Determining the Income Tax Basis of Property Gratuitously Transferred to Grantor Trusts

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[i]In the current financial climate, where it is not uncommon that the fair market value of assets held by a grantor trust has fallen below the grantor's basis, the determination of the income tax basis of property gratuitously transferred to grantor trusts has taken on renewed importance. Specifically, the question is whether the grantor trust rules of I.R.C. §§ 671-679 (the "grantor trust basis rules") or the basis rules for gifts in I.R.C. § 1015 (a) and (b) (the "gift basis rules") are applicable. With the exception of Rothstein v. U.S., 735 F.2d 704 (2d Cir. 1984) and Revenue Ruling 85-13, 1985-7 I.R.B. 28, 1985-1 C.B. 184, the I.R.S.'s response to Rothstein, this question has received little attention since the 1940's. This article presents a rationale for the application of the grantor trust basis rules to the exclusion of the gift basis rules.

Example:

A simple example demonstrates how the application of the grantor trust basis rules differs from that of the gift basis rules.

> *A owns property in which A's basis is $50,000 (the Property). A is the Grantor of a grantor trust ("GT"). A transfers the Property to the trustee of GT. The fair market value of the Property at the time of the transfer is $30,000. One year later, the property is distributed from GT to B, the remainder beneficiary of GT. B is unrelated to A.*

The following questions arise from the example:

(1) What is the basis of the Property in the hands of the trustee of GT?
(2) What is the basis of the Property in the hands of B?

The answer to the first question is uncontroversial. Because GT is a grantor trust, under both the grantor trust basis rules and the gift basis rules the basis of the property in GT is $50,000, the same as its basis in the hands of A.

The answer to the second question depends on whether the grantor trust basis rules or the gift tax basis are utilized.

> Grantor Trust Basis Rules. If the grantor trust basis rules apply, the basis of the property in B's hands is determined at the time it is distributed to B. At that time, for income tax purposes, B's basis in the Property is the same as A's, or $50,000. The transfer from A to B through GT is not treated as a gift from A to B for income tax purposes.

> Gift Basis Rules. If the gift basis rules apply, the transfer from A to B would be treated as a gift from A to B. B's basis in the property would not be determined until B disposes of the property. B's basis would be $50,000 for purposes of determining gain and $30,000 for purposes of determining loss. If B sells the property for $40,000, B would realize neither gain nor loss.

Fundamental Principles of Grantor Trusts:

The analysis of the problem properly begins with a review of some of the fundamental principles of the income taxation of grantor trusts:

1. Because the grantor has powers allowing him to exercise "dominion and control" over the property in a grantor trust, the grantor is taxed as the owner of income accruing to the trust. A beneficiary to whom such income may be distributed is not taxed. Treas. Reg. § 1.671-2(b).

2. The grantor of a grantor trust is treated as actual owner of the trust property for all income tax purposes. Treas. Reg. § 1.671-2(c). In computing grantor's tax liability, the grantor "takes into account all items of income, deduction and credit … to which he would have been entitled had the trust not been in existence during the period he is treated as owner." Treas. Reg. § 1.671-3(a)(1). [ii]

3. The grantor is treated as the owner of "any portion of a trust ... where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both." I.R.C. § 676(a).

4. By attributing the income of a grantor trust to the grantor, the Code effectively disregards the trust entity. Estate of O'Connor v. Commissioner, 69 T.C. 165, 174 (T.C. 1977).

5. A grantor is defined as a person who makes gratuitous transfers to a grantor trust. A gratuitous transfer is any transfer other than a transfer for fair market value. A transfer is for fair market value "only to the extent of the value of the property received from the trust, services rendered by the trust, or the right to use property of the trust. Treas. Reg. § 1.671-2(e)(2)(ii). A person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust. Treas. Reg. §1.671-2(e)(1).

6. The Treasury Regulations distinguish between the income taxation and the gift taxation of transfers to grantor trusts. The transfer of property to a grantor trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes. Treas. Reg. §1.671-2(e)(2)(i).[iii] The transfer of property from a grantor to a grantor trust is not treated as a transfer of property by gift. I.R.C. § 2511(c). I.R.C. § 2511 (c) provides that "a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under [the grantor trