*), or the stock received a basis on contribution (*Lessinger*). Both of these cases are limited to subchapter C corporations and should be so limited.

**QUERY:** What would happen if the subchapter C corporation made an S election and converted to a subchapter S corporation? Would that election eliminate the basis? How much of the basis of the note would be eliminated? What if the note was partially paid before the election? After the election?
2. Basis of Interest Acquired other than by Contribution

a) Purchase

In general, if a partner acquires his/her interest other than by contribution, the acquiring partner’s initial outside basis is determined under the general basis rules (i.e., cost basis). IRC §§ 742 and 1012.

b) Gift

In the case of an inter vivos gift, the initial basis of a partnership interest in the case follows the general gift rules of a transferred basis plus any gift taxes paid attributable to the gift. IRC §§ 1015(a) and (d).

c) Inheritance

The initial basis of a partnership interest from a decedent follows the general rules of fair market value on the date of death or alternate valuation under IRC §§ 1014(a) and 2032.

C. Basis Adjustments – Distributive Share of Income, Gains, Deductions and Losses

After the partner begins as a partner, his/her initial basis is continuously adjusted based on activities of the partnership and activities of the partner. The partnership’s activities can be divided into those activities from the normal course of business (i.e., activities that generate income/loss) and other activities that related directly to the partner, such as additional contributions from the partner or distributions from the partnership.

In this section we address the impact of the day-to-day activities that affect basis. In general, with respect to such day-to-day activities, the Code provides a systematic way of adjusting basis. First, the Code (and the regulations thereunder) sets forth the manner in which items of income, gains, deductions, losses, credits, etc., are to be determined (IRC §§ 702 and 703). Second, the Code (and in particular the regulations) explains how those items will be allocated among the partners (IRC §704). Finally, the Code (and regulations) determines how those allocated items will increase and decrease the partner’s outside basis (IRC § 705).

1. IRC § 702 – Separately Stated Items

Each partner is to take into consideration such partner’s “distributive share” of a list of separately stated items, including but not limited to net taxable income (or loss), charitable contributions, short- and long-term gains (or losses), to determine such partner’s income tax. IRC § 702.

2. IRC § 703

The partnership’s net taxable income (or loss) is computed in a manner similar to that of an individual, except that certain items are to be separately stated, and there are certain items that are not allowed as deductions (e.g., personal exemptions).

3. IRC § 704 – Distributed Share Calculation

IRC § 704, and particularly the regulations thereunder, provides some of the most complex rules in tax law on how the “distributive share” is calculated for each partner. See, IRC § 704; Reg. § 1.704-1; Prop. Reg. § 1.704-1; Reg. § 1.704-1; Reg. § 1.704-1T; Reg. 1.704-2; Prop. Reg. § 1.704-2; Reg. 1.704-3; Prop. Reg. § 1.704-3; Reg. 1.704-4; and Prop. Reg. § 1.704-4.

In general, for most LPs (or LLCs) created for estate planning purposes, the partner’s (or member’s) distributive share is determined by his or her interest in the LP (or LLC). Thus, if a partner is a 20% partner, he or she will generally share in 20% of the separately stated items. Importantly, the so-
called, special allocation rules, under IRC § 704(b), would generally not be in play. The allocations are generally simple and easy to understand.

4. **Section 705 - Basis Adjustment**

A partner’s outside basis is adjusted (i.e., increased and decreased) by a number of transactions. Generally, with respect to the day-to-day activities, the partner’s outside basis is from his or her distributable share of taxable and non-taxable income and expenses of the partnership. IRC § 705(a); Reg. § 1.705-1. The basis is also affected by contributions (whether actual or deemed) and distributions (whether actual or deemed).

a) **Basis Increases**

In general, the partner’s initial outside basis is increased by the sum of such partner’s distributive share of taxable income, tax exempt interest, and excess of the deduction for depletion over basis of property subject to the depletion. IRC § 705(a); Reg. § 1.705-1(a)(2)(i) – (iii).

b) **Basis Decreases**

In general, the partner’s initial outside basis is decreased by the sum of such partner’s distributive share of taxable loss (including capital losses), partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures. IRC § 705(a)(2); Reg. § 1.705-1(a)(3)(i & (ii). There are other reductions related to depletion and disposition of oil and gas interests. IRC § 705(a)(2); Reg. § 1.705-1(a)(4) & (5).

c) **Don’t Forget Other Transactions Affect Basis Too!**

Recall, the partner’s outside basis is also adjusted for non-day-to-day activities, such as subsequent contributions to and distributions from the partnership. IRC § 705(a)(1) and (2). We discuss distributions below in the next subsection.

D. **Inside Basis**

The inside basis of contributed assets take a transferred basis and are adjusted for any gains recognized on the contribution. IRC § 723; Reg. § 1.723-1. The holding period for such assets is determined under the rules of IRC § 1223(2).

1. **General Rule**

   The general rule is that the inside basis is generally adjusted for sales and other disposition under the normal basis rules.

2. **Exception –754 Election**

   However, if an election is made under IRC § 754 (“754 Election”) (discussed at XVIII.J below), then such inside basis may be adjusted when there is a shift in the partner’s ownership of the partnership (e.g., partner’s sales of the partnership interest and termination of an interest due to death).

E. **Basis for Distributions**

Partnership distributions fall into two general categories: (1) cash distributions (which includes relief of a partner’s share of liabilities); and (2) property (other than cash) distributions.
Distributions are further characterized as liquidating or current distributions. Liquidating distributions are those distributions that liquidate or terminate a partner’s entire interest (whether in one or a series of distributions). IRC § 761, Reg. § 1.761-1(d). Current distributions are defined to be distributions that are not liquidating distributions.

When distributions are made, the distributed property’s basis in the partner’s hands must be determined. Additionally, if the distribution is a current distribution, it will affect the outside basis of the partnership (and possibly the inside basis), and if the distribution is a liquidating distribution, the basis before distribution determines the amount of gain or loss on liquidation.

1. Current Distributions

   a) Non-Recognition Transactions

      (1) Generally

      Current distribution of cash, marketable securities, or other property will generally not trigger gain to the partner. IRC § 731(a)(1).

      A partner will never recognize a loss from a current distribution. IRC § 731(a)(2). However, a partner can recognize a loss from a liquidating distribution, as discussed in section XVIII.E.2 below.

      (2) Outside Basis

      If no gain is recognized, the partner’s outside basis is reduced by the amount of money and the adjusted basis of the property distributed from the partnership. IRC § 733.

      For consistency purposes, that reduction of basis is transferred to the money and other property.

      The term “money” is defined to include marketable securities. IRC §§ 731(c) and 737(e).

      (a) Basis for Cash

      Regardless of whether gain or loss is recognized, the outside basis for cash is always its face value.

      (b) Basis for Property Other Than Cash

      If no gain or loss is recognized on the distribution, the basis of the property received in the partner’s hands is the pre-distribution basis of such property (i.e., a transferred basis) (reduced any cash that may have been received in the same transaction). IRC § 732(a)(1); Reg. § 1.732-1(a). To the extent that a 754 Election is in effect, any basis adjustments from such election would be reflected in the partner’s hands.

      (c) Holding Period

      (i) General Rule

      In general, the holding period of property other than cash will be a tacked holding period of the partnership’s distributed asset. IRC §§ 735(b); 1223(2), and Reg. § 1.735-1(b).
It should be noted that the basis in the assets is derived from the partner’s partnership interest (i.e., the outside basis is derived from the basis of the asset received), but the holding period is not the holding period of the partnership interest, rather it is the distributed asset’s holding period.

(ii) Exception

IRC § 735(b) only applies in cases where there has been a distribution of property to the partner. If the property was deemed to have been sold to or exchanged with (and not distributed) the partner, then tacking under IRC § 735(b) is not permitted, rather the holding period would start on the date of the deemed sale or exchange. See, McCauslen v. Comm’r, 45 T.C. 588 (1966).

Example XVIII-5

Janet has an outside basis of $100,000 in JL,LP on January 1, 2015. On that day, JL,LP distributes cash of $5,000 and a parcel of land to Janet where the fair market value of such land was $15,000 and its inside basis was $5,000 and acquisition date of December 1, 2001. Janet’s outside basis will be $90,000 (i.e., $100,000 minus $5,000 (cash) and $5,000 (inside basis of land)). Janet’s basis in the cash will be $5,000 (its face value) and the adjusted basis in the land will be $5,000, and its holding period begins December 1, 2001.

(3) Impact to the Partnership

(a) Gain/Loss

Generally, for current distributions, the partnership does not recognize gain or loss on a distribution of property, including money. IRC § 731(b).

(b) Basis

(i) General Rule

If no gain or loss is recognized, then generally the basis is not affected as a result of the distribution. IRC §§ 734(a) and 743(a).

(ii) Exception – IRC § 734(b)

A partnership’s inside basis may be adjusted as a result of an existing 754 Election or if there was a “substantial basis reduction” with respect to that distribution. IRC § 734(b).

A discussion of the intricacies of this rule is beyond the scope of this paper. See, W.S. McKee, W.F. Nelson & R.L. Whitmire, Federal Taxation of Partnership and Partners, ch. 25 (Thomson Reuters/Tax & Accounting, 4th Ed. 2007 & Supp. through 2018-1).

Example XVII-6
Assume the same facts of Example XVII-5, with regard to the partnership, no gain was recognized on its transfer of the cash (of $5,000) or the property (with a fair market value of $15,000 and inside basis of $5,000) to Janet.

When Janet later sells the property, assuming the same fair market value and adjusted basis, the gain will be recognized. The gain is simply deferred by the distribution from the partnership to the partners. This is consistent with the aggregate theory.

b) Exceptions to Gain Recognition

Generally, there are three exceptions to the non-gain-recognition rule for current distributions:

● First, if the distribution consists of “money” where the fair market value of such money in excess of the distributee-partner’s outside basis, then gain will be recognized. IRC § 731(a). Note: The term “money” means both cash and marketable securities. IRC § 731(c) and § 737(e).

● Second, if the partnership distributes property to a partner who contributed property within 7 years of the distribution, gain may be recognized under IRC § 737.

● Third, if there is a distribution to the partner and IRC § 751(b) is triggered, then gain may be recognized. IRC §§ 741 and 751.

If gain is recognized, then such gain is treated as gain from the sale or exchange of the partner’s interest. If IRC § 741 applies to that gain, it receives capital gain treatment, and if § 751 applies to that gain, it receives ordinary income treatment.


c) Effect on Basis

(1) Inside Basis

In general, if gain has been recognized on the distribution of an asset, the inside basis of the remaining assets are generally not affected.

(2) Outside Basis

In general, the outside basis is reduced (but not below zero) by the amount of money and basis of the distributed property (other than money) in the distributee-partner’s hands. IRC § 733.

The term “money” is defined to include marketable securities. IRC §§ 731(c) and 737(e).

(3) Basis of Property Received by Distributee-Partner

The basis of the property (other than money) received by the distributee-partner shall be the inside basis immediately before the distribution. IRC § 732(a)(1); Reg. § 1.732-1(b). Provided, however, that if the inside basis of such property
exceeds the outside basis, the basis of the distributed property in the hands of the partner would be the partner’s outside basis. IRC § 732(a)(2); Reg. § 1.732-1(a).

When both money (defined as cash and marketable securities) and non-money assets are received, the money first uses up the distributee-partner’s outside basis. Thereafter, the basis of the distributed asset in the hands of the partner will be the lesser of the outside basis (after adjustment for the money received) or the inside basis (immediately before the distribution). IRC §§ 732(a)(1) and (2); Reg. § 1.732-1(a)

Example XVIII-7

X is a partner with an outside basis of $20,000, receives in a current distribution in non-money property having an adjusted basis of $12,000 to the partnership immediately before distribution, and $3,000 cash. The basis of the non-money property in X’s hands will be $12,000. Under IRC §§ 733 and 705, X’s outside basis will be reduced by the distribution to $5,000 ($20,000 less $3,000 cash, less $12,000, the basis of the distributed non-money property to X).

Example XVIII-8

Y is a partner with an outside basis of $20,000. Y receives a current distribution of $12,000 cash and non-money property with an inside basis of $16,000. The basis of the distributed non-money property to Y is limited to $8,000 (i.e., $10,000, Y’s outside basis, reduced by $12,000, the cash distributed).

(4) Holding Period of Property Received by Distributee-Partner

In general, the holding period rule is the same for current as it is for liquidating distributions. That is, the holding period of the property in the partner’s hands (other than money) will be a tacked holding period of the partnership’s distributed asset. IRC §§ 735(b); 1223(2), and Reg. § 1.735-1(b).

Note that the basis in the assets is derived from the partner’s partnership interest (i.e., the outside basis become the basis of the asset received), but the holding period is not the holding period of the partnership interest, rather it is the distributed asset’s holding period.

2. Liquidating Distributions

a) Generally

Liquidating distributions are one or more distributions that terminate a partner’s entire interest in a partnership. IRC § 761; Reg. § 1.761-1(d). A partner’s interest is not liquidated until the final distribution is received. Reg. § 1.761-1(d).

(1) No Gain/No Loss

In general liquidation of a partner’s interest is a non-recognition event to both the partner and the partnership. However, it is possible to trigger gain or loss, as described in section XVIII.E.2.a)(2) below.
(a) Basis

(i) Outside Basis

The outside basis will disappear as a result of the liquidating distributions to the liquidating partner.

(ii) Basis of Assets Received by the Liquidating Partner

If no gain or loss is recognized on the liquidation, the basis of the property (other than money) received by the liquidating partner in liquidation of such partner’s interest shall be an amount equal to such partner’s outside basis (reduced by any money received in the same transaction). IRC § 732(b); Reg. § 1.732-1(b).

Thus, when both money (defined as cash and marketable securities) and non-money assets are received in liquidation, the money first uses up the liquidating partner’s outside basis, and any remaining outside basis is allocated to the non-money assets.

(iii) Inside Basis

The inside basis of any assets remaining will generally stay the same as a result of the liquidation of the liquidating partner’s distribution.

Example XVIII-9

Z is a partner with an outside basis of $20,000 before his interest will be fully liquidated. Upon liquidation, Z receives cash of $8,000, and raw land with an inside basis of $10,000 (immediately before the liquidating distribution) and a fair market value of $21,000. Z’s basis in the raw land after the liquidation is $12,000 (i.e., Z’s outside basis of $20,000, reduced by $8,000, the cash distributed).

(2) Exceptions to No Gain/No Loss Rule

As with current distributions, liquidating distributions have exceptions to the current rules.

Gain can be recognized when the money distributed exceeds the outside basis immediately before distribution. IRC §§ 731(a)(1), (a)(2) and (c).

Additionally, loss may be recognized to the extent that the outside basis before the liquidating distribution is less than the sum of: (a) cash, (b) the fair market value of marketable securities distributed; and (c) the pre-distribution adjusted basis of any “unrealized receivables” (defined in IRC § 751(c) and “inventory” (defined in IRC § 751(d)). IRC §§ 731(a)(1), (a)(2), and (c).

F. When is Basis Determination Important?
Determining a partner’s basis is typically an annual event. This is especially true when there are losses from the partnership, because such losses are generally limited to the extent of basis under IRC § 704(d). Additionally, annual determination is important in years where there is a partnership’s liquidation or disposition of a partner’s interest (to determine gain or loss under IRC § 732(b)), and when distributions (non-liquidating) are made from the partnership (to determine if gain or loss may be recognized under IRC §§ 732(a)(2) and 731(a)(1)).

G. A Few Words on the Term “Negative Basis”

There is no such thing as “negative basis.” Quite often the term is confused with the term “negative capital account.” The tax laws allow the basis to go to zero, but not below. For an interesting discussion on the implications of “negative basis” (or as the author sometimes calls it “subzero basis”) and the overriding considerations for tax laws not to incorporate “negative basis.” See, Cooper, Negative Basis, 75 Harv. L. Rev. 1352 (1961-1962), see also, Wilhelm v. Comm’r, 46 TC Memo (CCH) 176 (1983) (where the Tax Court rejected the IRS’ argument based on negative basis in a depreciated automobile and cited to Hall v. Comm’r, 595 F2d. 1059 (5th DCA 1979), where the IRS position that an asset can have no negative basis, to which the 5th DCA agreed).

H. Basis for Shifting Interests

The typical planning structure with LPs is to have the senior generation create the LP. Thereafter, typical planning strategies include:

- Making inter vivos gifts of the LP interests to the junior generation (whether in trust or otherwise);
- Selling LP interests to irrevocable grantor trusts; and
- Keeping the interests until death and having the interests pass to the children.

Typically, the strategies rely on discounting of the LP interests to achieve minimization of the impact of estate and gift (and sometimes GST) taxes.

We address how basis is impacted by inter vivos and testamentary transfers, below.

1. Inter Vivos Transfers

   a) Transfers to Irrevocable Grantor Trusts

      Generally, transfers to irrevocable grantor trusts occur during the donor’s life. When these transfers are made, under the theory of Rev. Rul. 85-13, 1985-1 C.B. 184, there is no transfer for federal income tax purposes, accordingly, there is no gain and no loss, and basis and holding period for the partner and the partnership are unaffected.

      See discussion titled, Basis and Grantor Trusts – Lots of Questions Not so Many Answers (section XX, below), for a fuller discussion about basis issues and grantor trusts.

   b) Transfers to Non-Grantor Trusts

      When the partner makes a lifetime or testamentary transfer to a person, other than to such partner’s grantor trust (i.e., to a non-grantor trust), outside and inside basis may be affected.

      (1) Outside Basis
A donee-partner’s outside basis is generally the donor’s outside basis adjusted by any gift tax paid. IRC § 1015(a). See the discussion in section III above regarding gifts of property. The rules enumerated therein apply equally here.

(a) **Suspended 704(c)(1)(C) Basis Adjustments Lost**

If the contributing partner originally contributed property with a basis in excess of its fair market value on the date of contribution (“loss property”) an IRC § 704(c)(1)(C) basis adjustment (for pre-contribution loss) is created. If the donor-partner then makes a gift of his/her partnership interest, the basis adjustment related to that portion of the gifted partnership interest is eliminated. Prop. Reg. §§ 1.704-3(f)(3)(iii)(B)(2); 1.704-3(f)(3)(iii)(C), Ex. 5. In other words, the donee-partner does not succeed in the donor-partner’s Section 704(c)(1)(C) allocation; the basis adjustment is lost.

(b) **Suspended Losses – Lost?**

Unlike the provision that the IRC § 704(c)(1)(C) (pre-contribution loss) is eliminated, neither the statute or the regulations give guidance on what happens to suspended losses if the partnership interest is given away. It is unclear in the context of a gift, whether the suspended loss (which is in effect an adjustment to basis), is conveyed to the donee-partner, or whether it is lost. The better reasoning is that it is not lost, however, there is no statutory or regulatory guidance (to date).

(2) **Inside Basis**

By definition, inside basis only changes upon the sale, exchange of death of the partner. Thus, inside basis is generally not affected by gifts.

However, if the gift it to a charity and basis is determined by reason of assumption of the partnership’s liabilities, and the gift is considered a part-sale/part-gift, then it is possible for the basis to be adjusted as a result of the “sale part” of the transaction. See discussion in section XVII.C relating to the possibility of a part-gift/part sale when a gift of a partnership is made to charity.

2. **Testamentary Transfers**

a) **Outside Basis**

The outside basis of property acquired from a deceased partner is the sum of the fair market value of the decedent’s partnership interest at date of death or the alternate valuation date and the share of the inheriting partner’s partnership liabilities, less the inheriting partner’s share of the partnership’s income in respect of a decedent (IRD). This can be viewed mathematically by the following formula:

\[
\text{Inheriting Partner's new outside basis} = \text{Fair market value of the partnership interest at date of death or alternate valuation date} + \text{Partner's share of partnership liabilities assumed} - \text{Share of partnership’s IRD}
\]
b) Inside Basis

(1) Generally

In general, the inside basis is not adjusted as a result of a transfer of a partnership interest. IRC § 743(a).

(2) Exceptions

When a partner dies, then the inside basis may be adjusted if the partnership elects or had already made a 754 Election, and must be adjusted when there is substantial built-in loss. IRC § 743(a). A substantial built-in loss happens when at the time of death, the inside basis exceeds the partnership’s fair market value by more than $250,000. IRC § 743(d)(1). Certain investment partnership are entitled to elect out of the mandatory substantial built-in loss rule. IRC § 743(e).

If a 754 Election is in effect, then upon the decedent-partner’s death, the inside basis of assets is adjusted as to that particular deceased partner.

We discuss the 754 Election in section XVIII.J below.

I. Special Rules with Inter Vivos and Testamentary Transfers that Affect Basis and Holding Period

1. Gift to Charity

When a partnership interest is given to charity, if the partnership’s liabilities are included in the outside basis, the gift may be treated as a part-gift/part-sale transaction. For the treatment of basis with respect to part-gift/part-sale transactions, see section III.F above.

2. Allocation of Income to Donee Partner’s Interest

When a partnership interest is gifted on a date other than the first or last day of the year, then the partner’s distributive share of income, gains, loss, deduction, or credit shall be determined based on the varying interests of the donor and donee partners. IRC § 706(d)(2)(A).

3. Holding Period

a) Inside Basis Assets

(1) Generally

In general, the inside basis is not affected by transfers of partnership interests, whether by lifetime gift or testamentary transfer. IRC § 735(a).

(2) 754 Election Exception

If a 754 Election is in effect, inside basis will be affected in the case of a testamentary transfer, as discussed in section XVIII.J below, and may be affected by inter vivos gifts, if the gifts are recharacterized as a part-gift/part-sale as a result of relief of partnership debt, as discussed in section XVIII.I.1 above.

b) Outside Basis

(1) Inter Vivos Gifts
In the case of *inter vivos* gifts, the donee-partner’s outside basis is determined “in whole or in part” under IRC § 1015(a) (and perhaps IRC § 1015(d) for gift tax paid) by reference to the donor-partner’s outside basis. If this is the case, then donee-partner’s holding period is tacked. IRC § 1223(2).

(2) Testamentary Transfers

In the case of testamentary transfers, the inheriting-partner will have a holding period that starts on the decedent-partner’s date of death, but if the partnership interest is sold, the property will be deemed to have been held for more than one year. IRC § 1223(9).

J. The 754 Election

1. Rationale Behind the Election

The rules for determining a partner’s outside basis are separate from the rules that determine a partner’s inside basis. At the inception of a partnership, generally the aggregate of the partner’s outside bases is equal to the partnership’s inside bases for its assets. During the operation of the partnership, however, with changes in ownership, increases in partnership borrowings, and distributions, often times there is a divergence between inside and outside bases, which may cause potential timing differences in the recognition of income (which could unfairly affect some of the partners).

Specifically, when a sale, exchange or death of a partner occurs, a disparity generally arises between the inside and outside bases. This disparity occurs because the general rule of IRC § 743(a) mandates that the inside basis is not to be adjusted on the happening of those events. However, IRC §§ 743(a) and (b) provide that adjustments may be made to the inside basis of assets if a 754 Election is in effect.

Thus, the 754 Election is designed to mitigate some of those timing differences and disparities.

2. Mechanics of the Election

The partnership makes the 754 Election; the partners do not make the election. There is no required form; a written statement, signed by any partner that includes the partnership’s name and address and a statement saying that the election is being made to adjust the basis under IRC §§ 734(b) and 743(a) is all that is necessary.

The statement must be attached to a timely-filed return for the year in which the partnership made a distribution or there is a change in the partner’s interests in the partnership. IRC 754; Reg. §§ 1.754-1(a) and (b). If the statement is not timely filed, discretionary relief may be obtained under Reg. § 301.9100-2. Reg. § 1.754-1(b).

The election may be revoked by application by the partnership at the discretion of the Secretary. IRC § 754; Reg. § 1.754-1(c).

3. 754 Election is a Basis Adjustment

a) Only Applies to a Transferee Partner

The 754 Election affects only the transferee partner. When an adjustment under Section 743(b), is made it is made with respect to that partner.

Logistically, the 754 Election does not change the inside basis of the partnership assets. Rather, a separate “special basis” account is set up to keep track of all of the assets with respect to that particular partner. Every time there is an event that affects the basis of assets
respect to that particular partner, the separate special account is adjusted, and it is also reflected in the pass-through income, gain, expense, loss, etc., to such partner.

The adjustments that arise under the election only affect taxable income (and basis), they do not affect the partner’s capital accounts. Thus the 754 Election is not a book entry that affects capital.

b) Either Up or Down or Up and Down

The 754 Election is commonly referred to as the “754 basis step-up”, like the basis adjustment at death of an individual under IRC § 1014. But, like the general basis provision under Section 1014, the 754 Election “adjusts” inside basis; thus, it can have a net “increase” or “decrease” with respect to the particular transferee-partner.

If there is only one asset in the partnership (which would be highly unusual), then the net increase or decrease would apply to that asset. However, if there is more than one asset in a partnership (which is typically the case), then the net increase or decrease is directed to be allocated between two groups of assets. IRC § 755; Reg. § 1.755-1. The allocation is a five (5) step process.

● Step 1: Determine the total IRC § 754 adjustment (the “754 Adjustment”). This is generally the transferee-partner’s share of the aggregate difference between the fair market value and adjusted basis of each of the partnership’s assets.

● Step 2: Divide all assets into two classes: (1) capital assets and IRC § 1231(b) type assets (Class 1) – these assets generally trigger capital gain or loss on sale or disposition; and (2) all other property (Class 2) – these assets will generally trigger ordinary income property on sale or disposition.

● Step 3: Determine the 754 Adjustment for only the Class 1 assets (i.e., capital and § 1231(b) assets).

● Step 4: Determine the 754 Adjustment for the Class 2 assets (i.e., the assets other than Class 1 assets, or generally the ordinary income assets). To determine this amount, simply take the difference between the 754 Adjustment for all of the assets and subtract the Class 1 754 Adjustment. This difference may be positive or negative.

● Step 5: Allocate the Class 1 754 Adjustment among the Class 1 assets; and Allocate the Class 2 754 Adjustment among the Class 2 assets.

It is entirely possible to have a positive 754 Election for all of the assets and have a positive Class 1 754 Election while having a negative Class 2 754 Election. Thus, the adjustment may be up for one class of assets and down for the other.

Determining the 754 Adjustment lends itself well to a spreadsheet, which will be used every time there is a shift in the interest due to sale, exchange and or death of a partner, and each time an asset is sold and each year that assets have to provide for depreciation, depletion, amortization or some similar expense.

4. Effect on Basis for Lifetime Transfers

A 754 Adjustment only occurs when IRC §§ 743 (sales, exchanges and deaths of partners) and 734 (partnership distributions) are triggered. Thus, during the partner’s lifetime, only sales, exchanges and partnership distributions would trigger an adjustment.
It should be noted even though there may not be an event that triggers an adjustment under IRC §§743 or 734, the separate special basis account is continuously being adjusted because of transactions happening in the partnership. Because the 754 Adjustment may be allocated to assets that are depreciable, by example, each year, inclusive of the normal depreciation, the 754 Adjustment allocable to a parcel of improved real estate would also have to be depreciated, too.

5. **Effect on Basis for Testamentary Transfers**

Upon the death of a partner, if there has been no 754 Election, the partnership has an opportunity to determine whether an election should be warranted. If it is warranted, then the election can be made. See section XVIII.J.2 above regarding the mechanics of making the election.

If a 754 Election is in effect, the partnership determines the 754 Adjustment, and allocates it to the transferee-partners of the decedent-partner.

6. **Practical Pointers About the Election**

Although the 754 Election generally remedies some of the ill effects of inside and outside basis differentials upon the sale, exchange and death of a partner, it requires much effort to determine the 754 Adjustment and to maintain such adjustment on the partnership’s books.

Calculating the adjustment may be time consuming, because it requires the partnership to value each asset in the partnership. And, if there are hard to value assets (e.g., real estate, private equity, etc.) in the partnership then typically, an appraisal would be necessary.

Each time an event happens that triggers a basis adjustment, the 754 Adjustment must be calculated, and depending upon the situation, it may require prior adjustments to be adjusted or even eliminated (e.g., where a partner dies and his or her interest initially created a 754 Adjustment for such now-deceased partner).

If there are multiple partners and/or multiple sales and exchanges, the administrative cost of the 754 Election could be quite costly.

Because of the tremendous amount of data and recordkeeping, quite often clients are reluctant to make the 754 Election, despite the tax benefit it may offer (by rectifying timing differences) over time.

7. **Will Transfers from Estates and Trusts Trigger a 754 Adjustment?**

We assume for this section that a 754 Election is in effect.10

The question posed is whether distributions from estates and trusts will trigger a 754 Adjustment. By its terms, IRC §743, applies to “a transfer of an interest in a partnership by sale or exchange or upon the death of a partner.” Clearly when a partner dies, and his interest goes to his estate, then there will be a 754 Adjustment. But what happens, at the end of the estate administration when assets have to be funded into trusts or distributed outright to beneficiaries, will that distribution trigger another adjustment?

In 1984, IRC §761(e) was added to the Code to provide that:

> “Except as provided in regulations, for purposes of ... section 743 (relating to optional adjustment of basis of partnership property) any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange.”

10 Even if a 754 Election is not in effect, the transfer could be considered a transfer that would allow a 754 Election to be made. Thus, in order not to confuse the issue, we simply assume that a 754 Election is in effect.
There has been no regulatory guidance under IRC § 761 on this particular issue.

Read literally, if an estate or trust makes a distribution of a partnership interest to its beneficiary(ies), such distribution would trigger a 754 Adjustment.

Does this make sense? The purpose of the 754 Election was to ameliorate the tax burden arising from an adjustment to the outside basis resulting of a sale or exchange (i.e., a taxable transaction) or a death (a transaction that triggers basis adjustment because of IRC § 1014), but no correlative adjustment to the inside basis.

The problem with distributions from estates and trusts is that some are taxable events and others are not. That is, some are treated as sales or exchanges for purposes of IRC § 1001, while others are not.

The problem the authors see is that read literally, every time there is an estate or trust distribution, IRC § 761 says that there is an exchange thus a 754 Adjustment, however, it seems to fly in the face of the purpose of IRC § 754.

Let’s explore this some more …

a) Transfers from Estates

When an estate is to make a distribution to its beneficiaries, IRC § 761 provides that such distribution is an “exchange” triggering a 754 Adjustment.

If the distribution is a taxable event, such as the distribution to satisfy a pecuniary bequest, then under Kenan v. Comm’r, 114 F.2d. 217 (1940), there should be a deemed sale, and thus a 754 Adjustment should be warranted. If the distribution is not a taxable event, such as a distribution of the residue to the residuary beneficiaries, then typically gain is not recognized, and a 754 Adjustment should not be warranted.

In Example 3 of Reg. § 1.706-1(c)(3)(vi), H (husband), dies and his partnership interest passes into his estate. When the administration of the estate is completed, the partnership interest is distributed to W (wife). The example concludes that “[s]uch distribution by the estate is not a sale or exchange of H’s partnership interest.” Perhaps the writers of the regulations meant to say, since this was not a taxable transaction, it was not a sale or exchange, but they did not say that, they merely concluded that it was not a “sale or exchange.”

However, what happens if the beneficiaries wish to trigger gain under IRC § 643 (“643 Election”)?

Note: Example 3 was written before IRC § 643 was enacted. Arguably, an IRC § 643 election would change the result. IRC § 643(e)(3)(A)(ii) provides that if the election is made, gain or loss shall be recognized “as if such property had been sold to the distributee at its fair market value.” Thus, using the theory for why the 754 Election was made part of subchapter K, it appears that a 754 Adjustment would be warranted.

b) Transfers from Trusts

Distributions from a trust to its beneficiaries should be treated the same as distributions from estates, as set forth in the section above.

There is an additional scenario which regularly occurs in trusts that does not occur in estates that is worth exploring. This is when a life income beneficiary of a trust dies. The question
raised is, “Should there be a 754 Adjustment?” Again, assume that a 754 Election is in place.

There is no statutory or regulatory guidance on this issue. However, the authors’ analysis looks to the theory of the imposition of the 754 Election in subchapter K for guidance.

Let’s look at three examples to see how one would analyze whether a 754 Adjustment would be warranted.

- **GST Trust Example**: Jordan is the life income beneficiary of a GST Exempt Trust created in Delaware. Upon Jordan’s death, the balance of the trust estate is directed to be distributed into lifetime trusts (with the same provisions as Jordan’s) for his then living descendants, per stirpes. The descendants’ trusts have the same provisions in perpetuity. Jordan has many descendants and those descendants have many descendants, too. There is nothing else that would cause inclusion in any beneficiary’s estate upon a beneficiary’s death.

- **Non-GST Trust with Contingent General Power of Appointment Example**: Jordan is also a life income beneficiary of a Non-GST Exempt Trust with the same provisions as the GST Trust. There is, however, a contingent general power of appointment that allows inclusion in the beneficiary’s estate for Federal estate tax purpose.

- **Non-GST Trust Example**: Jordan is also a life income beneficiary of a Non-GST Exempt Trust with the same provisions as the GST Trust (i.e., there is no contingent general power of appointment).

In the GST Trust Example, notwithstanding the literal language of IRC § 761(e) (i.e., the distribution from the GST Trust for the benefit of Jordan to the trust for the benefit of his descendants, would mandate a 754 Adjustment), it does not appear appropriate to have a 754 Adjustment. The reason is that there will be no triggering of either an estate tax or a GST tax upon Jordan’s death. Thus, there will be no basis adjustment under either IRC §§ 1014 or 2654(a). Therefore, the inside and outside basis will remain the same and there should be no need for the 754 Election. The better analysis in this case is that a 754 Adjustment should not be made.

In the Non-GST Trust with Contingent general power of appointment Example, the trust’s assets to the extent that the trust’s assets (i.e., the partnership interest) will be included in Jordan’s estate and therefore it would receive an outside basis adjustment under IRC § 1014, a 754 Adjustment should be warranted.

In the Non-GST Trust Example even though there is no estate tax inclusion, there will be a taxable termination, thus, under IRC § 2654(a)(2) there will be a date of death adjustment to the asset’s fair market value. Thus, since the outside basis is adjusted, a 754 Adjustment appears to be warranted. See the discussion in section titled “Basis and the GST Tax.”
XIX. PROBLEM BASIS SITUATIONS: BASIS AND PASSIVE ACTIVITY ASSETS – IRC § 469

A. Brief Overview of Passive Activity Loss Rules

The passive activity rules (relating to the limitations on deductions for passive activity losses and passive activity credits (passive activity credits)) were added to the Code, as IRC § 469, as part of the Tax Reform Act of 1986. Pub. L. 99-514, 99th Cong., 2d Sess. (Oct. 22, 1986), 100 Stat 2085. Those passive activity loss/passive activity credit rules, combined with the at-risk rules, under IRC § 465, were designed to limit the perceived ill-effects of individuals participating in “tax shelters.” The term “tax shelter” generally describes investments in passive-type activities used primarily (if not solely) for the purpose of taking losses and credits from those activities to offset other unrelated income.

The passive activity loss and passive activity credit rules were designed to apply primarily to individuals. However, to back-stop individuals from using entities to bypass IRC § 469, the rules were extended to estates, trusts, closely held C corporations and personal service corporations. The limitations do not apply to flow-through entities (i.e., entities taxed as partnerships (under subchapter K) or S corporations (under subchapter K)), because those entities are non-taxpaying entities, rather they are merely conduits (i.e., where their income, gains, deductions, losses, credits, etc., flow through to the owners).

In general, the passive activity loss/passive activity credit rules are applied on an activity-by-activity basis. An example of “activity” could be holding rental real estate.

When activities are held in a pass-through entity (i.e., a partnership or S corporation) such entity must segregate all such activities and report them separately to the owners.

The passive activity loss/passive activity credit limitations apply at the ultimate owner’s level. Generally, an owner’s passive activity losses from all passive activities can be offset from passive activity income from other passive activities, however, if there is a net loss, such net passive activity losses cannot be used against other income, instead those net passive activity losses are suspended. The aggregation, netting and then allocation of the passive activity losses are very complex and beyond the scope of this paper. For details see, B. I. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts, ¶86.1 (Thomson Reuters/Tax & Accounting, 2nd/3rd Ed., 1993 - 2014, 2018 Cum. Supp. N. 1); and Shaviro, 549-2nd T.M., Passive Loss Rules. Additionally, see the same resources for the rules of determining if an activity is a passive activity.

When a particular activity’s losses/credits are limited by IRC § 469, they will generally only be used against future passive activity income, or for a particular activity, any suspended passive activity losses may be used when such activity is sold or exchanged.

When the activity is given away during life or at death, in general part or all of the losses are added to basis and are not able to be used by the subsequent owner, until the activity is sold or otherwise disposed. We discuss this in detail below.

B. Suspended Losses

Passive activity losses and passive activity credits may not be deducted. IRC § 469(a). However, disallowed passive activity losses and passive activity credits for any year may be carried forward (indefinitely, at least until used and/or death). IRC 469(b).

There are four ways in which one can release the suspended losses:

- First, if the passive activities generate income, generally the suspended passive activity losses can be used to the extent of such income.
- Second, if there is an entire disposition (i.e., sale, exchange or abandonment) of the entire interest of the passive activity, the suspended passive activity losses/passive activity credits are able to be used. IRC § 469(g)(1)(A).
• Third, if the activity is given away during life. IRC § 469(j)(6).
• Fourth, if the activity is given away at death. IRC § 469(g)(2).

We discuss the *inter vivos* and testamentary transfers below.

C. Disposition of Passive Activity by Gift

If any interest in a passive activity is transferred by gift, the basis of such interest immediately before the transfer is increased by the amount of any suspended passive activity losses allocable to such interest. IRC § 469(j)(6)(A). Under this rule, the suspended passive activity losses are merely added to basis and the donee is unable to use the suspended losses. IRC § 469(j)(6)(B).

There are four things to note. First, there is no need to dispose of the entire interest in order for the suspended losses to be used. Second, in the year of the gift, the income/loss from the given interest is prorated through the date of the gift, thus, the suspended passive activity loss would be adjusted as of the date of the gift. IRC § 469(j)(4). Third, even though the suspended losses are used, they are only added to basis, and they cannot be used by the donee against the donee’s income, they may only be used to offset gains from future sales. Fourth, after giving effect to IRC § 469(j)(6), if the basis is greater than the fair market value of such property, the rules about “gifts of depreciated property” under IRC § 1015(a) would apply, so that the basis (after adjustment) would be limited to the fair market value on the date of gift. See discussion of gifts of depreciated property in section III.E above.

If the transferred asset becomes a passive activity in the donee’s hands, then from the date of gift forward the passive activity loss rules will apply to that transferred interest.

D. Disposition of Passive Activity by Death

1. Generally

When the owner of a passive activity dies, his or her death is treated similarly to a sale or exchange of his / her entire interest in the activity, where suspended passive activity losses can offset income. In death, however, some of the suspended passive activity losses may be non-deductible.

2. Three Step Process

There is a three-step process to determine the amount of the allowable passive activity loss:

First, determine the amount of the passive activity loss attributable to the decedent’s interest through the date of death. IRC § 469(b) and (j)(4).

Second, determine if (1) the estate’s date-of-death adjusted basis (i.e., the IRC § 1014 basis in the hands of the estate / beneficiary, which is generally the fair market value at date of death or alternate valuation date) is greater or less than (2) the decedent’s adjusted basis immediately before death. IRC § 469(g)(2)(A). If the estate’s adjusted basis is less than or equal to the decedent’s adjusted basis, then the passive activity loss is fully deductible. If the estate’s basis is greater than the decedent’s basis, determine this excess and continue to the third step. IRC § 469(g)(2)(B).

Third, the passive activity loss is deductible to the extent it is greater than the excess (determined in the second step). The rationale for this rule is to prevent passive activity losses from exceeding true economic loss. Death eliminates any built-in-gains because of the basis adjustment under IRC § 1014. By disallowing passive activity losses equal to built-in gains, one prevents losses from exceeding the economic loss.
The deductible passive activity loss is used as follows: first, offset income from the particular passive activity; second, offset income of other passive activities; and finally, offset non-passive activity income. IRC § 469(g)(1).

**Example XIX-1 – Fully Utilized Passive Activity Losses**

X dies on July 1, 2014, with a passive activity that he leaves to B. X’s suspended passive activity loss with respect to passive activity was $235,000 immediately before his death. X’s basis immediately before death was $250,000. B’s IRC § 1014 basis is $100,000 (i.e., passive activity’s date of death adjusted basis).

The results will be as follows:

First, X’s passive activity loss attributable to passive activity was $235,000.

Second, there is no excess. X’s adjusted pre-death basis (of $250,000) is less than the B’s date-of-death adjusted basis (or $100,000).

Third, the deductible passive activity loss is $235,000 to be used to offset X’s income on his final income tax return.

In this case, there is no built-in gain (i.e., the value of the property is less than the adjusted basis in the hands of the decedent immediately before death); thus, the passive activity loss could be fully utilized to offset the decedent’s income.

**Example XIX-2 – Partially Utilized Passive Activity Losses**

Assume the same facts as Example XIX-1, except B’s IRC § 1014 basis is $350,000. The results will be as follows:

First, X’s passive activity loss attributable to passive activity was $235,000.

Second, the excess is $100,000 (i.e., B’s basis of $350,000 minus X’s basis of $250,000).

Third, the deductible passive activity loss is $135,000 (i.e., the passive activity loss is deductible to the extent of the excess).

**Example XIX-3 – Totally Non-Deductible Passive Activity Losses**

Assume the same facts as Example XIX-1, except B’s IRC § 1014 basis is $510,000. The results will be as follows:

First, X’s passive activity loss attributable to PA was $235,000.

Second, the excess will be $260,000 (i.e., B’s basis of $510,000 less the decedent’s basis of $250,000).

Third, since the excess (of $260,000) is greater than the passive activity loss (of $235,000), there is no deductible passive activity loss.

In this case, there was a built-in-gain at the time of death (i.e., the fair market value at death was greater than the decedent’s basis immediately before death). Thus, since that built in gain was eliminated because of the date of death adjustment (under IRC § 1014), and such built-in-gain exceed the passive activity loss, the passive activity loss will be non-deductible.
E. Passive Activity and IRC § 1022 Election

For decedents dying in 2010, if an IRC § 1022 election was made (which is discussed briefly in section IV.A. above, Rev. Proc. 2011-41, 2011-2 C.B. 1988, addressed the issue of the impact of the election on passive activity assets that passed from a decedent to beneficiaries. Section 4.06 of Rev. Proc. 2011-41 provided that if the election was made, the transfer would be treated as if a gift were made. Thus, the discussion regarding gifts in section XIX.C above would apply.
XX. PROBLEM BASIS SITUATIONS: BASIS AND GRANTOR TRUSTS – LOTS OF QUESTIONS, NOT MANY ANSWERS

A. Sale to an Intentional Grantor Trust

1. Generally

The assets of a grantor trust are deemed to be owned directly by the grantor (or other deemed owner), which makes a determination of the basis of the assets dependent upon what that basis would have been had the grantor, rather than the trustee, owned the asset directly. Treating the grantor as the owner of the underlying assets of the trust is at the heart of determining the adjusted basis of the assets of the trust and of any debt obligations issued by the trust.

2. Background

A full understanding of the background of this principle is essential to determining the basis of the assets held by a grantor trust and the basis of debt instruments issued by the trust.

a) Rothstein


(1) Facts

Alexander Rothstein created an irrevocable trust for his three children, naming his wife Reba as the trustee. He funded the trust with shares in a closely held corporation. Seven years later, Alexander bought some of the shares back from the trust for an installment note bearing an adequate rate of interest but no security. This caused the trust to be a grantor trust under IRC § 675(3). The stock was later transferred back to the corporation as part of a liquidation following several years of business reversals. The amount paid to Alexander for the stock was less than he had paid the trust for the shares.

(a) Interest and Loss Deductions Claimed

Alexander claimed an income tax deduction for the interest he paid on the installment note and for the loss he recognized on the sale of the stock to the corporation. He asserted that he was entitled to a new cost basis when he bought shares of stock from the trusts, and that he was entitled to a deduction for interest paid to the trustee on the promissory note used to purchase the stock. The Commissioner contended that the step-up in basis and the interest deduction should be disallowed because the grantor had, in effect, bought the stock from himself and had paid interest to himself.

(b) Deductions Disallowed

The IRS disallowed both deductions.

(2) District Court

The District Court held for the Commissioner.

(3) Second Circuit Reverses and Holds for Taxpayer

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The Second Circuit disagreed with the IRS. Judge Friendly, writing for the court, stated that the trust was a grantor trust, but disagreed with the IRS regarding disallowance of the interest deductions and the basis of the stock in the hands of Alexander. The court stated that the grantor trust rules require only that the grantor who is treated as the owner of the trust include the trust's "items of income, deduction, and credits" in his or her own computation of taxable income. The rules do not, the court stated, require that the grantor's basis in property bought from the trust be computed under rules different from those applicable to transactions between unrelated parties. Under the majority opinion, therefore, Alexander received a step-up in basis and a capital loss on an exchange of assets with the trust.

(4) Dissent

Judge Oakes dissented from the majority. He agreed that the trust was a grantor trust, but stated that Alexander was entitled to neither an interest deduction nor an increased adjusted basis in the purchased stock. Judge Oakes argued that treating Alexander as the owner of the trust under IRC § 671 meant that there was never a genuine installment sale.

b) Rev. Rul. 85-13


(1) Facts

The IRS posited a grantor who created a nongrantor irrevocable trust, and then bought the corpus of the trust in exchange for the grantor's unsecured, interest-bearing promissory note.

(2) Grantor Trust Status

The ruling agreed with the Second Circuit that the grantor was considered to have borrowed the corpus of the trust and, as a result, owns the trust under IRC § 675(3). The ruling disagreed, however, regarding the effect of grantor trust status.

(3) Result of Trust Ownership

The IRS stated that, because the grantor is treated as the owner of the trust, the grantor is deemed the owner of the trust assets for federal income tax purposes.

(a) Rationale

The IRS stated:

"If it is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of the trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor."

(b) No Gain Realized
In addition, because the grantor is considered to own the purported consideration both before and after the transaction, the exchange of a promissory note for the trust assets is not recognized as a sale for federal income tax purposes.

(c) **No True Debt Created for Income Tax Purposes**

The grantor owns the trust assets and thus cannot have a sale to himself or herself; nor can there be a valid debt obligation running between the grantor and himself or herself.

(4) **IRS Reaffirms This Position**

For several years after intentional grantor trusts became popular, there was concern that the IRS might change its mind and revoke Rev. Rul. 85-13. The IRS has made the principles of Rev. Rul. 85-13 the foundation upon which it has built its approach to all grantor trusts, and it now appears virtually impossible for the IRS to revoke Rev. Rul. 85-13.

(a) **How Deep is the IRS Hole?**


(b) **A Sobering Thought**

As one of the leading practitioners pointed out in an article about installment sales to intentional grantor trusts:

“The fountainhead of modern grantor trust law is Rev. Rul. 85-13. Nevertheless, lest it be thought that the technique addressed in this article is iron-clad, it is good for one’s perspective to be reminded from time to time that the most serious authority in this area is an IRS ruling that defies the holding of a respected U.S. Court of Appeals.”


3. **Initial Basis in Typical Grantor Trust Arrangements**

The IRS has not actually addressed directly the question of the basis either of the assets given or sold by a grantor to a wholly-owned grantor trust, or the basis of any debt instrument issued by the trustee in satisfaction of such a transfer, but a reasonable analysis of Rev. Rul. 85-13 can reveal the correct answer to at least some of these questions.

a) **Assets Given to the Trust**

(1) **Generally – Carryover Basis**
A gift by the grantor to the trustee of a wholly-owned grantor trust is not a gift for income tax purposes, because there is no change in the owner for income tax purposes. The grantor owned the asset before the transfer, and the grantor owns the asset after the transfer. Clearly, therefore, the grantor’s adjusted basis in the asset before the transfer becomes the trustee’s adjusted basis in the asset after the transfer.

(2) Depreciated Property

The grantor, for income tax purposes, continues to own the assets of the grantor trust. The trustee, therefore, does not actually have a carryover basis; rather, the trustee continues to represent the grantor as owner of the property. This can be important if the assets are thereafter sold at a loss, because the loss should still be realized by the grantor. See section III.E above for a discussion of gifts of depreciated property.

b) Basis Adjustment for Gift Tax Paid

It is difficult to determine whether there is a basis adjustment under IRC § 1015(d) for the gift tax paid by the grantor on the net appreciation in the value of a gift to a grantor trust. However, see our under Section XX.B where we conclude based on a mathematical analysis that there should be a basis adjustment.

(1) What the Code and Rulings Suggest

The transaction is not a gift at all for income tax purposes, and basis is strictly an income tax concept. The transfer is, however, a gift for gift tax purposes, and a gift tax may be imposed and paid on the net appreciation.

(2) PLR 9109027 – Basis Increased by Gift Tax

The only ruling on point appears to be PLR 9109027, in which the donor made gifts to two grantor trusts. The trusts would be grantor trusts for 10 years less one day. The IRS expressly considered whether the gift tax on the net appreciation was added to basis, and it concluded that the basis increase was allowed.

The IRS discussed Post v. Comm’r, 26 T.C. 1055 (1956), acq., 1958-1 C.B. 5, in which the Tax court held that the date of the gift to beneficiaries was the date that the grantor transferred the property into the trust under the predecessor of IRC § 1015(a), despite the grantor’s retained powers over and interests in the trust. On the ruling facts, the IRS stated that when the grantor transfers property to a grantor trust, the trust initially takes the grantor’s basis. The ruling is not absolutely clear, but it appears that the basis at that point is not increased by the gift taxes paid. When the trust ceases to be a grantor trust, the basis is increased by the gift tax paid on the net appreciation. The IRS stated:

“In general, under section 1015(a), the basis of the stock transferred by gift in the hands of the donee, here the children, is the basis in the hands of the donor, here Settlor adjusted by any gain or loss resulting from the transfer since the gift occurred after December 31, 1920. However, since the transfer also occurred after December 31, 1976, the basis in the hands of the donee is the basis in the hands of the donor under section 1015(a) of the Code but increased not by the entire amount of gift tax paid to the extent of the fair market value of the stock as required in section 1015(d)(1)(A) of the Code, but instead the

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basis is increased by a percentage of the gift tax paid as it relates to the net appreciation of the property as defined by section 1015(d)(6)(B) of the Code. See, section 1015(d)(6)(A) of the Code.”

c) Debt Assumed or Taken Subject to by the Trustee

Again, there is no real authority on point, but because the trustee and the grantor are deemed to be a single taxpayer for income tax purposes, and neither gain nor loss is realized on a transfer of encumbered property to a wholly-owned grantor trust, there ought to be no basis adjustment for any debt assumed by the trustee or to which the transferred property is received subject. The debt should increase basis if it still exceeds basis when the trust ceases to be a grantor trust during the grantor’s lifetime, because gain is then recognized.

4. Promissory Note Given by the Trustee

The trustee of a wholly-owned grantor trust may buy assets from the grantor in exchange for an installment obligation. The IRS views this obligation as nonexistent, because it is, in effect and for income tax purposes (though not wealth transfer tax purposes), an obligation of the grantor to pay money to himself or herself. Thus, there can be no basis in the promissory note given to the grantor. This could be significant if the grantor sells the note to a third-party, because the entire amount paid by the transferee would appear to be taxable as a gain. See discussion on basis of promissory notes contributed by a partner to a partnership and a shareholder to a C corporation in section XVIII.B.1.d) above.

5. Effect on Basis of Termination of Grantor Trust Status During Grantor’s Lifetime

a) Generally

The mere termination of grantor trust status does not, in itself, constitute a taxable event for income tax purposes. See discussion in CCA 200937028. Termination of grantor trust status during the grantor’s lifetime, however, can result in the recognition of gain and, logically, the increase in the basis of assets held by the now-nongrantor trust. See, Rev. Rul, 77-402, 1977-2 C.B. 222 (discussed below).

b) Encumbered Assets

The termination of grantor trust status during the grantor’s lifetime is a constructive transfer of the property from one taxpayer to another, and if the property is subject to debt in excess of its basis, gain may be realized. This has been addressed in a key ruling, regulation, and case, and there appears to be little doubt about the validity of these consistent precedents.

(1) Rev. Rul. 77-402

In Rev. Rul. 77-402, G established a grantor trust funded with a contribution of money that the trustees used to acquire a limited partnership interest in a real estate investment partnership. During the first few years of the trust, the partnership generated losses and G, as owner of the entire trust, deducted the distributive share of partnership losses attributable to the partnership interest held by the trust. When the basis of the partnership interest had been significantly reduced, G renounced the powers that caused the grantor to be treated as the owner of the trust.

(a) Analysis

The IRS ruled that G recognized gain upon the renunciation of powers to the extent that the share of partnership liabilities attributable to the
partnership interest exceeded the adjusted basis of that interest. The ruling explains that during the period that G was treated as the owner of the trust, G was considered to be the owner of all the trust property for federal income tax purposes, including the partnership interest. Consequently, when G renounced the grantor trust powers, G was considered to have transferred the partnership interest to the trust.

(b) GCM

See also GCM 37228, discussing in greater detail the reasoning behind this ruling.

(2) Reg. § 1.1001-2(c)

(a) Generally

Example 5 of Reg. § 1.1001-2(c) closely parallels the facts and holding of Rev. Rul. 77-402.

(b) Facts

In that Example, C, an individual, creates an irrevocable wholly-owned grantor trust. The trustee bought an interest in a partnership. C deducted the distributive share of partnership losses attributable to the partnership interest held by the trust. In 1978, when the adjusted basis of the partnership interest held by the trust was $1,200, C renounced the grantor trust powers. The trust then ceased to be a grantor trust and C ceased to be the owner of the trust. At the time of the renunciation all of the partnership’s liabilities are nonrecourse liabilities on which none of the partners have assumed any personal liability. The trust’s proportionate share of the partnership liabilities was $11,000.

(c) Conclusion

The regulations explain that, since prior to the renunciation of the grantor trust powers, C was the owner of the entire trust, C was considered the owner of all the trust property (including the partnership interest) for Federal income tax purposes. C, and not the trust, was considered to be the partner in the partnership during the time the trust was a "grantor trust," because C was considered to be the owner of the partnership interest. When C renounced the grantor trust powers, the trust no longer qualified as a grantor trust, with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C was considered to have transferred ownership of the partnership interest to the trust, which was now a separate taxable entity, independent of C. On the transfer, C’s share of partnership liabilities ($11,000) was treated as money received; C’s amount realized was $11,000; C’s gain realized was $9,800 ($11,000 - $1,200).

(3) Madorin

The Tax Court followed Reg. § 1.1001-2(c), Ex. 5 in Madorin v. Comm’r, 84 T.C. 667 (1985).
(a) **Facts**

Bernard Madorin was the grantor of four trusts. The trustee of each of the four trusts had the power to sprinkle income and principal among a class of beneficiaries, and the power to add charitable beneficiaries. The four trusts were, therefore, grantor trusts pursuant to IRC § 674(a). The trusts bought limited partnership interests in Metro Investment Co., a limited partnership, which in turn purchased a partnership interest in Saintly Associates. Bernard recognized on his joint income tax return the losses generated by Saintly Associates. When Saintly Associates began generating income, the trustee renounced his power to add beneficiaries and the trusts ceased to be grantor trusts. The grantor argued that he should be treated as the owner of the trust only to attribute to him items of income, deductions, and credits – the Rothstein position.

(b) **IRS Position**

The IRS disagreed with the taxpayer and assessed a deficiency. The IRS based its position on Reg. § 1.1001-2(c), Ex. 5, contending that the grantor was the owner of the partnership interests and when the trusts ceased to be grantor trusts there was a disposition of the trusts’ assets (the partnership interests) on which gain would be recognized to the extent that the underlying debt from which the trust was released exceeded the taxpayer’s basis in the partnership interests.

(c) **Tax Court Holds for IRS**

The Tax Court rejected the Rothstein rationale and upheld the validity of the regulations. The court stated that defining the “owner *** of a trust” under IRC § 671 as the owner of the trust’s assets was consistent with the usual, ordinary and everyday meaning of the word “owner.” 84 T.C. at 671.

(i) **Code Requires Deemed Ownership of Assets.**

The taxpayer argued that the legislative history of the 1954 codification showed that the grantor trust rules were designed only to cause the grantor to include in income the trust’s items of income, deduction, credit, gain and loss. The Tax Court found no such requirement in the legislative history and noted that the grantor trust rules treat the grantor as if he or she were the owner in cases where the grantor has reserved some of the powers normally attendant to outright ownership. 84 T.C. at 674-675.

(ii) **Code Also Requires Recognition of Gain**

The taxpayer argued that the plain language of IRC § 671 limited the attributes of ownership to the imputation of income, deductions, and credits only, but the Tax Court agreed with the IRS that this list was not necessarily exclusive. 84 T.C. at 672. The court stated that the combination of IRC § 671 and the partnership provisions of subchapter K, along with the recognition of gain or loss provisions of IRC § 1001, required the recognition of gain upon the sale or disposition of a partnership interest where the amount realized exceeds the adjusted basis of the partnership interest, and that the basis of a partnership interest
includes the partner’s share of partnership liabilities. The partner’s share of the liabilities is also included in the amount realized if the assets are transferred. *Crane v. Comm’r*, 331 U.S. 1 (1947).

(d) **Effects on Basis**

Logically, the grantor realizes gain equal to the excess of the indebtedness to which the property is subject over the carryover adjusted basis, so the trustee should increase its basis in the encumbered assets by the amount of the realized gain. In effect, the termination of the grantor trust status has caused the debt to become a *bona fide* indebtedness between two different taxpayers, and basis in the trustee’s assets should be increased to reflect this change.

6. **Effect on Basis of Termination of Grantor Trust Status at Grantor’s Death**

a) **Generally**

There is no case, regulation or ruling that directly addresses the income tax treatment of the termination of grantor trust status at the grantor’s death, but the IRS’s own rulings suggest that the grantor’s death should not be a recognition event for income tax purposes, even when the trust holds encumbered property with a debt in excess of its adjusted basis. Although this conclusion seems correct, there are several practitioners who take a different view.

b) **Why Gain Should Not be Recognized**

(1) **Generally**

The income tax law has long viewed death as not a recognition event.

(a) *Crane*

The Supreme Court held in *Crane v. Comm’r*, supra., that the assumption of a mortgage, or taking property subject to a mortgage, in connection with the acquisition of property to which the mortgage relates, is treated for purposes of determining the basis of such property as though the purchaser had paid cash in the amount of the mortgage. The taxpayer had inherited property that was encumbered by a liability exactly equal to its fair market value, but in excess of the decedent’s basis in the property on the date of death. The court treated the transaction as one in which the basis in the assets was increased under the predecessor to IRC § 1014. Thus, it treated the transaction as a devise, rather than a sale.

(b) *Rev. Rul. 73-183*

In *Rev. Rul. 73-183*, 1973-1 C.B. 364, updating and restating O.D. 219, 1 C.B. 180 (1918), the IRS stated that no loss is recognized on the decedent's final income tax return as a result of the transfer of the stock to the executor of the decedent's estate, even though the stock had an adjusted basis in excess of its fair market value at the date of the decedent's death. The IRS stated that, if the fair market value of the stock at the date of the decedent's death was in excess of the adjusted basis of the stock, no gain is recognized on the decedent's final income tax return as a result of the transfer of such stock to the executor of the decedent's estate.
(c) 1954 Legislative History

The House and Senate committee reports on the re-codification of the tax law in 1954 also stated:

“The mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income even though the property may have appreciated in value since the decedent acquired it.”


(d) Legislative History of 2001 Act

In the Conference Committee negotiations on the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16 § 542(a), 107th Cong., 1st Sess., 115 Stat. 38 (2001), a proposal was made and rejected to impose gain at death in situations where debt exceeded basis. The Conference Committee Report states:

“The bill clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent’s basis in the property.”


(2) No Gain Under Rev. Rul. 85-13

Rev. Rul. 85-13 and Madorin treat the grantor as the owner of the grantor trust’s assets for income tax purposes, as if the trust did not exist. The death of an individual is not itself a recognition event, and testamentary transfers of encumbered assets do not themselves result in recognition of gain, so the grantor’s death should be treated for income tax purposes as if the grantor owned the encumbered assets and disposed of them by traditional testamentary transfer at death. See, Aucutt, Installment Sales to Grantor Trusts, 2 Bus. Entities 28 (April/May 2002); F. L. Boyle & J. G. Blattmachr, Blattmachr on Income Taxation of Estates and Trusts § 4:8.2 (PLI 15th ed.); Blattmachr, Gans & Jacobson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death, 96 J. Tax’n 149 (Sept. 2002); Hatcher, Buffaloed by Bongard? Struggling with Strangi? Tormented by Turner/Thompson? Confused by Kimbell? Reeling from Rosen? Freezing and Bridging the Increasingly Troubled Waters of FLPs, SM093 ALI-ABA 95 (2007); Manning & Hesch, Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements, 24 Tax Mgmt. Estates, Gifts & Tr. J. 3 (1999).

(3) Basis of Installment Obligation

The promissory note should take a basis in the hands of the grantor’s estate equal to its fair market value on the date of death. The grantor is deemed to own the installment obligation on the date of death, even though the note is not actually a
debt obligation under Rev. Rul. 85-13. Therefore, the note should receive a basis adjustment under IRC § 1014(b)(1) and 1014(b)(9).

The only applicable exception to this rule might be if the note is an item of income in respect of a decedent (“IRD”) under IRC § 691, which would not receive a basis adjustment under IRC § 1014(c).

(a) Definition of IRD

IRD is defined as amounts of gross income that were not properly includible in computing the decedent’s taxable income for the taxable year ending with the date of his death (or a previous taxable year), under the decedent’s accounting method. Reg. § 1.691-1(b).

(b) Character of IRD

The fact of an item of IRD and the amount and character of the IRD are all determined as if “the decedent had lived and received such amount.” IRC § 691(a)(3). As the decedent would not have realized any income had he received the note payments during life under Rev. Rul. 85-13, there is arguably no IRD associated with the note. Thus, the note receives a stepped-up basis and the subsequent principal payments on the note are not taxed. See Aucutt, Installment Sales to Grantor Trusts, 2 Bus. Entities 28 (April/May 2002); Manning & Hesch, Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements, 24 Tax Mgmt. Estates, Gifts & Tr. J. 3 (1999).

(4) Basis of Trust Assets

The trust assets are not included in the grantor’s gross estate for estate tax purposes, and thus do not appear to receive a basis adjustment under IRC § 1014(b)(9). In CCA 200937028, an e-mail response, an attorney in the IRS Chief Counsel’s Office stated:

“In this case, the taxpayer transferred assets into a trust and reserved the power to substitute assets. Section 1014(b)(1)-(10) describes the circumstances under which property is treated as having been acquired from the decedent for purposes of the section 1014 step-up basis rule. Since the decedent transferred the property into trust, section 1014(b)(1) does not apply. Sections 1014(b)(2) and (b)(3) apply to transfers in trust, but do not apply here, because the decedent did not reserve the right to revoke or amend the trust. None of the other provisions appear to apply at all in this case.”

Quoting from section 1.1014-1(a) of the Regulations:

“The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent’s death. . . . Property acquired from the decedent includes, principally . . . property required to be included in determining the value of the decedent’s gross estate under any provision of the [Internal Revenue Code].”
Based on a literal reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to IRC § 1014, unless the property is included in the gross estate for federal estate tax purposes as per IRC § 1014(b)(9).

It may be argued, however, that the assets of a grantor trust receive a date-of-death value basis adjustment under IRC § 1014(b)(1), as property “in the hands of a person [the trust] acquiring the property from a decedent or to whom the property passed from a decedent.” This would be the analysis most consistent with Rev. Rul. 85-13 and Madorin, which say that the grantor is deemed to own the trust assets for all income tax purposes, which should include determination of basis. See, Blattmachr, Gans & Jacobson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death, 96 J. Tax’n 149 ‘sept. 2002). Unfortunately, a court may be reluctant to give a basis increase without a concomitant estate or income tax, and a practitioner must ponder whether the basis increase is a position on which the practitioner may reasonably believe there to be a more-than-50% chance of success.

c)  Possible Contrary Views

The IRS may well argue that the same rule that applied to the termination of grantor trust status during the grantor’s lifetime in Reg. § 1.1001-2(c), Ex. 5, Rev. Rul. 77-402, and Madorin, should apply equally to termination of grantor trust status on account of the grantor’s death. Of course, there are no cases, regulations or rulings that directly support (or directly contradict) this point. See, Aucutt, Installment Sales to Grantor Trusts, 2 Bus. Entities 28 (April/May 2002); Cantrell, Gain Is Realized at Death, 149 Tr. & Est. 20 (Feb. 2010); Hodge, On the Death of Dr. Jekyll -- the Disposition of Mr. Hyde: the Proper Treatment of an Intentionally Defective Grantor Trust at the Grantor's Death, 29 Est., Gifts & Tr. J. 275 (Nov. 11, 2004).

(1)  IRS Precedents Are Not on Point

The IRS will likely rely on Reg. § 1.1001-2(c), Ex. 5, Rev. Rul. 77-402, and Madorin for the proposition that the termination of the grantor trust status of a trust that holds encumbered assets is a recognition event, but all of these precedents involved a lifetime termination of grantor trust status. Lifetime transfers of encumbered assets, even between unrelated individuals, are taxable events, but there is no reason why the same rule must apply to testamentary transfers. See also, CCA 200923024 (“Regulation 1.1001-2(c), Ex. 5, Madorin, and Rev. Rul. 77-402 are silent regarding the income tax consequences to the party who receives trust assets (the ‘transferee’). . . . [T]he rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.”) and Blattmachr & Gans, No Gain at Death, 149 Tr. & Est. 34 (Feb. 2010).

(2)  When Gain Recognized Under IRS Argument

A specific critique of the IRS argument will depend upon when the IRS deems the constructive transfer of the installment obligation to have occurred. There is a significant difference in tax results between an analysis that (a) perceives a transfer to have occurred at the moment before death, and (b) one that perceives it to have occurred at the moment after death.

(a)  Moment-Before Analysis
The IRS seems likely to adopt the analysis that results in gain recognized at the moment before the grantor’s death, because this analysis is closer to that of Rev. Rul. 77-402 and because it results in a more certain recognition of gain.

(i) **Gain Recognized on Grantor’s Final Income Tax Return**

The grantor would recognize the difference between the adjusted basis in the assets on the date of death (before adjustments under IRC § 1014) and the outstanding balance on the note. This gain would be reported on the grantor’s final income tax return, because the deemed disposition of the encumbered assets occurred before the grantor’s death. See also, Reg. § 1.684-2(e), Ex. 2 (the termination of grantor trust status at the death of the U.S. grantor of a foreign trust is treated as if the grantor had transferred the assets to the trust at the moment before death).

(ii) **Decedent’s Basis in the Assets**

The grantor’s adjusted basis in the assets would be their adjusted basis on the moment before death.

(b) **Part Gift/Part Sale?**

The transfer of property deemed to occur would likely be a part-sale/part-gift. It would be a sale to the extent that the remaining balance on the note exceeds the grantor’s adjusted basis in the transferred assets, and a gift to the extent that the value of the property on the date of death exceeds the outstanding balance on the note.

In a noncharitable part-sale/part-gift, the grantor is not required to allocate any portion of the basis to the gift component. Cf. IRC § 1011(b) (in a charitable part-sale/part-gift, basis must be apportioned between the sale and gift components). Therefore, all of the grantor’s adjusted basis would be allocated to the sale portion of the transfer. See discussion in section X.C above (discussing part-gift/part-sale with charities).

(i) **Installment Reporting**

The grantor’s executor should be able either to report any recognized gain under the installment sales rules of IRC § 453 or elect out of installment reporting under IRC § 453(d). The entire gain would not have to be recognized immediately.

(ii) **IRD**

If gain is recognized as if the property were sold at the moment before death in exchange for an installment obligation, and if the personal representative of the decedent’s estate does not elect out of installment reporting, the promissory note should be an item of IRD under IRC § 691(a)(4).

As noted above, IRD means gross income that was not properly includible in the decedent’s taxable income for the taxable year ending with the date of his or her death under the decedent’s accounting method. Reg. § 1.691-1(b).
Rev. Rul. 85-13 states that there would have been no amount includible in gross income had the decedent not died, suggesting that there was no IRD. If sale is deemed to occur immediately before death, however, the application of Rev. Rul. 85-13 would have to be deemed terminated immediately before death, too. This means that the grantor trust would be entitled to an income tax deduction for any federal (but not state) estate taxes attributable to the net appreciation in the note on the date of death. IRC § 691(c).

(iii) Trust’s Basis in Its Assets

Under the moment-before analysis, the trust should take an adjusted basis in the property it bought equal to the amount of the debt on the date of the grantor’s death. IRC § 1012. The trust assets would not be entitled to a basis adjustment under IRC § 1014.

(c) Moment-After Analysis

It seems more logical that, if gain must be recognized, it should be deemed to occur at the moment after death, because the trust remains a grantor trust until the grantor’s death and not until the moment before the grantor’s death.

If the IRS deems a transfer to have occurred on the moment after the date of death, the grantor would not report any gain on the grantor’s final income tax return; the trust would report any gain on its own income tax return. See Hodge, On the Death of Dr. Jekyll -- the Disposition of Mr. Hyde: the Proper Treatment of an Intentionally Defective Grantor Trust at the Grantor’s Death, 29 Est., Gifts & Tr. J. 275 (Nov. 11, 2004).

(i) Frane Analogy

One should consider the relevance, by analogy, of Frane v. Comm’r, 998 F.2d 567 (8th Cir. 1993), aff’d in part, rev’d in part 98 T.C. 341 (1992), in which the decedent sold assets for a self-canceling installment obligation and died while the debt was outstanding.

The Tax Court held that the decedent’s gross estate included no portion of the note, and that gain was recognized by the decedent immediately before death.

The Eighth Circuit affirmed in part and reversed in part, holding that the decedent’s death effected a cancellation of installment obligation under IRC §§ 453B and 691(a)(5), and that gain was recognized immediately after death.

The IRS might cite the appellate opinion in Frane for the proposition that the grantor’s death should cause recognition of gain, but Frane is really inapplicable. The Frane analysis is based on IRC § 453B, which applies only if there is a sale in exchange for an installment obligation. Rev. Rul. 85-13 negates the existence of either a sale or an installment obligation, and no election could be made under IRC § 453 in the absence of a sale.
(ii) **Basis in Assets**

In a moment-after analysis, the decedent is deemed to have owned the underlying assets on the date of death. The property seems clearly to be “property acquired by . . . the decedent's estate from the decedent,” and so it should take a basis increase to its fair market value on the date of death. IRC § 1014(b)(1). IRC § 1014(b)(9) grants a basis adjustment for property that is included in the decedent’s gross estate for Federal estate tax purposes. The fact that IRC § 1014(b)(9) does not apply to assets in an Intentional grantor trust does not preclude the application of IRC § 1014(b)(1).

(iii) **IRD**

The promissory note would be deemed received by the decedent’s estate after the date of death, and thus should not be an item of IRD.

(d) **Does the IRS Really Believe This?**

In CCA 200923024, however, the IRS Chief Counsel suggested that the IRS might not take this position at all.

(i) **Facts**

A married couple (the parents) and their three adult children (the “taxpayers” or the “family”) owned low-basis stock of an S corporation. The corporation filed a Form S-1 with the SEC to register securities in anticipation of an initial public offering. The Form S-1 stated that the family intended to sell all of their shares (except for one of the spouses who intended to sell one-half of his or her shares).

(a) **Formation of Partnership and Trusts**

Each taxpayer transferred his or her shares of stock to a partnership, and also formed an irrevocable nongran- tor trust, funded with $100,000 in cash. Each taxpayer sold his or her partnership interests to his or her trust, in exchange for unsecured private annuity promises to pay a fixed annual sum to the seller for the rest of his or her life.

(b) **Terms of the Trusts**

The terms of each trust directed that the principal and income would be distributed, in the trustee’s discretion, for the benefit of the grantor's then-living issue. The trustee of each trust was one of the parents, together with an independent trustee and an independent corporate trustee, neither of which was related or subordinate to the grantor. The trustees acted by majority vote. The trusts continued until the grantor’s death, upon which time the trustees would distribute the trust funds to the grantor’s then-living issue, outright. None
of the trusts were grantor trusts, in part because no more than one-half of the trustees were related or subordinate to the grantor of the trust. IRC § 674(c).

(c) Sale of Partnership Interests for Private Annuities

The parents and their adult children then sold their partnership interests to their respective trusts in exchange for unsecured private annuities. The partnership then made a 754 Election to increase its inside basis in the stock to be equal to the outside basis taken by the trust. This would be the present value of the private annuity obligation, which represented the fair market value of the stock on the date of the sale.

(d) Partnership Goes Public

The partnership then sold the shares in an initial public offering, receiving an amount approximately equal to the partnership’s inside basis in the stock. The partnership distributed to the trusts amounts sufficient to pay the annuity due that year, but otherwise retained the rest of the cash for reinvestment. The individual taxpayers continued to pay the capital gains tax on the sale of the stock to the trusts on a deferred basis, over their lifetimes, despite the fact that the partnership had received the entire value of the shares in cash.

(e) Toggling Off Grantor Trust Status

Thereafter, the corporate trustee of each trust was removed by the trust adviser (a person who was neither related nor subordinate to the grantor), and replaced with an individual who was related or subordinate to the grantor of the trust, because that person was employed by a corporation in which the stock holdings of the family are significant from the viewpoint of voting control and/or a subordinate employee of a corporation in which the family are executives. This left, as trustee, one independent party and two related or subordinate persons, causing the trusts to become grantor trusts under IRC §§ 674(a) and 674(c).

(ii) Taxpayers’ Argument

The family contended that, as of the date that the trusts converted to grantor trust status, and although the family directly held partnership interests, the family members would report no further annuity income, because, as grantor-owners of the trusts, they were both payors and payees on the annuities. Rev. Rul. 85-13.

(iii) IRS’ Argument

The IRS agent auditing the transaction sought to make the taxpayers recognize the gain on the sale under one of two theories.
(a) **Deemed Disposition**

First, the agent argued that the taxpayers should recognize gain on the conversion of the trust from nongrantor trust to grantor trust, because, the agent argued, ownership of a trust’s assets is deemed to change hands when the trust’s separate tax existence disappears and it becomes a grantor trust. Therefore, the agent argued, the conversion of a nongrantor trust into a grantor trust should result in the recognition of any appreciation in the value of the trust assets, as if they had been transferred in a taxable exchange. The nongrantor trusts, therefore, would have only the modest gain on the initial public offering that they had reported, but the grantor trusts and their family members owners would recognize taxable gain on the deemed exchange when the trusts became grantor trusts.

(b) **Indirect Borrowing**

Alternatively, the agent argued that the sale of the partnership interests to the trusts in exchange for private annuities should be treated as an indirect borrowing of the trust assets, causing the trusts to become grantor trusts on the date of the sale, rather than when the corporate trustee was removed. Thus, the sale of property to the trust would not be a taxable event, no gain would be recognized, and the partnership’s IRC § 754 election would not increase its adjusted basis in the stock it held. Therefore, the partnership, and through it, the grantors, would recognize as gain the excess of the amount realized on the initial public offering over their original low basis in the stock.

(iv) **Chief Counsel’s Response**

The IRS Chief Counsel agreed with the agent that the transactions were abusive but rejected both arguments under which the agent had sought to tax the gain realized in the transactions.

(a) **No Deemed transfer**

First, the IRS stated that the conversion of a nongrantor trust into a grantor trust is not a deemed transfer for income tax purposes and that gain is not recognized on the transaction.

The agent relied on Rev. Rul. 77-402, Madorin, and Reg. § 1.1001-2(c), Ex. 5, but the Chief Counsel stated that these authorities did not support the claim that the conversion of a trust from a nongrantor trust to a grantor trust is a taxable exchange, and that they do not even suggest that the termination of grantor trust status constitutes a taxable transfer of the trust assets. Even assuming that the transaction was abusive, the Chief Counsel added, asserting that the conversion of a
nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations.

The Chief Counsel also stated:

“The authorities cited only discuss the application of § 1001 to the party who is considered to have transferred ownership (the “transferor”) of trust assets. Regulation 1.1001-2(c), Example 5, Madorin, and Rev. Rul. 77-402 are silent regarding the income tax consequences to the party who receives trust assets (the “transferee”), which in these examples was the nongrantor trust. We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.”

(v) Favorable Analysis

This is the most favorable statement that the IRS has ever made officially regarding the effect of the death of the grantor on encumbered assets held by a grantor trust. See Blattmachr & Gans, No Gain at Death, 149 Tr. & Est. 34 (Feb. 2010).

B. Tax Basis Adjustment for Gift Taxes Paid on Gifts to Irrevocable Grantor Trusts


1. Does Section 1015(d)(6) Adjust Basis of a “Gift” to an IGT?
   
   a) Gut Feeling v. Empirical Data/Studies

   Though not empirically studied, it is the gut feeling, based on review of list serve chatter, conversations and review of various articles, a majority of planners probably believe that a gift of appreciated property to an IGT, which results in the payment of gift tax would enable the basis in the donated asset to be adjusted by the gift tax paid attributable to the appreciation under section 1015(d)(6). However, some planners reach the opposite conclusion.

   b) Historical Perspective – Transferred Basis Underpinning is Cost Basis

   (1) Cost Basis

   From an historical perspective, the general “cost basis” rule, currently in section 1012, provides the basis is determined by looking at the property’s cost (i.e., generally, the amount paid for the property). This historical rule, which still applies in many different situations today, was originally placed in the 1913 Code. However, when determining the basis of property acquired from a gift, the Revenue Act of 1921 replaced the traditional “cost basis” rule and introduced what is now in section 1015.
In its original form, the rule was simple, when the donee received property from the donor, the donee received not only the property, but the donor’s adjusted basis. In effect, the “cost basis” of the donor was transferred over to the donee. As the law matured, there were a number of modifications to what is now IRC § 1015. See Section III.A discussing the history of IRC § 1015.

Of note, one of the theories why the basis should be ‘transferred’ from the donor to the donee, was that fact that property transferred in a gift was a non-taxable transaction. From 1913 to 1920, even though there was no recognition of income on gifts, taxpayers were using gifts as a way to “step-up” the basis, because before the Revenue Act of 1921, when the donee received the gift, the donee could adjust the basis to the donated property’s fair market value. Thus, before 1921, the fair market value basis adjustment was effectively a ‘non-recognition’ provision, in that no gain was recognized at the time of the gift and the basis was adjusted to the donated property’s fair market value.

(2) No Gain Recognized – The Other Side of The Coin

Today, the basis provision under section 1015 is a deferral provision; upon making the gift, no gain is recognized under section 1001, and, as a corollary thereto, the basis is transferred from the donor to the donee under section 1015(a). Section 1015(a) now provides:

“If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor...” [Emphasis Added]

It is interesting to review the actual language of section 1001, which states as follows:

“The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis ... and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.” [Emphasis added]

Interestingly, technically, a ‘gift’ could, in normal parlance in the English language, be considered an ‘other disposition’, but for some reason, the tax laws have never considered a ‘gift’ as an ‘other disposition’.

Over the years, IRC § 1015 has been modified from its original language. Of note is the provision related to gifts of appreciated property and the gift tax paid with respect to such property.

(a) The 1958 Change

Section 1015(d)(1)(A) was originally enacted, as part of The Small Business Tax Revision Act of 1958, to provide a wholesale adjustment for any gift taxes paid related to a gift, provided that the adjusted amount was limited to the donated property’s fair market value on the date of the gift, and later, in 1976 (to be effective January 1, 1977), the Tax Reform Act of 1976 added section 1015(d)(6) to further modify section 1015(d)(1)(A) to limit the basis adjustment to gift taxes paid that are attributable to the net appreciation in the donated property. (IRC § 1015(d)(6)(B) defines “net appreciation” as the difference between the fair market value and the basis of such gift on the date of the gift.)

(b) What was Congress Thinking in 1958?
Examining Congress’ thinking at the time they were enacting the provision that provided the gift tax paid attributable to the entire donated property (and not just limited to the net appreciation) would increase basis; provided, however, the new basis would be limited to the property’s fair market value at the time of the gift. The rationale, as explained in the Senate Finance Committee’s report in 1958 was as follows:

“In general, carrying over the basis of property in the case of gifts is in accord with the general principle followed in determining basis; namely, setting the basis of the property at its “cost.” In this case the “cost” is the cost of the property to the donor, adjusted for any subsequent depreciation, etc. However, this ignores the fact that in reality there is another “cost” incurred in transferring the property from the donor to the donee; namely, the gift tax, which must be paid in order to make this transfer. As a result, your committee has concluded that to properly reflect total “costs” incurred with respect to donated property, it is necessary to increase the basis of the property by the amount of any gift tax paid with respect to it.”


There are a few of things worth highlighting in this comment. First, Congress continued to indicate that the “cost basis” concept (originally set forth in the 1921 law) was still the theory on which the transferred basis relied upon. The Committee concluded that the new “cost” or carryover basis was the donor’s basis, as it may have been adjusted for depreciation, etc. Second, Congress believed that the gift tax was a “cost” incurred in transferring the property from the donor to the donee (i.e., the gift tax), and that “cost”, even though borne by the transferor / donor as a result of the transaction / gift is a “cost” that is transferred over to the transferee / donee. As a result of the changes in 1976, which we discuss next, a third observation is warranted; section 1015(d)(1) only applies to gifts made between 1958 through December 31, 1976.

It should be noted, in income taxable transactions (e.g., sales), commonly the cost of the transferor / seller does not become a basis adjustment to the transferee / buyer. In the gift transaction, the primary liability for the gift tax is on the transferor / donor (and secondarily on the transferee / donee), what Congress appears to be saying, is since this is a “non-taxable” transaction for income tax purposes, passing that “cost” of the gift tax to the transferee / donee is reasonable. Note, as of 1977, the transfer of the gift tax “cost” is limited to the net appreciation.

(c) The 1976 Change

The 1977 modification, under the Tax Reform Act of 1976, added section 1015(d)(6). This modification, applicable to gifts made after December 31, 1976, limits the basis adjustment to the gift tax attributable to the net appreciation in the donated property.

(d) What was Congress Thinking in 1977?
In reviewing the efficacy of this provision, the House Ways & Means Committee stated as follows:

“The purpose of the increase in basis for gift taxes paid on the gift is to prevent a portion of the appreciation in the gift (equal to the gift tax imposed on the appreciation) from also being subject to income tax, that is, to prevent the imposition of a tax on a tax. However, [§ 1015(d)(1)] is too generous in that it permits the basis of the gift property to be increased by the full amount of the gift tax paid on the gift and not just the gift tax attributable to the appreciation at the time of the gift. Consequently, the bill provides that the increase in basis of property acquired by gift is limited to the gift tax attributable to the net appreciation on the gift.”


The idea behind the new provision was to provide a way in which to minimize the “tax on the tax” only on the net appreciation. Understanding Congress’ intention behind the basis adjustment for the net appreciation on the donated property, let’s refocus our attention to the issue at hand — Should the basis of property donated to an IGT be adjusted?

c) The Initial Hypothesis – Was Congress Right?

Clearly, if a donor made an outright gift of appreciated assets to an individual donee (and not a trust) and a gift tax was paid, to the extent that the gift tax is attributable to the net appreciation, probably all agree that the adjustment under IRC § 1015(d)(6) is appropriate. The question is whether the same basis adjustment should be made if the asset were transferred to an IGT.

If the gift is made to a non-grantor trust, it seems as though the same result would apply as if given to an individual.

(1) What Does “Acquired by Gift” Mean?

Recall, IRC § 1015 is only triggered if property is “acquired by gift”. There is no definition of what it meant by “acquired by gift” in the Code or its accompanying regulations.

By analogy, when looking at the basis adjustment provision for testamentary transfers, the Code specifically defines the term “acquired from or to have passed from the decedent”. See, IRC § 1014(b)(1) through (b)(10). Thus, there appears to be an anomaly between the two basis rules under sections 1014 and 1015. One would have thought that there would have been a good definition of what Congress meant when they wanted to say that a property was acquired by gift, but they did not.

We know for gift tax purposes, it is clear, as long as dominion and control has been given up by the donor (in favor of the donee), which is usually the case for transfers to intentional grantor trusts, there is a completed gift. We also know, under the Duberstein case and its progeny, that the requirement for property transferred from one person to another to be treated as a gift for income tax purposes is slightly different. Comm’r v. Duberstein, 363 U.S. 278 (1960). For income tax purposes, donative intent (a subjective standard) is required. The distinction between the income and gift tax definitions of a gift is probably not relevant in the
case where property has been donated to an IGT, since it appears that it would be considered a “gift” under either definition.

(2) Impact on Rev. Rul. 85-13

(a) In General

What, however, is relevant is whether the purported transfer is respected for purposes of IRC § 1015. The crux of the matter turns on the IRS’ own ruling -- Rev. Rul. 85-13.

Recall that under the terms of Rev. Rul. 85-13, there has been no “transfer” for income tax purposes. And some (maybe just a few) may argue, if there is no transfer for income tax purposes then perhaps there was no “gift”, which is a pre-condition for the application of IRC § 1015(d)(6). This is the argument that is made why IRC § 1015(d)(6) should not adjust basis, at least during the time that the trust is a grantor trust. We revisit this argument later.

(b) A Close Review of Rev. Rul. 85-13 – What did the IRS really mean?

Others will say that section 1015 is operational, regardless of Rev. Rul. 85-13. Perhaps we ought to look at Rev. Rul. 85-13 with a critical eye. Recall that the two issues under Rev. Rul. 85-13 were:

“(1) Whether a grantor's receipt of the entire corpus of an irrevocable trust in exchange for an unsecured promissory note given to the trustee, the grantor's spouse, constituted an indirect borrowing of the trust corpus which caused the grantor to be the owner of the entire trust under section 675(3) of the Internal Revenue Code.”

and

“(2) To the extent that a grantor is treated as the owner of a trust, whether the trust will be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor.”

With respect to the first issue, the Service concluded:

“(1) A's receipt of the entire corpus of the trust in exchange for A's unsecured promissory note constituted an indirect borrowing of the trust corpus which caused A to be the owner of the entire trust under section 675(3) of the Code.” [Emphasis added]

Further, with respect to the second issue, the Service concluded (in part):

“(2) At the time A became the owner of the trust, A became the owner of the trust property. As a result, the transfer of trust assets to A was not a sale for federal income tax purposes and A did not acquire a cost basis in those assets... ” [Emphasis added]
In their analysis, the Service stated that their holding is contrary to the Rothstein holding [*Rothstein v. United States*, 735 F.2d 704, 2nd DCA (1984)], stating that:

“It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor’s benefit, the grantor has treated the trust property as though it were the grantor’s property. The Service position of treating the owner of an entire trust as the owner of the trust’s assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.” [Emphasis added]

The IRS’ theory is if the trust is considered a grantor trust under the grantor trust rules (contained in section 671 et seq.), the grantor is treated as the “owner of the trust’s assets”. Further, in its second holding, it is interesting to note the Service’s thought that the grantor did not acquire a new cost basis in the assets, rather, the Service concluded that the grantor continued to hold onto those assets (keeping its old cost basis).

(3) Analyzing Section 1015(b)(6) and How it Relates to Rev. Rul. 85-13.

So, how does the rationale behind Rev. Rul. 85-13 square with the theory behind IRC § 1015(d)(6)? The Congressional rationale behind IRC § 1015(d) (before 1977) and IRC §1015(d)(6) (after 1977) was to give the donee a basis adjustment so that the donee does not suffer a tax on the tax (i.e., an income tax on the gift tax paid attributable to the gain) when the assets are later sold. If the assets are in an IGT and the assets are sold during the grantor’s lifetime, then, with respect to the donee, the Congressional intent is not violated, since the donee is not liable for the tax in any event. However, when examining the impact to the donor, when the property is sold, is the donor worse off by having paid the income tax, without a basis adjustment?

(4) Using Examples to Analyze the Theory

To understand the impact to the donor, consider the following examples:
(a) Basic Fact Pattern for All Examples

- The donor (D) has consumed all of D’s applicable exclusion amount.
- D had two assets before the gift: Cash of $3,500,000, and C corporation stock in P, Inc., with a fair market value of $100,000 with an adjusted basis of $0 (P stock). Thus, the total fair market value is $3.6 million and total adjusted basis is $3.5 million.
The income derived from the investment of the cash will generate just enough every year to pay taxes, living expenses, other gifts, etc. so that at any given time, D will have $3.5 million, except that the effect of the gift, sale, or other disposition of P stock will have a direct impact on D’s cash. By example, when D makes a gift of P stock and pays $40,000 of taxes, D’s cash would reduce to $3.46 million (i.e., $3.5 million less $40,000).

D’s income, gift and estate tax rates are 25%, 40% and 40% respectively.

The donee’s (E’s) income tax rate is also 25%.

D donates all of the P stock to a trustee (T) to hold in trust for E’s benefit for life, then upon D’s death to E (outright and free of trust), if E is alive, or if not to E’s then living descendants, per stirpes. E will survive D.

The fair market value of all assets stays the same through D’s date of death.

The trust is a grantor trust as to D during D’s entire lifetime.

D dies more than three years after the gift was made to T (to avoid and IRC § 2035(b) issues).

D consumed all of D’s applicable exclusion at the date of death (having made gifts of the increasing applicable exclusion amount each year), and D had only cash at death, which was adjusted for the gifts, taxes, living expenses, etc.

(b) Different Assumptions for Examples 1 - 6
Let’s look at six different examples to see the net result to D and E.

- **Example 1**, D sells P stock before making the gift and gives the net proceeds of $80 to T (for E’s benefit).
- **Example 2**, D makes the gift of P stock to T. IRC § 1015(d)(6) adds the gift tax to the basis.
- **Example 3**, D makes a gift of P stock to T. There is no adjustment for the gift tax to the basis.
- **Example 4**, D makes a gift of P stock to T on day 1. IRC §1015(d)(6) adds the gift tax to the basis. T sells P stock on day 5. (D pays the income tax).
- **Example 5**, D makes a gift of P stock to T on day 1. There is no adjustment for the gift tax to the basis. T sells P stock on day 5 (D pays the income tax).
- **Example 6**, D does not make a gift, D holds onto P stock until death.

(c) The Results of the Six Examples
The results of the examples can be viewed in the next table.
They start at the same place, where the fair market value is $3.6 million and the adjusted basis is $3.5 million. The difference between the fair market value and the adjusted basis is $100,000, which is attributable to P stock having a zero basis.

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of all of D’s assets before the gift</td>
<td>$3,600,000</td>
<td>$3,600,000</td>
<td>$3,600,000</td>
<td>$3,600,000</td>
<td>$3,600,000</td>
<td>$3,600,000</td>
</tr>
<tr>
<td>Basis of all of D’s assets before the gift</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
</tr>
</tbody>
</table>

After the gift of D to T, the income and gift tax ramifications (if any) are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax Paid before the transfer</td>
<td>25,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Fair market value of gift on date of transfer</td>
<td>75,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Gift Tax Paid by D</td>
<td>30,000</td>
<td>40,000</td>
<td>40,000</td>
<td>40,000</td>
<td>40,000</td>
<td>-</td>
</tr>
</tbody>
</table>

The resulting fair market value and basis of the assets are as follows immediately after the gift from D to T:

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of all of D’s assets immediately after the gift (excludes P stock, if given)</td>
<td>3,470,000</td>
<td>3,460,000</td>
<td>3,460,000</td>
<td>3,460,000</td>
<td>3,460,000</td>
<td>3,600,000</td>
</tr>
<tr>
<td>Fair market value of P stock in T’s hands as trustee for E</td>
<td>-</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Fair market value of cash in T’s hands as trustee for E</td>
<td>75,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Adjusted basis of P stock in T’s hands</td>
<td>-</td>
<td>40,000</td>
<td>-</td>
<td>40,000</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Note, in Examples 2 and 4 IRC § 1015(d)(6) applies. Thus, the donor’s basis (i.e., $0) is increased by the amount of the gift taxes paid which is attributable to the net appreciation (i.e., $40,000). In this case, since the donor’s basis (before the transfer) was $0 and the fair market value was $100,000, the net appreciation was $100,000, or in percentage terms, the net appreciation was 100% (i.e., $100,000 ÷ $100,000). Thus, since the gift tax paid in those examples was $40,000, 100% of the gift tax would adjust the basis (from $0 to $40,000). In Examples 3 and 5, however, IRC § 1015(d)(6) does not apply. Thus, the basis of those assets would be $0 (i.e., the donor’s basis). In Example 1, P was sold and cash was given, thus there is no basis in P stock. In Example 6, the donor did not make a gift.
Five days after the gift (in Examples 4 and 5) P stock is sold, the results would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross sales proceeds after T sells P stock</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>100,000</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Gain on sale of P stock after the gift</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>60,000</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Income tax paid by D on sale of P stock after the gift</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>15,000</td>
<td>25,000</td>
<td>-</td>
</tr>
</tbody>
</table>

The difference between Examples 4 and 5 is in the former IRC § 1015(d)(6) is operative (thus, a higher basis and lower gain) and in the latter there is a lower basis (i.e. $0) and greater gain.

Upon D’s death, the fair market value and basis of the assets in E’s hands would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable estate when D dies</td>
<td>3,470,000</td>
<td>3,460,000</td>
<td>3,460,000</td>
<td>3,445,000</td>
<td>3,435,000</td>
<td>3,600,000</td>
</tr>
<tr>
<td>D’s Estate tax liability (40%)</td>
<td>1,388,000</td>
<td>1,384,000</td>
<td>1,384,000</td>
<td>1,378,000</td>
<td>1,374,000</td>
<td>1,440,000</td>
</tr>
<tr>
<td>Net Estate passing to E at D’s death</td>
<td>2,082,000</td>
<td>2,076,000</td>
<td>2,076,000</td>
<td>2,067,000</td>
<td>2,061,000</td>
<td>2,160,000</td>
</tr>
</tbody>
</table>
The resulting fair market value and adjusted basis of assets in D’s hands (from D’s estate and from T) is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net estate passing to E at D’s death</td>
<td>2,082,000</td>
<td>2,076,000</td>
<td>2,076,000</td>
<td>2,067,000</td>
<td>2,061,000</td>
<td>2,160,000</td>
</tr>
<tr>
<td>Add Value of assets in T for the benefit of E</td>
<td>75,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Total fair market value of assets passing to E at D’s death</td>
<td>2,157,000</td>
<td>2,176,000</td>
<td>2,176,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
</tr>
<tr>
<td>Basis of assets in E’s hands at D’s death</td>
<td>2,157,000</td>
<td>2,116,000</td>
<td>2,076,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
</tr>
<tr>
<td>Built in Gain</td>
<td>-</td>
<td>60,000</td>
<td>100,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Possible income tax on Built in Gain</td>
<td>-</td>
<td>15,000</td>
<td>25,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Based on the foregoing, the economic value (i.e., the value assuming that all assets were converted to cash) on D’s death is as follows:

<table>
<thead>
<tr>
<th>Economic Value of assets that passed to E upon E’s death (this is the difference between the fair market value and the possible built in gains tax)</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,161,000</td>
<td>2,151,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
<td>2,160,000</td>
</tr>
</tbody>
</table>

(d) **Initial Conclusions About the Results**

If Congress’ goal was to try to equate the results, on its face it appears that they did a fairly poor job since there is disparity between the economic results. However, when we look deeper into the numbers and evaluate the difference, we see that perhaps the results are not too bad, or even good.

If one of Congress’ goals was to try to have the net result of the different alternatives (i.e., Examples 2 through 6) be roughly equal to Example 1, where (a) the donor sells the assets, (b) recognizes the gain and pays the income tax, (c) gives away the net proceeds and (d) pays the gift tax, perhaps they accomplished what they set out to do. At first blush, the results seem to show disparity, but when we look at them closely, we see that maybe there is some sense to all of this.

(e) **Comparing Examples 1 and 6**

First, let’s examine the results of the only two examples, where IRC § 1015(d)(6) would have been inapplicable, and see where the differences lie (i.e., examining Examples 1 and 6).
In comparing the Examples 1 and 6, there is difference of $3,000 (i.e., $2.16 million - $2.157 million). What makes up this economic difference?

There are two things, first, the *quid pro quo* for inclusion in the estate is that basis adjustment under IRC § 1014 (i.e., assets included in the gross estate are entitled to a basis adjustment to the fair market value) at the time of death.

In Example 6, P stock was retained until death, thus, achieving full basis step up. Thus, D avoided the income tax of $25,000, but since that $25,000 was included in D’s estate at death, he suffered an estate tax of 40% of such savings, yielding a net benefit of $15,000. However, D had to pay the tax inclusive tax on the P stock, versus the tax exclusive tax.

By comparison, in Example 1, D’s estate did not have to pay an estate tax on the gift tax paid, thus, there was an estate tax savings of 40% of the $30,000 of gift tax paid (or $12,000).

The difference between the benefits in Example 6 of $15,000 and in Example 1 of $12,000, is $3,000, which explains the difference between the net result to E in the same examples.

In this case, it is clear that the difference is not due to the gift tax basis adjustment, rather it is attributable the tax-free step-up rules and the tax inclusive and exclusive nature of the estate and gift taxes.

(f) Comparing Examples 1 and 2

Comparing Examples 1 and 2, where the basis adjustment under IRC § 1015(d)(6) comes into play in Example 2, we note the following:

<table>
<thead>
<tr>
<th>Economic Value of assets that passed to E upon E’s death</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,151,000</td>
<td>2,160,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The net after tax amount passing to the donee, E, in Examples 1 and 2 are $2.157 million and $2.161 million, respectively. The difference is $4,000. We note that the difference has nothing to do with the basis adjustment under IRC § 1015(d)(6), rather it has to do with the tax exclusive nature of the gift tax vis-à-vis the tax inclusive nature of the estate tax.

Recall, in Example 1, the asset was sold, income tax paid, the net proceeds given and the gift tax was paid, and in Example 2, the asset was not sold, thus, no income tax was paid, the asset was donated and the gift tax was paid, and the basis of the asset was increased by the gift taxes paid (since the net appreciation was 100%). In Example 1, D gave away the net proceeds of $75,000 (i.e., $100,000 gross proceeds from the sale of P stock less $25,000 of income taxes attributable to the sale), whereas in Example 2, D gave away P stock then valued at $100,000. The
$25,000 difference in value (i.e., $100,000 (in Example 2) and $75,000 (in Example 1)) meant that there were less gift taxes paid in Example 1 than in Example 2, by an amount equal to the difference (of $25,000) multiplied by the gift tax rate (of 40%), which was $10,000.

When D died, that $10,000 was still there, and since the gift tax is exclusive (in that there is no estate tax paid on the gift tax paid) and the estate tax is tax inclusive, the $10,000 difference, when multiplied by the estate tax rate (of 40%) yields a tax effected difference of $4,000. Therefore, the difference between Examples 1 and 2 has nothing to do with the basis adjustment, and everything to do with the tax exclusive nature of the gift tax.

(g) Comparing Examples 2 and 3

Now, let’s compare Examples 2 and 3. The results, as stated above, are restated as follows:

<table>
<thead>
<tr>
<th>Economic Value of assets that passed to E upon E's death</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,161,000</td>
<td>2,151,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
<td></td>
</tr>
</tbody>
</table>

The difference between Examples 2 and 3 is that in Example 2, IRC § 1015(d)(6) was applied and in Example 3, it was not applied. Recall, that P stock was held through date of death. In reviewing the fair market value of the assets received at date of death, we note there was no difference between the results, to wit:

<table>
<thead>
<tr>
<th>Total fair market value of assets passing to E at D's death</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,176,000</td>
<td>2,176,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
<td></td>
</tr>
</tbody>
</table>

The difference only occurred when we looked at the ‘economic value’ of the assets (i.e., taking the value of P stock and hypothetically selling the stock for its value and paying the income tax attributable to the stock). In this case, the difference in ‘economic value’ is merely due to the fact that in Example 2, we had a tax basis of $40,000, whereas, in Example 3 we had zero basis. Thus, the hypothetical gain was $40,000 more in Example 3 and the resulting hypothetical income tax would be such hypothetical gain multiplied by the income tax rate of 40%, which is $10,000 (i.e., the difference between $2.161 million (in Example 2) and $2.151 million (in Example 3). Thus, we see the difference between the examples is strictly in the assumption where the basis is adjusted in one scenario and not in the other.

(h) Comparing Examples 2 and 4

Comparing Examples 2 and 4, we note that there is a $6,000 difference, as follows:

<table>
<thead>
<tr>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
That $6,000 difference is attributed to the fact that in Example 2, the assets are sold after the estate tax is imposed, whereas in Example 4, the assets are sold and income tax is paid before the estate tax is imposed. Thus, the difference between Examples 2 and 4 is attributed to the tax inclusive nature of the estate tax over the tax exclusive nature of the gift tax.

By paying the income tax before death (in Example 4), there is a benefit equal to the amount of the income tax adjusted by the estate tax. In this case, the income tax was $15,000, and the estate tax rate was 40%, thus, the product of the two is $6,000 (i.e., the difference between $2,167,000 and $2,161,000). Again, the difference has nothing to do with the basis adjustment, rather it has to do with the tax inclusive / tax exclusive natures of the estate and gift taxes, respectively.

(i) **Comparing Examples 4 and 5**

When comparing Examples 4 and 5, we note that there is also a $6,000 difference.

This $6,000 difference is directly related to the impact of the assumption that in one case the basis is $40,000 and in the other it is $0. With the basis adjustment in Example 4, D recognizes $40,000 less of gain, and thus pays $10,000 less of income tax (i.e., $40,000 x 25% income tax rate). Adjusting that difference for estate taxes of 40%, the net difference is $10,000 x (100% – 40%), or $6,000. Again, the difference in this case, as the difference when we compared Examples 2 and 3, had everything to do with the basis adjustment at death.

(5) **Overall Comparison–How did Congress Do?**

Examples 2 and 4 demonstrate that the client in parity with Example 1 (i.e., as if D had sold the property and gave the net proceed to the beneficiary). Thus, strictly from a mathematical standpoint, taking into consideration that Congress wanted to avoid a tax on tax, and tried to reach a fair result, on balance, it appears that it is fairer to add the gift tax paid on the net appreciation to the donor’s basis.

(6) **Revisiting the Rev. Rul. 85-13 “Nothing Happened” Argument**

Notwithstanding the fairness of adding back the gift tax paid on the net appreciation, one could argue that under the theory of Rev. Rul. 85-13, nothing happened. Stated differently, since D was the owner of the assets before and after the “gift”, for income tax purposes, and IRC § 1015 is an income tax provision, nothing
happened. Thus, because there was no gift (because nothing happened) for income tax purposes, that there should be no basis adjustment, so long as the intentional grantor trust remains a grantor trust. This argument has merit, but as demonstrated from a pure mathematical standpoint, it appears that this may be not as strong of an argument considering the stated Congressional intent.

d) **Squaring the Basis Adjustment Under IRC § 1015 and 1014**

Knowing now that the better argument appears to favor a basis adjustment during life even for a gift to an intentional grantor trust, for any gift tax paid, does it make sense that there should be a second adjustment at death to the intentional grantor trust assets because of the grantor’s death and termination of grantor trust status? It’s a red herring to argue that a basis adjustment during life under IRC § 1015(d)(6) prevents an adjustment to the same assets at death. There is no provision anywhere in the Code (or the regulations thereunder) that prohibits a basis adjustment under IRC § 1014 if there was a lifetime adjustment under IRC § 1015. Whether death is an event that triggers an adjustment to basis in a grantor trust not part of the grantor’s taxable estate is another question not addressed herein.

C. **GRATs and QPRTs**

1. **Trust’s Initial Carryover Basis**

Virtually all GRATs and QPRTs are wholly-owned grantor trusts, so as discussed above, the trustee should take the grantor’s adjusted basis in the assets transferred to the GRAT. Any gain or loss on the sale of the trust assets while the trust remains a grantor trust should be measured by the carryover basis obtained by the trustee from the grantor, as discussed above.

2. **Basis Adjustment for Gift Taxes Paid**

It is unclear precisely whether and when the basis in property given to a wholly-owned GRAT or QPRT is increased to reflect the gift tax paid on the net appreciation. The best analysis, as discussed above, is that the trustee takes a pure carryover basis until grantor trust status ends, at which time there would be an adjustment for the gift tax payment.

3. **Expiration of Retained Interest Term**

At the end of the reserved annuity or use term, the asset passes to the remainder beneficiaries with no change in basis, unless the asset is encumbered by a debt in excess of basis and the trust then ceases to be a grantor trust. In that situation, gain should be recognized by the grantor and the basis of the underlying assets should be increased accordingly.

4. **Death of the Remainder Beneficiary During Retained Interest Term**

   a) **Uniform Basis**

Reg. § 1.1014-8(a)(1) states that the death of the remainder beneficiary does not affect the uniform basis of property held in a trust. Therefore, the basis of the property in a GRAT or QPRT is unaffected by the death of the remainder owner before the termination of the retained interest term.

   b) **Basis to Heir, Legatee, or Devisee for the Remainder Interest**

The remainder is, however, includible in the remainder beneficiary’s gross estate under IRC § 2033, whether vested or contingent. Rev. Rul. 67-370, 1967-2 C.B. 324; Rev. Rul. 76-472, 1976-2 C.B. 264; *Estate of Williams v. Comm'r*, 62 T.C. 400 (1974). Reg. § 1.1014-8(a)(1) states that, if the remainder passes in fee, the basis increase under IRC §
1014 will be taken into account in calculating the basis of the remainder interest in the hands of the heir, legatee, or devisee for the remainder beneficiary. Reg. § 1.1014-8(a)(2) also takes it into account when the trust ends and its assets are distributed to the remainder beneficiary’s heir, legatee, or devisee of the remainder interest. See also, Rev. Ruls. 69-239, 1969-1 C.B. 198 and 68-268, 1968-1 C.B. 349; and PLR 6906060320A.
XXI. PROBLEM BASIS SITUATIONS: BASIS AND PRIVATE ANNUITIES

A. Generally

A private annuity is a sale of property by one family member to another in exchange for the buyer’s unsecured promise to make specific, periodic payments to the seller for the rest of the seller’s life. The seller is often referred to as the “annuitant” and the buyer as the “obligor,” and the transferred property as the “annuity property.” Private annuities may be an excellent tool for removing a significant asset from an individual’s gross estate for estate tax purposes, while simultaneously providing that individual with a lifetime source of income. The value of the unpaid portion of a private annuity obligation should be excluded from the annuitant’s gross state because the annuity represents an amount received in a bona fide sale for full and adequate consideration in money or money’s worth. See Fidelity Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958); Helvering v. Estate of Rhodes, 117 F.2d 509 (8th Cir. 1941); Estate of Zeitz v. Comm’r, 34 T.C. 351 (1960); Estate of Milner v. Comm’r, 6 T.C. 874 (1946); Estate of Bergan v. Comm’r, 1 T.C. 543 (1943), acq. 1943 C.B. 2; Rev. Rul. 55-438, 1955-2 C.B. 601. On private annuities generally, see Hodges & Panarisi, Planning Private Annuities, 4 Rev. Tax’n Individuals 214, 225–226 (1980); Leimberg & Hodges, The Income Tax and Estate Planning Advantages of Private Annuities, 33 Est. Plan. 3 (Feb. 2006); Leimberg & Hodges, Maximizing the Planning Opportunities of Private Annuities, 33 Est. Plan. 13 (Mar. 2006); McGrath, Private Annuity Sales and the Exhaustion Test, 47 Tax Mgmt. Memo. 235 (June 12, 2006); Wojnaroski, Jr., Tax Aspects of Private Annuities, 22 Tax Mgmt. Est., Gifts & Tr. J. 119 (May/June 1997); Wojnaroski, Jr., Tax Aspects of Private Annuities Part II—Income Tax Considerations, 22 Tax Mgmt. Est., Gifts & Tr. J. 178 (July/Aug. 1997).

B. Income Taxation of Private Annuities

Understanding the basis issues for a private annuity is easier if one also understands how the seller (annuitant) is taxed.

1. Taxation of the Annuitant

The traditional income tax treatment of a private annuity sale is designed to return to the annuitant the same net income and gains that would have been recognized had the annuitant sold the property for an installment obligation with a term equal to the annuitant’s life expectancy. Because the annuitant’s actual life expectancy is unknown, the income tax treatment is based on the annuitant’s actuarial life expectancy. Rev. Rul. 69-74, 1969-1 C.B. 43.

a) All Annuities Are Divided into Three Parts

Rev. Rul. 69-74, 1969-1 C.B.43 states that each annuity payment is divided into three components: (1) a return of capital (i.e., adjusted basis) component, (2) a gain (capital or ordinary) component, and (3) an annuity component.

(1) Return of Capital

The return of capital component is recovered from each annuity payment through application of an “exclusion ratio.” The exclusion ratio is the result of dividing the annuitant’s “investment in the contract” by the expected return on the annuity contract. IRC § 72(b); Reg. § 1.72-4(a)(4).

(a) IRS View of the Investment in the Contract

The annuitant’s investment in the contract is his or her income tax basis in the annuity property. Rev. Rul. 69-74.

(b) Another View
Some commentators contend that the investment in the contract should be the fair market value of the annuity property, rather than the annuitant’s adjusted basis. This is consistent with the computations used in the purchase of commercial annuities. IRC § 72(c)(1)(A). Also, Reg. § 1.1011-2(c), Ex. 8, issued after Rev. Rul. 69-74, says that the investment in a private annuity contract bought from a church that does not regularly sell private annuities is the value of the annuity property, and not its basis. See Stewart, Private Annuities Revenue Rule 69-74 Partially Repealed, Sub Silentio, by Reg. § 1.1001-2(c), Ex. (8), 24 Mercer L. Rev. 585 (1973). This argument has some validity since there seems to be no reason why a different rule should apply to private annuities bought from a charity and those bought from an individual. Furthermore, if the private annuity transaction fails to qualify for pro rata recognition of gain, the Tax Court has said that the investment in the contract is the entire value of the property. 212 Corp. v. Comm’r, 70 T.C. 788 (1978); Estate of Bell v. Comm’r, 60 T.C. 469 (1973); Comm’r v. John C. Moore Corp., 15 B.T.A. 1140 (1929), nonacq. VIII-2 CB 67, aff’d, 42 F.2d 186 (2d Cir. 1930). See also Croft & Hipple, Planning Lifetime Property Transfers: Private Annuities, Installment Sales, and Gift-Leasebacks, 11 Real Prop., Prob. & Tr. J. 253, 265–269 (1976); Magram, The Use of Private Annuities Under the 1976 Tax Reform Act, 30 S. Cal. Tax Inst. 655, 671–673 (1978). While the gain on this basis should probably be reported, the current IRS position is still that enunciated in Rev. Rul. 69-70.

(c) Exclusion Ratio is Permanent

The exclusion ratio, once established, applies to all payments received by the annuitant, until the annuitant recovers his or her entire adjusted basis, after which the exclusion ratio is irrelevant.

(2) Return of Capital

The gain component of each annuity payment is the difference between the present value of the annuity promise on the date of the sale, and the annuitant’s adjusted basis in the property, divided by the annuitant’s life expectancy.

(3) Annuity Component

The balance of each annuity payment is the annuity component, which is taxed as ordinary income. If the annuitant lives longer than the actuarial life used to determine the annuity (as well as the value of the annuity for determining gain on the annuity sale), all annuity payments received thereafter are treated entirely as ordinary income (as derived solely from the annuity component). This is because, at this point in time, the annuitant-seller will have recovered from previously paid annuity payments both (a) his or her adjusted basis in the property exchanged for the annuity, and (b) all gain realized at the time of the annuity sale.

b) 2006 Proposed Regulations

In 2006, the Treasury Department and the IRS proposed regulations under IRC §§ 72 (concerning taxation of annuities and certain proceeds of endowment and life insurance contracts, Prop. Reg. § 1.72-6(e)) and 1001 (concerning the determination and recognition of gain or loss, Prop. Reg. § 1.1001-1(j)) that would dramatically alter the taxation of private annuity sales to the annuitant by eliminating the deferral of income taxes on such exchanges through requiring current realization of the fair market value of the annuity in the year of the exchange. 71 Fed. Reg. 61,441 (Oct. 18, 2006). See also Lederman, Proposed
Regulations on the Tax Treatment of Private Annuities Would Generally Make Them Unattractive, 106 J. Tax’n 175 (March, 2007); and Leimberg, McGrath, & Zaritsky, Deferral of Gain Eliminated in Sales of Appreciated Property for an Annuity—A Whole New Ballgame and the IRS Hits for the Fence!, 33 Est. Plan. 3 (Feb. 2006). These regulations have not yet been finalized, but their finalization remains on the Treasury/IRS Priority Guidance Plan for 2017-2018 (Updated May 9, 2018).

(1) Generally

The proposed regulations are relatively simple. They state that if an annuity contract is received in exchange for property (other than money), the following three results occur:

- The amount realized attributable to the annuity contract is its fair market value determined under IRC § 7520 at the time of the exchange. Prop. Reg. § 1.1001-1(j)(1);

- The entire amount of the gain or loss, if any, is recognized at the time of the exchange regardless of the taxpayer’s method of accounting. Prop. Reg. § 1.1001-1(j)(1); and

- For purposes of determining the initial investment in the annuity contract under IRC § 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to the annuity contract (i.e., the fair market value of the annuity contract). Prop. Reg. § 1.72-6(e)(1).

Thus, where the fair market value of the property exchanged equals the fair market value of the annuity contract received, the investment in the annuity contract will be the fair market value of the property exchanged for the contract.

The preamble explains that this rule, determining the investment in the annuity contract under IRC § 72(c)(1), is intended to ensure that none of the gain or loss on the exchange is duplicated or omitted by the application of IRC § 72 in the years after the exchange. The annuitant’s investment in the contract would be reduced in subsequent years under IRC § 72(c)(1)(B) for amounts already received under the contract after the exchange and excluded from gross income when received as a return of the annuitant’s investment in the contract. 71 Fed. Reg. 61,443.

Thus, if an unsecured private annuity promise or a commercial annuity contract is received by the transferor in exchange for property other than cash, the entire amount of the seller’s realized gain or loss (if any) must be recognized at the time of the exchange, rather than ratably over the seller’s life expectancy.

(2) Accounting Methods

This rule will apply regardless of the method of accounting used by the taxpayer, and regardless of whether the annuity is created in the exchange or is a pre-existing contract.

(3) Secured and Unsecured Agreements

The proposed regulations do not distinguish between secured and unsecured annuity contracts, nor between annuity contracts issued by an insurance company and those issued by a taxpayer who is not an insurance company. The same set of rules would apply to leave the transferor and transferee in the same position
before tax as if the transferor had sold the property for cash and used the proceeds to buy the annuity contract. 71 Fed. Reg. 61,443 (Oct. 18, 2006). Security of any type, directly or indirectly, has traditionally been held to preclude income tax deferral. Estate of Bell v. Comm’r, 60 T.C. 469 (1973), acq. in part and nonacq. in part, 1974 WL 36039 (Jan. 8, 1974), acq. AOD 1979-184 (Aug. 15, 1979), aff’d per curiam, 668 F.2d 448 (8th Cir. 1981); 212 Corp. v. Comm’r, 70 T.C. 788 (1978).

(4) Gain or Loss Recognized

The same rules would apply whether the exchange produces a gain or loss. The preamble notes, however, that this does not prevent the application of other provisions, such as IRC § 267, to limit deductible losses in the case of related party exchanges. 71 Fed. Reg. 61,443.

(5) Effective Date

The proposed regulations generally apply to exchanges of property for an annuity contract after October 18, 2006 (the publication date of the proposed regulations.) The new regulations would not apply to amounts received after October 18, 2006, under annuity contracts that were received in exchange for property before that date. The effective date is delayed for six months (until April 18, 2007) for transactions that meet the following three requirements: (1) The issuer of the annuity contract must be an individual, rather than a corporation, partnership, trust, or other legal entity; (2) The obligations under the annuity contract cannot be secured, either directly or indirectly; and (3) The property transferred in the exchange cannot be sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.

(6) Analysis

The new rules would significantly undermine the utility of traditional private annuity sales by requiring that all gain from the annuity sale be recognized on the date of the exchange, to the extent of the actuarial fair market value of the annuity contract.

(a) Unappreciated Assets

Obviously, this is relevant only with respect to the exchange of substantially appreciated assets for an annuity. Private annuities would still be valuable in exchange for assets with little or no appreciation because they would generate very little taxable gain, as purchases of a private annuity for cash will generate no taxable gain and are expressly excluded from the operation of the proposed regulations.

(b) Installment Sales

The proposed regulations do not generally apply to installment sales agreements, the taxation of which is controlled by IRC § 453 rather than IRC §§ 72 and 1001. Reg. § 1.1275-1(j)(6) states that an annuity with a maximum payout provision (i.e., an obligation to pay a stated amount each year, or more often, but in no event more than a fixed sum) is a debt instrument, rather than an annuity, for income tax purposes, unless “the period of time from the annuity starting date to the termination of the annuity is at least twice as long as the period of time from the annuity starting date to the expected date of the annuitant’s death.” Therefore, a
private annuity could be brought out of the ambit of the proposed regulations and under the rules for installment sales if (1) it included a fixed maximum total dollar payment (as with an agreement to make periodic payments for the shorter of the annuitant’s life or a set number of years), and (2) the set number of years is less than twice the annuitant’s life expectancy.

(c) Annuity Sales to a Grantor Trust

The proposed regulations should not apply where a private annuity sale is made to a grantor trust. See, Rev. Rul. 85-13, 1985-1 C.B. 184.

2. Taxation of the Obligor – Basis Rises

a) Generally

The annuity obligor is treated like the purchaser of the annuity property except that amounts paid in excess of the purchase price are nondeductible annuity payments, rather than deductible interest. See, Rev. Rul. 55-119, 1955-1 C.B. 352; Bell v. Comm’r, 76 T.C. 232 (1980), aff’d per curiam, 668 F.2d 448 (8th Cir. 1981); FA Gillespie & Sons v. Comm’r, 154 F.2d 913 (10th Cir. 1946), cert. denied, 329 U.S. 781 (1946); Kaufman’s, Inc. v. Comm’r, 28 T.C. 1179 (1957); Reliable Incubator & Brooder Co. v. Comm’r, 6 T.C 919 (1946). See also Rye v. United States, 25 Cl. Ct. 592 (1992) (reaffirming that a private annuity sale is not an installment sale under IRC § 453(b)(1) and that the annuity payments are not deductible as interest).

b) Open Basis Concept

The obligor’s basis in the annuity property is computed using an open basis approach, under which the obligor’s basis depends on when and for what purpose it is being computed.

(1) Basis During Annuitant’s Lifetime for Depreciation and Sale at a Gain

The obligor’s basis in the annuity property during the annuitant’s lifetime, for purposes of depreciation and determining the gain recognized on a sale or exchange of the annuity property, is the amount of consideration paid for the property (assuming there was no gift feature). This is the present value of the annuity promise on the date of the agreement. An obligor who makes actual capital payments in excess of this amount may increase his or her adjusted income tax basis, for both subsequent depreciation as well as determining gain or loss on any subsequent sale or exchange, to reflect these additional payments. See, Rev. Rul. 55-119, 1955-1 C.B. 352; Rev. Rul. 72-81, 1972-1 C.B. 98.

(2) Sale at a Loss

The obligor’s basis in the annuity property for purposes of determining loss recognized on a sale or exchange of the annuity property during the annuitant’s lifetime is equal to the amount of the payments actually made less any allowable depreciation. The present value of any annuity payments not yet made is disregarded for this purpose, and any additional annuity payments made after a sale at a loss are additional losses. Id.

(3) Sale Between Gain and Loss

A sale by the obligor during the annuitant’s lifetime at a sales price that (1) exceeds the amounts actually paid by the obligor to that date but (2) is less than the
present value of the promised annuity results in neither a gain nor a loss. Subsequent payments may ultimately cause the obligor to recognize a loss on such a sale if the total of actual annuity payments exceeds the sales price. *Id.*

(4) **Basis After Annuitant’s Death**

The obligor’s basis after the annuitant’s death is the total of all of the annuity payments made by the obligor less any depreciation deductions allowable with respect to the annuity property. *Id.*

(5) **Tax Benefit Recovery**

The obligor’s depreciation deductions during the annuitant’s life are based on the present value of the annuity projected over the annuitant’s actuarial life expectancy, so a combination of fast depreciation and a premature death by the annuitant can give the obligor a negative basis. A negative basis should be recaptured as ordinary income under the tax benefit rule. *Id.* On the tax benefit rule generally, see Bierman & Severin, *Effect of Deduction Phase-Out on Tax Benefit Rule*, 80 J. Tax’n 181 (Mar. 1994); Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. Rev. 265 (1978); Goldman, *Tax Benefit Rule Affects Trusts and their Beneficiaries*, 75 Pract. Tax Strat. 293 (Nov. 2005); Yin, *Supreme Court’s Tax Benefit Rule Decision: Unanswered Questions Invite Future Litigation*, 59 J. Tax’n 130 (1983).

c) **Proposed Regulations**

The 2006 proposed regulations on private annuities state that the obligor’s investment in the contract under IRC § 72(c)(1) would be the aggregate amount realized attributable to the annuity contract (i.e., the fair market value of the annuity contract). Prop. Reg. § 1.72-6(e)(1) (Oct. 18, 2006). Thus, where the annuitant had to recognize gain, the obligor would take a fair market value basis for all purposes.
XXII. PROBLEM BASIS SITUATIONS: BASIS AND SELF-CANCELING INSTALLMENT NOTES (SCINS)

A. Generally

A self-cancelling installment note (SCIN) is a transaction where the seller ("transferor") sells property ("transferred property") to a buyer ("transferee") in exchange for a promissory note that generally expires upon the death of the transferor. The SCIN is structured like any other ordinary installment note (OIN), in that one payment is made on the date of sale and there is at least one other payment made in a later year (or years), thereby allowing the transferor to defer the gain. IRC § 453(b)(1).

Although the SCIN could be a transaction between unrelated individuals, it is most common between related individuals, and quite often it is between the transferor and his or her irrevocable grantor trust. When the latter strategy is used (i.e., sale to one’s irrevocable grantor trust), gain recognition on the sale may not only be deferred, but may be eliminated, and the basis of the transferred property will likely be transferred basis from the transferor (i.e., there will be no step-up in basis under IRC § 1015). We discuss this in detail below.

SCINs, like private annuities, may be an effective planning tool for removing significant asset values from an individual’s gross estate for estate tax purposes, while simultaneously providing that individual with a lifetime source of income. It is most favorable, from a gift and estate tax perspective, when the transferor dies before his or her life expectancy; if the transferor outlives his or her life expectancy, a SCIN may not be as effective.

For an in-depth discussion about SCINs, see, Wojnaroski, 805 3rd TM, Private Annuities and Self-Cancelling Installment Notes.

1. SCINs vs. Private Annuities

The Service, in GCM 39503 (May 7, 1986), distinguished a private annuity from a SCIN, and concluded that a transaction will be treated as an installment sale only if it is reasonably anticipated that the payments (including interest) for the transferred property will be received by the transferor before the expiration of the transferor’s actuarial life expectancy. As a corollary, if the payments are not anticipated to be received before the life expectancy, the transaction would be taxed as an annuity (a private annuity) under IRC § 72 (discussed above in Section XX).

2. SCINs Versus Ordinary Installment Notes (OINs)

SCINs are similar to OINs in that they both have the installment feature that defers the gain recognition, thus, deferring income tax liability. IRC § 453(b)(1). The regulations permit SCINs because it is anticipated that the selling price (plus interest) will be received by the transferor. Temp. Reg. § 15A.453-1(c)(2).

The contingency in a SCIN is not the sales price, which is generally known, but rather whether the transferor will survive the payment period.

SCINs and OINs are similar, in that both can be effective in freezing estate values, can convert illiquid assets into liquid assets, and can offer similar income tax treatment.

SCINs are different from OINs, in that the typical SCIN does not obligate the transferee to make any further payments after the transferor’s death. To avoid adverse gift and estate tax results, the transferor/seller must be compensated for the chance that the entire purchase price will not be paid because of the transferor/seller’s premature death, by a “risk premium.”

B. Transfer Tax Consequences

1. Gift Tax
a) **Common Issues**

When there is a “sale” between related parties, the typical gift tax issue is whether the amounts exchanged represent full and adequate consideration. This is especially true when discounted assets (such as limited liability company or limited partnership interests) are sold. Some of the issues arising in sales of discounted assets can be mitigated by using formula allocation or defined value clauses. In this respect, sales involving SCINs are no different that sales of other assets.

b) **Risk Premium**

When a SCIN is used, in addition to determining the asset’s fair market value (independent of the SCIN transaction), because there is a cancellation feature to the note, the transferee must pay a risk premium. The risk premium can be assessed by (a) increasing the interest rate, (b) increasing the purchase price, or (c) a combination of (a) and (b).

c) **Mortality Tables**

To determine the risk premium, and to determine the length of the annuity, one needs to use the mortality tables. It is currently unclear which mortality tables should be used in determining the interest rate. For a good discussion about which mortality tables should be used, see, Crotty, Hesch, Wojnarowski, & Gassman, *IRS Puts More Skin in the Game of Using SCINs*, Est. Plan. (Jan 2014).

See also, CCA 20133033 (Aug. 5, 2013), discussing the IRS’ position on the use of SCINs (and other estate planning techniques) employed by William Davidson (former owner of the NBA’s Detroit Pistons), now deceased. See also, H.M.Zaritsky & R. Aucutt, *Structuring Estate Freezes: Analysis with Forms* ¶ 12.02[3] (Thompson Reuters/ Tax & Accounting, 2nd ed. 1997 & Supp 2018-1).

d) **Interest Rates**

It is also unclear which interest rates should be used (e.g., the IRC § 7520 rate or the applicable Federal rate). The conservative planner generally uses the higher of the two rates based on the actual term of the note. In CCA 201320033, the IRS took the position that the Section 7520 rate did not apply to SCINs in the particular transaction that they reviewed. However, it appears that in *Dallas v. Comm’r*, T.C. Memo 2006-212, the IRS used the IRC § 7520 rate to determine the SCIN’s value. See, H. M. Zaritsky & R. Aucutt, *Structuring Estate Freezes: Analysis with Forms* ¶ 12.02[3] (Thompson Reuters/ Tax & Accounting, 2nd ed. 1997 & Supp 2018-1).

e) **Inadequate Risk Premium**

If it is determined that the risk premium is inadequate, then the sale may be re-characterized a part-gift/part-sale transaction. See, *Dallas v. Comm’r*, T.C. Memo 2006-212.


2. **Estate Tax**

a) **General Rule - No Estate Tax Inclusion**
Properly structured, the unpaid balance on a SCIN is not included in the transferor’s gross estate. *Estate of Moss v. Comm’r*, 74 T.C. 1239 (1980). Technically, the note is cancelled at the moment of death and thus has no value at death.

b) **Include Payments Received**

The note is not included in the transferor’s estate, but any payments received by the transferor from the time of the sale through his or her death (including any appreciation thereon) will be included in the transferor’s estate, to the extent not expended or consumed.

c) **Bona Fide Sale for Full and Adequate Consideration**

In negotiating the SCIN transaction the sale must be a *bona fide* transaction for full and adequate consideration. To compensate the transferor/seller for the contingency of death before full payment is received, the transferor must be paid a risk premium as part of the bargained for consideration.

1. **Non-Bona Fide Sales**

   If it determined that the sale was not *bona fide*, the SCIN could be ignored and the transfer may be considered a gift and have estate and/or estate tax consequences. *Estate of Musgrove v. United States*, 33 Fed. Cl. Ct. 657 (1995).

2. **Burden of Proof - Taxpayer**

   The burden is on the taxpayer (not the IRS) to demonstrate that the transaction was *bona fide*. *Estate of Costanza v. Comm’r*, 320 F.3d 595 (6th Cir. 2003), rev’g, T.C. Memo 2001-128.

C. **Income Taxation – Individuals and Non-Grantor Trusts**

In this section we assume that the transferor is an individual and the transferee is an individual or a non-grantor trust (i.e., for instance, the sale could be between an individual and his or her child, or between an individual and a non-grantor trust). For a discussion of the income tax issues for SCIN transactions between the transferor and his or her grantor trust, see the discussion in section XXI.D below, and for a general discussion about sales between a grantor and his or her irrevocable grantor trust, see section XX above.

Generally, there is one income tax issue facing the transferor/seller -- the recognition of income. There are two income tax issues that affect the transferee/buyer -- (1) the deductibility of the interest paid by the transferee; and (2) the tax basis of the transferred property.

1. **Transferor’s Income Tax Implications**

   a) **Date of Sale**

   1. **Amount Realized**

      The amount realized (as defined under IRC § 1001) on the sale will generally be (a) the fair market value of the property (had the property not been sold for a SCIN), plus (b) the risk premium (if assessed as a principal addition to the sale price).

   2. **Gain Realized/Recognized**

      The gain realized will equal to the amount realized less the transferred property’s adjusted basis. If a gain is realized, then it can be deferred under IRC § 453. It
would be imprudent to have a sale where is loss is realized, since they will likely be denied the loss under IRC § 267.

Whether the gain is a capital gain, IRC § 1031 gain, recapture of ordinary income, or otherwise will be determined as it is normally determined on any other sale. The capital gain component can be deferred under IRC § 453.

(3) Interest Income

In general, there will be no interest income earned on the closing date. Interest is recognized as it is accrued and/or paid (depending on whether the seller is an accrual or cash basis taxpayer). Since most individuals are cash basis taxpayers, interest income will be recognized when collected (i.e., when payments are made by the transferee).

b) Future Payments

As payments are received periodically a portion of the payments will be a recovery of principal, a portion will be capital gain, and the balance will be interest income. Depending upon how the risk premium is computed (i.e., as an addition to principal or as an increased interest rate), the amount of capital gain and interest will differ.

2. Transferee’s Income Tax Implications

a) Interest Expense

GCM 39503 (June 25, 1986) provides that the accrued or paid interest may be deductible by the transferee. Deductibility may be limited by some of the provisions of IRC §163, however. For instance, if the interest is characterized as investment interest expense, then the limitation rules under IRC § 163(d) would apply.

b) Transferee’s Tax Basis

(1) GCM 35903

(a) Conclusions by General Counsel

In GCM 35903, General Counsel concluded, with regard to a SCIN, the transferee/buyer’s basis in the transferred property is the fair market value of assets exchanged including the full face value of the note (i.e., the basis is generally be the purchase price for the transferred property).

(b) General Counsel’s Analysis

In analyzing whether the buyer’s basis would be increased to reflect contingent obligations, General Counsel cited to a number of cases which held that if the seller was no longer receiving payments (and the buyer was no longer obligated to make payments on the note), that such basis could only be increased to the extent that the buyer/transferee was “in fact required to make payments pursuant to the obligation.”

However, General Counsel took the analysis further concluding since the transferor/seller (and/or his or her estate) has to recognize all of the income from the sale, even though the buyer/transferee’s obligation terminated. The recognition of income by the seller supports the increase of basis to the extent of the full face value of the note.
GCM 35903 provides in the case of a SCIN, “the full face value of the note will in all events be realized by the seller or the seller’s estate, whether or not the seller lives long enough to require payment of the face amount.” In GCM 35903, ultimately, General Counsel concluded that IRC § 691(a)(5) would cause the recognition of income by reason of cancellation of the indebtedness upon the transferor’s death. Therefore, it appears that General Counsel felt that there would be symmetry in the transaction (i.e., the transferor/seller would recognize gain, which supports the basis in the hands of the transferee/buyer).

3. Risk Premium - The Basis Game

As discussed above, when determining how to structure the risk premium, the parties could agree to an increased purchase price, an increased interest rate or some combination of the two.

If there is an increased purchase price, (compared to a higher interest rate), there will be more capital gain and less interest income to the transferor/seller, and a higher basis and less interest expense to the transferee/seller.

On the other hand, if the purchase price is not adjusted for the risk premium, and instead the interest rate is increased, the transferor/seller will recognize less capital gain, but will have to recognize more interest income over the term of the note. The transferee/seller will have a lower basis and more interest expense.

The planner should analyze which approach would be better for the family, by running the numbers for the buyer and seller, and taking into consideration the needs and desires of the parties.

a) Estate of Frane

(1) Tax Court Decision

In the Tax Court’s decision in the Estate of Frane v. Comm’r, 98 T.C. 341 (1993), aff’d in part, rev’d in part, 998 F.2d 567 (8th Cir. 1993), the Tax Court held that upon the transferor’s death, income would be recognized, and that it would be recognized by the decedent (i.e., on his final return) under IRC § 453B.

(2) Eighth Circuit Decision

Frane was appealed to the Eighth Circuit, which affirmed that in the case of a “death-terminating installment note”, as they called it, that income would be recognized as a result of the “termination” or cancellation of the debt. The appeals court, however, disagreed with the Tax Court and held that the income would be recognized not by the decedent (on his final income tax return), but by the estate as income in respect of the decedent (IRD) under IRC § 691, by reason of IRC §691(a)(5)(iii).

The appeals court’s decision is consistent with General Counsel’s conclusions in GCM 35903 (i.e., that the income after death is IRD in the hands of the transferor’s estate).

What is unanswered at this point is what happens if income is not recognized by the transferor’s estate upon death? Would the basis still be increased by the full-face value of the note? It is unclear at best.

(3) An Alternative Argument – Tax Court’s Dissent

(a) Judge Halpern’s Arguments
The Tax Court majority decision in *Frane* was met with a strong five-judge dissent, written by Judge Halpern, who took the position that there should be no recognition event. Judge Halpern, agreeing with the taxpayer, felt that there was no cancelation of the note, since there was no “obligation that came into being”, thus, there can be no cancellation of something that never was. The dissent argues that the condition precedent for an obligation to arise is that the transferor/seller is to survive to the payment date, failure to survive does not cause an obligation to arise; thus, death does not cancel the obligation, rather life causes the obligation. Therefore, if the transferor dies, there is no obligation.

Judge Halpern argued that the majority’s holding is inconsistent with *Estate of Moss v. Comm’r*, 74 T.C. 1239 (1980), in which the Tax Court held that since the decedent had “no interest in the notes” there could be no inclusion in the gross estate. Judge Halpern points out that, “when the decedent has no interest remaining and no right to collect, borrower has no obligation to pay”; thus, it is impossible to cancel something that does not exist in the first place.

The argument is compelling.

(b) *Frane’s Application*

Under the rule established in *Golsen v. Comm’r*, 445 F.2d 995 (10th Cir.) (commonly referred to as the *Golsen* rule), *Frane* is precedent for the Eighth Circuit. If the taxpayer faces the same issue in a different circuit, one should consider using Judge Halpern’s dissenting arguments.

(c) *Planning*

In light of the uncertainty when planning in jurisdictions outside of the Eighth Circuit, perhaps the planner could use a grantor trust as the transferee/buyer for the SCIN transaction. This is discussed below. For a recent article on planning with SCINs, see, Crotty, Hesch, Wojnaroski and Gassman, *IRS Position Puts More Skin in the Gam of Using Skins*, 41 Est. Plan. 3 (Jan. 2014).

D. SCINs and Grantor Trusts

Like ordinary installment sales, (commonly called “sales to defective grantor trusts”, “sales to IDGTs”, or simply, “sales to irrevocable grantor trusts”), SCINs can be used with grantor trusts.

If a transaction is structured so that the note is a SCIN and the transferee is a grantor trust with respect to the transferor’s, Rev. Rul. 85-13, provides for income taxes there has been no sale. If there is no sale, there is no income recognized by the transferor at the time of the sale and the basis in the hands of the transferor passes to the transferee.

1. *Rev. Rul. 85-13*

In Rev. Rul. 85-13 the grantor acquired the corpus of a trust in exchange for the grantor’s unsecured promissory note, resulting in the trust being a grantor trust for income tax purposes. The IRS ruled the exchange of a promissory note for the trust assets is not recognized as a sale for federal income tax purposes, because the grantor is considered to own the purported consideration both before and after the transaction. The IRS also stated that since the grantor owns the trust assets, the grantor
cannot have a sale to him or herself. Finally, the IRS confirmed that there cannot be a valid debt obligation running between the grantor and him or herself.

2. **Is the SCIN a “Note” in a “Sale” to the Transferor’s Grantor Trust?**

   Applying the logic and reasoning of Rev. Rul. 85-13 to a SCIN transaction involving a “sale” from a grantor to his/her irrevocable grantor trust, since there is no “sale”, there is no note. And, since there is no note, there can be no obligation. And, using Judge Halpern’s logic in the *Frane* dissent, if there is no obligation, there is nothing that can be cancelled. This is true so long as the trust remains a grantor trust during the grantor’s lifetime.

3. **Basis in the hands of the Transferor**

   a) **Before the “Sale”**

   Immediately before the “sale” the basis in the hands of the transferor would be the adjusted basis of the transferred asset.

   b) **After the “Sale”**

   Immediately after the sale, the transferor would own a promissory note, with a cancellation provision (only for state law purposes, not for Federal income tax purposes), and the asset would be in the hands of the transferee

   (1) **Gain Recognition**

      a) **If the Trust Remains a Grantor Trust**

      Under Rev. Rul. 85-13, there would be no sale or exchange (as is contemplated under IRC § 1001); thus, no gain could be realized or recognized.

      b) **If the Trust Ceases to be a Grantor Trust**

      If the trust ceases to be a grantor trust during the transferor’s lifetime, and if the SCIN has not been fully paid, gain may be triggered at that point in time. See detailed discussion above in Section XX.A.5 and Section XX.A.6, regarding Reg. § 1.1001-2(c), Ex. 5; Rev. Rul. 77-402, 1977-2 C.B. 222; and *Madorin v. Comm’r*, supra.

4. **Basis in the hands of the Transferee/Grantor Trust**

   a) **After the Sale and before the Grantor’s Death**

   For Federal income tax purposes there is no sale; however, there is a transfer, the transferee (i.e., the irrevocable grantor trust) would have a transferred basis in the transferred property. Therefore, the basis in the property immediately after the sale would be the basis in the hands of the transferor immediately before the sale. That basis could be adjusted after the transfer, for items that would normally adjust basis (e.g., depreciation for depreciable property).

   b) **After the Death of the Grantor**

   After the transferor dies, the Federal income tax basis in the hands of the transferee (i.e., the irrevocable grantor trust) should be a transferred basis (i.e., the same basis immediately before the sale).
See the full discussion about the impact on basis and whether gain should be recognized on the death of the transferor/grantor in the section titled, Effect on Basis of Termination of Grantor Trust Status at Grantor’s Death, above in Sections XX.A.5 and XX.A.6.
XXIII.  PROBLEM BASIS SITUATIONS: BASIS AND SPECIAL USE VALUATION PROPERTY -- IRC § 2032A

A.  Generally

IRC § 2032A permits the executor of a decedent’s estate to value real estate and used in a closely-held business or family farm and certain personal property used in a family farm at its current use value, rather than its highest and best value.  This valuation can reduce the estate tax value of the assets by up to $1,090,000 for estates of decedents dying in 2014 ($750,000, indexed for inflation after 1997) for estates of decedents dying in 2012.  Rev. Proc. 2013-35 § 3.33, 2013-2 C.B. 537.

B.  Value for Basis.  IRC §1014(a)

The estate tax value of an asset for basis purposes of IRC § 1014(a) is its value under IRC § 2032A, if that section’s benefit is validly elected by the executor.  IRC § 1014(a)(3).

C.  Adjustment to Basis for Recapture Tax.  IRC § 1016(c)

1.  Recapture Tax Generally

The estate tax savings from a IRC § 2032A election are recaptured as an additional estate tax, if the use of the property is changed from a family business or farm, or the property is disposed of outside of the decedent’s family within ten years after the decedent’s death.  IRC § 2032A(c).

2.  Recapture Tax Added to Basis

a)  Full Recapture

If the recapture tax is imposed with respect to special use value property, the qualified heir can elect to increase the basis of the property by the amount of the estate tax value reduction allowed earlier by IRC § 2032A.  IRC § 1016(c)(1).

b)  Partial Dispositions

In the case of any partial disposition, the basis increase is proportionate, bearing the same to the total valuation adjustment as the amount of the recapture tax bears to the adjusted tax difference attributable to the entire interest.  IRC § 1016(c)(2).

c)  Time Adjustment Made

Any increase in the basis of property with respect to a recapture tax is deemed to occur immediately before the recapture disposition or cessation of use.  IRC § 1016(c)(3).

d)  Substituted Property

(1)  Involuntary Conversions

Where special use valued real property is the subject of an involuntary conversion (such as a condemnation) under IRC § 1033, no recapture tax is imposed if the cost of the qualified replacement property equals or exceeds the amount realized on such conversion, in light of the reinvestment of the proceeds in “qualified replacement property.”  IRC § 2032A(h)(1).  “ Qualified replacement property” means real property into which the special use valued property is converted or in which the proceeds are reinvested under IRC § 1033.  IRC § 2032A(h)(3).  The basis increase for a recapture tax imposed with respect to “qualified replacement
property” is made by reference to the involuntarily converted property. IRC § 1016(c)(4).

(2) Tax Free Exchange

Where special use valued real property is the subject of an like-kind exchange under IRC § 1031, no recapture tax is imposed if the cost of the qualified exchange property equals or exceeds the amount realized on such exchange, in light of the reinvestment of the proceeds in “qualified exchange property.” IRC § 2032A(i). "Qualified exchange property” means real property for which the special use valued property is exchanged. IRC § 2032A(i)(3). The basis increase for a recapture tax imposed with respect to “qualified exchange property” is made by reference to the exchanged property. IRC § 1016(c)(4).

3. The Election

The election to increase basis by the recapture tax under IRC § 2032A(c) must be made as provided by regulations, and once made is irrevocable. IRC § 1016(c)(5)(A). There are no such regulations, but the Publication 551 and the instructions to Form 706-A state that the election is made by filing with Form 706-A (reporting the recapture event and paying the recapture tax) and

- Checking the box on line 7 of Part I,
- Entering on line 20 of Part II the amount of the interest being paid on the additional estate tax due;
- Filing a statement that:
  - Contains your name, address, and taxpayer identification number and those of the estate;
  - Identifies the election as an election under IRC § 1016(c); and
- Specifies the property for which the election is made.

4. Interest on Recaptured Amount

A taxpayer who elects to increase basis must pay interest on the recapture tax, running from the original estate tax return due date to the date the recapture tax is paid. IRC § 1016(c)(5)(B). The potential interest expense means that one must compare the benefit of the basis with the detriment of the interest.
XXIV. PROBLEM BASIS SITUATIONS: BASIS AND THE GST TAX

A. Basis for Taxable Terminations Generally

1. IRC § 2654(a)(2)

IRC § 2654(a)(2) states that the basis of property transferred in a taxable termination that occurs at the same time as, and as a result of, the death of an individual, is adjusted for the GST tax imposed in a manner similar to that provided under IRC § 1014(a). If the inclusion ratio with respect to such property is less than one, however, any basis adjustment is limited by multiplying the adjustments by the inclusion ratio.

2. IRC § 2654(a)(1)

IRC § 2654(a)(1) states that the basis of property transferred in a generation-skipping transfer other than a taxable termination that occurs at the same time as, and as a result of, the death of an individual, the basis of such property shall be increased (but not above the fair market value of such property) by an amount equal to that portion of the GST tax attributable to the appreciation in the value of the transferred asset immediately before the transfer. This rule is applied after any basis adjustment under Section 1015 with respect to the transfer. This rule applies to direct skip transfers, taxable distributions, and taxable terminations other than those occurring upon the death of and on account of the death of an individual.

B. Taxable Termination Versus Taxable Distribution

Whether a generation-skipping transfer is a taxable termination or a taxable distribution can affect the income tax basis of the property involved and determine who bears liability for the tax. IRC §§ 2654(a), 2603. IRC § 2612(b) provides that a transfer that meets the definitions of both “taxable termination” and “taxable distribution” is a taxable termination. For example, where the trustee has discretion to distribute trust funds to the grantor’s children and grandchildren, a distribution of all of the trust assets to a grandchild is both a taxable distribution and a taxable termination. Under IRC § 2612(b), this is taxed exclusively as a taxable termination.

C. Certain Partial Terminations

IRC § 2612(a)(2) characterizes distributions to skip persons that occur on the death of a lineal descendant of the transferor as taxable terminations, rather than as taxable distributions. Reg. §§ 26.2612-1(b)(2) and 26.2612-1(f), Ex. 11. This rule is confusing and its purpose unclear. It can produce a favorable income tax result, however, because IRC § 2654(a) provides an increase in the adjusted income tax basis of an asset that is the subject of a taxable termination that occurs on an individual’s death, but not for a taxable distribution occurring at such a time.

Example XXIV-1

Transferor creates an irrevocable trust to pay income to Child-1 and Child-2, in such shares as the trustee deems appropriate. When the first child dies, half of the trust fund is to be paid to Transferor’s then-living grandchildren, and the balance of the trust fund will be paid to the then-living grandchildren when the later of the two children dies. Child-1 dies first, causing half of the trust fund to be paid to Transferor’s grandchildren. This is a taxable termination as to one half of the trust fund, rather than a taxable distribution, because the distribution is a distribution of a portion of the trust that occurs as a result of the death of a lineal descendant of Transferor. That the rest of the trust continues to be held for the benefit of Child-2 and the grandchildren, and that Child-2 is not a skip person, does not change this result. Reg. § 26.2612-1(f), Ex. 11.
XXV.  PROBLEM BASIS SITUATIONS: BASIS IN TRUST OR ESTATE DISTRIBUTIONS

A.  Generally

IRC § 643(e)(1) states that the basis of property received by a beneficiary in a distribution from an estate or trust is the adjusted basis of the property in the hands of the fiduciary immediately before the distribution, adjusted for any gain or loss recognized. The basis adjustment for the recognition of gain or loss, however, creates four possible options for the calculation of basis, depending upon the facts of the distribution.

B.  Distribution of Property in Satisfaction of a Specific Gift – No Recognition of Gain or Loss and Carryover Basis

A fiduciary recognizes no gain or loss on a distribution in satisfaction of a specific gift of property, if the fiduciary delivers to the beneficiary the exact property described in the will or trust. The beneficiary receives a carryover of the fiduciary’s adjusted basis. IRC § 643(e)(4).

C.  Distribution of Property in Satisfaction of a Pecuniary Gift or of a Specific Gift of Other Property -- Recognition of Gain or Loss and New Basis

1.  Kenan Rule

A fiduciary recognizes gain or loss on most distributions to a beneficiary in satisfaction of a right to a specific dollar amount or of a right to specific property other than the property that is actually distributed, and the beneficiary takes as a basis the fiduciary’s adjusted basis, increased by the recognized gain. Reg. § 1.661(a)-2(f)(1). This is sometimes called the Kenan rule, after an early case that held that an estate recognized a gain when it distributed property in kind to satisfy a fixed dollar legacy. Kenan v. Comm’r, 114 F.2d 217 (2d Cir. 1940); see also Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), aff’d, 83 F.2d 1019 (2d Cir.), cert. denied, 299 U.S. 621 (1936).

2.  Distributions of Property in Satisfaction of a Right to Income

The Kenan rule applies equally to a distribution of property in satisfaction of a right to income, as defined in IRC § 643(b). Reg. §§ 1.651(a)-2(d) and 1.661(a)-2(f). This requires such recognition and fair market value basis on a distribution of traditional income or income defined as a unitrust amount.

3.  Hybrid Gifts

a)  Generally

The regulations distinguish between gifts of pecuniary amounts or specific property on the one hand, and other types of testamentary transfers on the other; mandatory recognition of gain applies only to distributions of pecuniary amounts or specific property. Some instruments, however, provide for transfers that in form or substance, have characteristics of both types, and the question arises of which rule to apply to them.

b)  Rev. Rul. 66-207

In Rev. Rul. 66-207, 1966-2 C.B. 243, a decedent’s will provided for a pecuniary legacy of $250,000, but at distribution, the estate had assets worth only $200,000, in which the executor had a basis of $150,000. The IRS ruled that the gift was a pecuniary legacy, and gain had to be recognized on the distribution to the extent of the $50,000 accrued gain, even though the legatee received what was, in essence, a residuary distribution of the estate.
c) Rev. Rul. 72-295

In Rev. Rul. 72-295, 1972-1 C.B. 197, the IRS concluded that a bequest of $100,000 worth of stock, but not more than all of the shares of such stock owned at the decedent’s death, was neither a pecuniary legacy nor a gift of specific property distributed as such. The ruling states that the estate did not recognize gain on the distribution of shares in satisfaction of the legacy (which was actually less than the total number of shares outstanding), and that the distribution did carry out DNI. Rather, the distribution was treated as a residuary gift. Were these facts to occur today, the executor could elect to recognize gain on the distribution. It does seem that the beneficiary in this ruling was in much the same position as a pecuniary legatee whose gift is satisfied with appreciated property. The scope of extent this ruling is uncertain. For example, would it apply if a will provided for a gift of stock, and also for a contingent legacy of the difference between the value of that gift on the date of death and a set pecuniary amount.

d) Rev. Rul. 82-4

In Rev. Rul. 82-4, 1982-1 C.B. 99, a decedent’s will provided for an equal division of the testator’s estate between two children, after taking into account the value of an *inter vivos* gift that had been made to one of them. The *inter vivos* gift was shares of stock and the will directed that the date of death value of the shares be deducted from the share passing to that donee. The value of the entire estate at the time of distribution was less than the date of death value of the *inter vivos* gift, so the entire estate (which had appreciated since the date of death) was distributed to the other beneficiary. The IRS ruled that the will provided for a pecuniary legacy to the nondonee equal to the date of death value of the donated shares, in addition to a residuary gift of the excess to two beneficiaries, which abated the legacies entirely. The estate, therefore, was required to recognize gain on the distribution of its assets in satisfaction of a pecuniary bequest.

e) Rev. Rul. 83-75

In Rev. Rul. 83-75, 1983-1 C.B. 114, a charitable lead trust was required to recognize gain when it distributed appreciated assets to satisfy part of a charitable annuity. Gain was recognized to the extent of the excess of the value of the assets distributed in kind over the basis of those assets, even though the trustee did not have enough cash on hand from income or other sources to satisfy the required annuity payment in full.

D. Satisfaction of Pecuniary Gift with Loss Assets – Basis Adjusted for Disallowed Losses

IRC § 267 denies a fiduciary a deduction for a distribution of loss assets (those with an adjusted basis above their fair market value) in satisfaction of a pecuniary bequest. In such cases, the beneficiary does not include in gross income any gain realized on later sale or exchange of the distributed property, to the extent of the disallowed loss. Thus, in effect, the beneficiary gets a partial carryover of basis. IRC § 267(d). A fiduciary who wishes to dispose of a loss asset should usually sell the asset and distribute the proceeds, rather than distributing the asset in kind. The fiduciary can then deduct the recognized loss and use that loss to offset gains it may have or as the basis for a capital loss carryover. IRC § 1212.

E. Discretionary and Residuary Distributions – Elective Recognition of Gain and Carryover or New Basis

1. Generally

A fiduciary may elect to recognize a gain or loss on distributions of property not governed by one of the other three rules. IRC § 643(e). The distributions that fall into this category are discretionary distributions, whether charged to income or principal, and residuary distributions of principal. Generally, such distributions carry out distributable net income (DNI) equal to the adjusted basis of the
distributed asset in the fiduciary’s hands, and the beneficiary receives a basis equal to the basis in
the fiduciary’s hands. IRC § 643(e)(1). The fiduciary may, however, elect to recognize gain or loss
on the distribution as though it had sold the property to the beneficiary for its fair market value; the
fiduciary recognizes gain or loss and treat the amount distributed as the fair market value of the
property. IRC § 643(e)(3). For more on the IRC § 643(e) election, see also R.T. Danforth, N. Lane,
& H.M. Zaritsky, *Federal Income Taxation of Trusts and Estates* ¶ 4.11[1][d] (Thomson-Reuters/WG&L,
3d ed. 2001 & Supp. 2018 No. 1) (from which this discussion is largely derived); and
also Acker, *The Impact of TRA ‘84 on Trust and Estate Distributions of Property*, 124 Tr. & Est. 54
(Jan. 1985); Aucutt, *Tax Planning for In-Kind Distributions Increased by New Special Elections,
62 J. Tax’n 48 (Jan. 1985); Bolling, *Tax Planning and Pitfalls of the DRA’s In-Kind Property Dis-
tribution Rules*, 16 Tax Adviser 730 (1985); Fields, *Tax Benefits of Property Distributions by Trusts
and Use of Multiple Trusts Restricted*, 11 Est. Plan. 264 (1985); Freeland, Maxfield & Sawyer,
449 (1985); Gerhart, *Trust and Estate Income Taxes Changed by Tax Reform Act*, 124 Tr. & Est. 16
(Jan. 1985); Salzarulo, *When to Elect to Recognize Gain or Loss on Distributions of Estate or Trust
Property*, 13 Est. Plan. 38 (1986); Vogel and Steinkamp, *Distributions of Income in Respect of a
Decedent After the Tax Reform Act of 1984*, 10 Rev. Tax. Ind. 316 (Autumn 1986); Zeitlin,

2. **Nondeductibility of Elected Losses**

Although IRC § 643(e)(3)(A)(II) states that the entity recognizes a gain or loss when it makes this
election, IRC § 267 still precludes a deduction for the recognized loss. It is unclear what is the
beneficiary’s basis when a fiduciary elects to recognize loss on a distribution, which loss deduction
is then disallowed by IRC § 267. The beneficiary’s basis could be the fiduciary’s basis for all pur-
poses, or it could be, as IRC § 267(d) states, a basis for computing gain equal to the fiduciary’s basis
but a basis for computing loss equal only to the fair market value at the time of the distribution. IRC
§ 643(e)(1) states that the basis to the beneficiary is the adjusted basis to the estate or trust immedi-
ately before the distribution “adjusted for...any gain or loss recognized to the estate or trust on
the distribution.”

3. **Timing of the Election**

IRC § 643(e)(3)(B) requires the election to recognize gain or loss to be made on the fiduciary income
tax return for the year in which the distribution is made. The IRS will, however, occasionally permit
93-28, 1993-2 CB 344, set out the standards the IRS will use to determine whether to grant a dis-
cretionary extension under Reg. § 301.9100-1 of time to make an election when the due date of the
election is fixed by regulation rather than by statute. On the discretionary extension rules generally,
see also Gillett, *Substantial Compliance, the 9100 Regulations, and the Special Use Election*, 5

4. **DNI and the Election to Recognize Gain**

In the absence of an election to recognize gain, property distributed in kind is taken into account,
for purposes of computing the distribution deduction under IRC § 661 and the amount included in
the beneficiary’s income under IRC § 662, at the lesser of its adjusted basis to the fiduciary or its
fair market value at the time of distribution. When the fair market value limitation applies for pur-
poses of computing the distributions deduction and the amount includable in the beneficiary’s gross
income, however, the trust’s adjusted basis in the property still carries out to the beneficiary, unless
the fiduciary elects to recognize loss. Fiduciaries should not elect to recognize loss, however, be-
cause the loss is disallowed under IRC § 267, and the beneficiary may get only a partial, rather than
total, carryover of basis, as previously explained.

5. **Consistent Elections**
A fiduciary must make consistent elections for all distributions made during a single taxable year. No consistency is required between different taxable years. IRC § 643(e)(3)(B).

6. Revocation of Election

The IRC § 643(e) election, once made, may be revoked only with the consent of the Secretary. To date, this has been permitted only twice.

a) PLR 8822016

In PLR 8822016, a testamentary trust was to terminate when B turned 30, and when he did, trustee distributed to him a house in which B lived. Trust distributed to C, another beneficiary, ten acres of unimproved land. A vice president of Bank's trust department told C that the taxes had been taken care of and that, at most, C would have to pay a small capital gain of not more than $2,000. The property distributions were reflected on the trust's final tax return, which was prepared by Bank's tax department. During preparation a reviewer noticed that the basis of the property distributed to C exceeded the basis of the property distributed to B and became concerned that this difference would lead to a disproportionate sharing of DNI (which would have been about $4,000. Reviewer asked the return preparer to consider whether trust should make the IRC § 643(e)(3) election. The return preparer discussed the election with the trust's administrator and made the election, believing that it had been approved. The administrator, however, denied that the tax consequences were ever discussed and no one had any conversation with or considered the circumstances of B or C. The trustee mailed the final K-1s to B and C, each reflecting a capital gain exceeding $29,000 which was largely due to the IRC § 643(e) election. After C protested, Bank asked for consent to revoke the election. Both B and C joined in Bank's request and represented that: (1) retroactive tax planning was not the reason for seeking to revoke the election; and (2) the bases of the properties received will be the same in the hands of B and C as the hands of the trustee before the distributions. The IRS allowed the revocation, noting that (a) the trustee timely filed its final return; (b) the trustee was diligent in having that return prepared by Bank's tax department; (c) C was diligent in asking about the tax ramifications of the distributions; (d) C acted promptly when her K-1 did not comport with Bank's prior statements; (e) Bank promptly filed a request to revoke the IRC § 643(e) election after C's contact and after Bank's discovery of its error; (f) there was no evidence that B or C used a stepped-up basis (available only under the election) to calculate any gain, loss or deduction; and (g) there was no evidence that B, C, or the trust's administrator ever intended to have the election made.

b) PLR 9641018

In PLR 9641018, Bank was executor of A's estate and trustee of a testamentary trust. Bank prepared the estate's final Form 1041, reporting certain capital gains from the funding of the trust with appreciated assets. Bank made the IRC § 643(a)(3) election. When preparing the return, Bank was advised by its in-house accountants that the estate was required to recognize gains upon the funding of the trust, and that the IRC § 643(e)(3) election was made only because the gains were being reported, and not because the estate intended to recognize any gains that were not otherwise required to be reported. After filing the return, Bank discovered that, absent the IRC § 643(e)(3) election, the estate was not required to recognize gains upon the funding of the trust with appreciated assets. Immediately after this discovery, Bank submitted a request for permission to revoke the election. The IRS allowed the revocation, noting that: (a) the final income tax return for the estate was timely filed; (b) Bank was diligent in seeking advice from its accountants as to the appropriate treatment of funding the trust with appreciated assets; (c) the estate would not have made the election, but for Bank's mistaken understanding of the law; (d) the estate had no intent to recognize gain except to the extent required by law; (e) the bases of the assets transferred to the trust will be the same in the hands of the trustee as in the hands of the estate before
funding the trust; and (f) Bank promptly filed a request to revoke the election after it discovered its error.

7. **Planning with the IRC § 643(e) Election**

The decision whether or not to make a IRC § 643(e)(3) election will often be difficult; many variables can affect its desirability. The fiduciary should consider the following factors:

- The respective current and probable future marginal tax rates of the entity and beneficiary;
- The likelihood of sale by the beneficiary in the near future;
- The trade-off between capital gain and higher basis for depreciation, if the appreciated asset is depreciable following its distribution to the beneficiary;
- The availability of capital loss carry-forwards to one party or both; and
- The requirement for consistent treatment of all distributions.

F. **Combining a Deduction and a Basis Increase – IRC § 642(g)**

1. **Limit on Double Deductions Generally**

IRC § 642(g) states that amounts allowable as estate tax deductions under IRC § 2053 or 2054 cannot also be allowed as an income tax deduction or as an offset against the sales price of property in determining gain or loss. If one wants to claim deductions on the Form 1041, one must also file, within the time and in the manner and form prescribed by the Secretary, a statement that the amounts have not been allowed as deductions under IRC § 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under those sections. Similar rules apply to amounts taken into account under IRC §§ 2621(a)(2) (expenses taken into account in calculating the amount of a taxable distribution) or 2622(b) (expenses taken into account in calculating the amount of a taxable termination).

2. **Is Basis Increase a Double Deduction?**

In *Long v. Comm’r*, 71 T.C. 724 (1980), *aff’d on other issues* 660 F.2d 416 (10th Cir. 1981), the Tax Court held that an estate whose decedent was a member of a partnership could both deduct its share of partnership liabilities paid out of estate funds as a claim against the estate under IRC § 2053, and also increase its basis in the partnership interest by the liabilities so paid, thereby generating a larger capital loss on liquidation of the estate's partnership interest. The rationale of Long appears applicable despite the present IRC § 642(g) which was enacted in 1976. *Long* involved pre-1976 taxable years, and the court noted that IRC § 642(g) (as it then read) only barred deductions, and that an increase in basis is not the same as a deduction, though it may potentially increase future deductions.
XXVI. PROBLEM BASIS SITUATIONS: BASIS FOR CERTAIN NON-CHARITABLE INTERESTS IN CHARITABLE REMAINDER TRUSTS – BEWARE THE PROPOSED REGULATIONS

A. Notice 2008-99 – Disposition of a Charitable Remainder Trust Annuity or Unitrust Interest

In Notice 2008-99, 2008-47 I.R.B. 1194 (Nov. 24, 2008), the IRS and Treasury described a transaction in which all of the interests in a charitable remainder trust are sold, after a contribution of appreciated assets to the trust and the reinvestment of those assets by the trustee.

1. The Claim

Promoters of this arrangement claimed that it results in the grantor or other noncharitable recipient receiving the value of that person’s trust interest, with little or no taxable gain.

2. Primary Variation

In one variation of the transaction, the grantor funded a charitable remainder trust with appreciated assets, retaining the noncharitable interest and the right to designate the charitable remainder beneficiary. The trust then sold or liquidated the appreciated assets and reinvested the net proceeds in other assets, such as money market funds or marketable securities, often creating a diversified portfolio. No tax was due on the sale, because the trust was a charitable remainder trust. The trust’s basis in the new assets is their purchase price. Next, the grantor and the charity would sell or otherwise dispose of their respective interests in the trust to an unrelated third party, for an amount that approximated the current fair market value of the trust assets. The promoters contended that this joint disposition is (a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons, as described in IRC § 1001(e)(3), and that the grantor and the charity each can apply their proportionate share of the trust’s adjusted basis against the amount realized, to avoid taxable gain on the transaction. The trust then terminated, and the trust assets were distributed to the buyer.

Example XXVI-1

Grantor, an individual, creates a charitable remainder unitrust on Date 1 and retains the unitrust interest. Grantor funds the trust with stock in which Grantor’s basis is $10x. The trustee thereafter sells the stock for $100x, realizing a $90x long-term capital gain, which gain is exempt from income tax under IRC § 664(c)(1). The trustee applies the sales proceeds, $100x, to buy Y stock. The trustee thereafter sells the Y stock for $110x and applies the proceeds to buy Z stock. The trustee’s basis in the Z stock is then $110x, and the trust’s undistributed net capital gains are $100x.

The fair market value of trust’s assets grows to $150x and the trust has no undistributed net ordinary income. Grantor and the remainder beneficiary jointly sell all of their interests in the trust to a third person, dividing the proceeds actuarially. Grantor receives $100x for the unitrust interest, and Charity receives $50x for the remainder interest. The entire interest in the trust was transferred to the third person, so IRC § 1001(e)(3) states that Grantor’s gain is determined using as Grantor’s basis Grantor’s actuarial share of the $110x adjusted uniform basis -- $73 1/3x. Grantor receives $100x but pays capital gains tax on only $26 2/3x. Grantor’s built-in gain on the creation of the trust had been $90x.

3. Other Variations

Some variations of this transaction used a net income charitable remainder unitrust with make-up provision (NIMCRUT) or a pre-existing charitable remainder unitrust or NIMCRUT (often holding the appreciated assets contributed to the trust). In some variations, the recipient and seller of the term interest would be the grantor and/or another person, or the grantor might contribute the appreciated assets to a partnership or other pass-through entity and then contribute the interest in the entity to the trust.
4. Transactions of Interest

The Notice classified these transactions as “transactions of interest,” and added that:

“The IRS and Treasury Department are not concerned about the mere creation and funding of a charitable remainder trust and/or the trust’s reinvestment of the contributed appreciated property, and such events alone do not constitute the transaction subject to this notice. However, the IRS and Treasury Department are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale or other disposition of appreciated assets.”

B. New Regulations Offer a Solution

In 2017, Treasury amended the income tax regulations to add a special rule for the sale or other disposition of a unitrust or annuity interest in a charitable remainder trust, where the entire trust is being disposed of. Reg. § 1.1014-5(b). The regulations state:

“(b) Sale or other disposition of certain term interests—(1) In general. In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010), that part of the adjusted uniform basis assignable under the rules of paragraph (a) of this section to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001-1(f). reduce the Grantor’s basis by a share of the trust’s undistributed net ordinary income and its undistributed net capital gains.”


Example XXVI-2

Assume the same facts as in the prior example, except that the proposed regulations have been finalized. Grantor’s adjusted basis will be reduced by Grantor’s share of the undistributed net ordinary income ($0) and Grantor’s share of the undistributed net capital gain ($100x). Grantor’s adjusted basis will be 2/3 x ($110x - $100x), or $6.67x, and Grantor will recognize a $93.33x gain on the sale of the annuity or unitrust interest. Reg. § 1.1014-5(d), Ex. 7.
XXVII. PROBLEM BASIS SITUATIONS: BASIS AND LIFE INSURANCE POLICIES

A. Generally

Generally, an insured's basis in the contract is the total premiums the insured had paid, reduced by the “cost of insurance protection” provided throughout the date of the sale, and nontaxable dividends the insured has received under the contract. Rev. Rul. 70-38, 1970-1 C.B. 11. The premiums paid, less the “cost of insurance protection,” are equal to those portions of the premiums paid that increase the cash surrender value of the policy. See, e.g., London Shoe Co. v. Comm'r, 80 F.2d 230 (2d Cir. 1935); Century Wood Preserving Co. v. Comm'r, 69 F.2d 967 (3d Cir. 1934); Keystone Consol. Publ'g. Co. v. Comm'r, 26 B.T.A. 1210 (1934). See also PLR 9443020 (Oct. 28, 1994) (amounts paid to a dying individual by a viatical settlement company on the assignment of his life insurance contract was a sale of the policy, but the gain was limited to the excess of the amount paid over the insured's basis in the policy, including the total premiums the insured had paid, reduced by the “cost of insurance protection” provided throughout the date of the sale and nontaxable dividends he received under the contract. The IRS also stated that, absent proof to the contrary, the cost of insurance protection is essentially the difference between the total amount of premiums paid and the policy's cash value (after any surrender charges)).

B. ILS 200504001 – Policy Basis in a Strange Context

1. Facts

In Internal Legal Memorandum 200504001, the taxpayer owned two life insurance policies issued by the same insurer. One policy insured the taxpayer's own life, and the other insured the life of her ex-husband. The insurer reduced the death benefit payable under the policy insuring the taxpayer's ex-husband's life, after the taxpayer had paid premiums for five years. The taxpayer later surrendered the policy on her own life. The taxpayer claimed that the insurer made several misrepresentations to encourage her to convert the policy on her ex-husband's life. Primarily, the insurer claimed that no additional premiums would be necessary if the taxpayer used the policy's cash surrender value to pay for a new policy. The insurer lied.

The taxpayer was a member of a class of policyholders that sued the insurer, claiming that it had “fraudulently induced class members to surrender, borrow against or otherwise withdraw values from their existing policies in order to purchase new policies.” The class also claimed that the insurer had “misrepresented the true financial effect of the transaction and uniformly failed to disclose to class members that the switch was against the best interests of the class members.”

The taxpayer and the class won their court case, and in 2001, the taxpayer received an award. Part of the award represented interest, which the taxpayer agreed was ordinary taxable income. None of the award represented punitive damages, which would also have been ordinary taxable income.

2. Taxpayer’s Arguments

The taxpayer contended that the balance of the award (above the interest portion) was a tax-free recovery of the premiums and costs she had paid with respect to the policy. She had paid these amounts with after-tax dollars, so the recovery should be tax-free, she claimed.

3. IRS Agent and Area Counsel Arguments

The IRS revenue agent and the IRS Area Counsel claimed that not all of the non-interest damages were tax-free, because the taxpayer had, for five years, received the benefit of the original policy through present insurance coverage on the life of her ex-husband. The taxpayer now had the benefit of the replacement life insurance policy. Thus, the revenue agent and area counsel argued, no portion of the taxpayer's payments for the life insurance policy on her ex-husband's life could offset the taxable portion of the award.

The IRS National Office agreed that the taxpayer was not taxable on that portion of the award that merely compensated her for a loss of pre-tax dollars, because she would have no economic gain that could be taxed. The question, they said, was how much was the taxpayer's basis in the policy on her ex-husband's life, because that would be the measurement of her loss. The IRS relied primarily on the 1934 Third Circuit decision in Century Wood Preserving Co. v. Comm'r, supra., and Rev. Rul. 70-38, 1970-1 C.B. 11, and stated that the taxpayer had already had the benefit of the annual insurance protection, and that her basis included only the excess premiums that increased the policy's cash surrender value. The IRS stated that the basis of the taxpayer's former policy on the life of her ex-husband was the premiums she had paid, less:

1. The cost of insurance protection provided through the date of sale (e.g., loading, expense, and mortality charges, and administrative fees); and

2. Amounts received under the contract that have not been included in the taxpayer's gross income.

The IRS stated, in part, that the taxpayer's taxable income from the award should not be reduced for the cost of the benefit provided for five years, or the value of the replacement policy that the taxpayer received. Those benefits were separately provided to the taxpayer and should not be deemed to increase her loss.

C. Rev. Ruls. 2009-13 and 2009-14


a) Situation 2. Sale of a Cash Value Life Insurance Policy

(1) Facts

In Situation 2, A, a cash method, calendar year individual who bought and owned an insurance contract on A’s own life. The policy had cash values and the named beneficiary was a member of A’s family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The contract was a capital asset in A’s hands. On June 15 of Year 8, A sold the contract to B, an unrelated person, for $80,000. B would suffer no economic or personal loss upon A’s death.

(2) IRS Analysis and Ruling

(a) Gain Realized

The IRS ruled that A’s gain on the sale was the excess of the amount realized by A on the sale, over A’s adjusted basis in the contract. IRC §§ 1011 and 1012. A realized $80,000 -- the sum received on the sale.

(b) Adjusted Basis
A’s adjusted basis in the insurance contract was its cost, adjusted to reflect expenditures, receipts, losses, or other items properly chargeable to capital account. IRC § 1016(a)(1). The IRS reduced A’s basis by the cost of the pure life insurance protection prior to the sale. London Shoe Co. v. Comm’r, supra.; Century Wood Preserving Co. v. Comm’r, supra.; and Keystone Publishing Co. v. Comm’r, 26 B.T.A. 1210 (1932). The IRS measured the cost of insurance by the $10,000 by which the insurer reduced the cash surrender value to reflect cost-of-insurance charges. Thus, A’s adjusted basis in the contract was $54,000 ($64,000 premiums - $10,000 cost of insurance), and A recognized a $26,000 gain ($80,000 - $54,000).

(c) Character of Gain

The IRS applied the “substitute for ordinary income doctrine,” which converts part of the gain on a sale into ordinary income, because neither "property" nor “capital asset” includes “property representing income items or accretions to the value of a capital asset themselves properly attributable to income.” United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965); Comm’r v. P. G. Lake, Inc., 356 U.S. 260 (1958); Arkansas Best Corp. v. Comm’r, 485 U.S. 212, 217, n. 5 (1988); Prebola v. Comm’r, 482 F.3d 610 (2d Cir. 2007); United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004); Davis v. Comm’r, 119 T.C. 1 (2002). This doctrine is limited to the amount that would be recognized as ordinary income if the contract were surrendered, which the IRS said was the inside build-up under the contract -- the excess of the cash surrender value over the premiums paid. Capital gains treatment is afforded the excess of the gain realized over the inside build-up. Comm’r v. Phillips, 275 F.2d 33, 36 n. 3 (4th Cir. 1960). Here, the inside build-up under A’s life insurance contract immediately prior to the sale was $14,000 ($78,000 cash surrender value less $64,000 aggregate premiums paid). A must recognize $26,000 of gain, of which $14,000 is ordinary income and $12,000 is capital gain.

b) Situation 3. Sale of Term Life Insurance Policy

(1) Facts

The facts in Situation 3 were identical to those in Situation 2, except that the contract was a level premium fifteen-year term life insurance contract with no cash surrender value. The monthly premium was $500 and A paid a total of $45,000 in premiums through the date of sale. A sold the policy to B for $20,000.

(2) IRS Analysis and Rulings

The IRS applied the same rules that it used in Situation 2, noting that the amount realized from the sale was the $20,000 that A received from B.

(a) Basis

The IRS stated that, absent any other proof, the cost of the pure life insurance protection would be presumed to be equal to the entire premium paid. Therefore, $44,750 of the total premium payments was attributable to pure life insurance protection and was not included in A’s adjusted basis. A’s adjusted basis was $250 (the unexpired portion of the last premium), and A would recognize a gain of $19,750 on the sale ($20,000 amount realized - $250 basis).
(b) Character of Gain

The IRS explained, further, that the entire gain would be capital gain, because there was no investment component to which the substitution for income doctrine could apply.

c) The Tax Cuts and Jobs Act of 2017


2. Rev. Rul. 2009-14

In Rev. Rul. 2009-14, 2009-1 C.B. 1031, the IRS also issued this ruling addressing the income tax consequences to the third-party buyer of a life insurance contract, regarding the collection of the death benefit or the resale of the policy. This ruling also posited three situations.

a) Situation 1: Receipt of Death Benefit by Third Party Purchaser

(1) Facts

B, a cash basis, calendar year, U.S. taxpayer bought a life insurance contract on the life of A. The sale occurred on June 15, 2008 and the sales price was $20,000. The contract originally issued to A on January 1, 2001, by a domestic insurer, and, was a level premium fifteen-year term life insurance contract with no cash surrender value. At the time of purchase, the remaining term of the contract was 7 years, 6 months, and 15 days. The monthly premium was $500, payable on the first day of each month. After the purchase, B continued to pay the premiums. B had paid $9,000 of premiums by December 31, 2009, when A died. The insurer paid a $100,000 death benefit to B. B had no insurable interest in A’s life and B bought the contract with a view to profit, promptly naming itself beneficiary. The contract in B’s hands was a capital asset. The likelihood that B would allow the contract to lapse by failing to pay any of the remaining premiums was remote.

(2) IRS Analysis and Rulings

(a) Basis and Realization of Gain

The IRS ruled that B must recognize $71,000 of ordinary income on the receipt of death benefits. The amount realized was $71,000 ($100,000 death benefit - $20,000 sales price - $9,000 premiums), and B can exclude from gross income the $20,000 B paid for the policy and the $9,000 of premiums B paid after the sale.

(b) Character of Gain

The IRS stated that the gain on the receipt of the death benefit is ordinary income, because although the policy might be a capital asset in B’s hands, neither the surrender of a life insurance contract nor the receipt of a death benefit from the issuer under the terms of the contract is a sale or exchange. Therefore, all realized gain must be taxed as ordinary income.
b) Situation 2: Resale of the Contract by the Buyer

(1) Facts

The facts in Situation 2 were identical to those of Situation 1, except that B resold the policy to C, a person unrelated to A or B. The sale occurred on December 31, 2009, and the sales price was $30,000.

(2) IRS Analysis and Rulings

(a) Basis and Realization of Gain

The IRS ruled that B should recognize a $1,000 capital gain on this sale. The IRS stated that B’s gain on the resale of the contract would be the amount realized by B on the resale ($30,000) over B’s adjusted basis in the contract ($29,000).

As in Situation 1, B’s adjusted basis in the contract included both the amount B paid to A for the contract ($20,000) and the premiums B paid after the purchase to maintain the policy in force ($9,000).

The IRS explicitly stated that “B is not required to reduce its basis in the life insurance contract by any cost of insurance charges that may have been imposed,” because B is wholly unrelated to A, the policy was not bought to protect B against any economic loss upon A’s death, B bought the policy solely with a view to profit, and the additional premiums were paid solely to prevent the loss of B’s financial investment. Thus, B’s basis for a resale is computed differently from A’s basis on the initial sale.

(b) Character of Gain

The IRS stated that the gain on the resale was a capital gain, because the policy was property owned by B and was not described in any of the exceptions from the definition of a capital asset under IRC § 1221(a), and because there was a sale or exchange. Assuming that B meets the holding period requirements, B’s gain on the resale is taxable as a long-term capital gain. The substitute for ordinary income doctrine will not apply, because the contract was a term contract with no cash value.

(3) Effective Date.

While Rev. Rul. 2009-13 stated that it was not retroactive, Rev. Rul. 2009-14 contains no such representation. Therefore, this ruling should be applied retroactively.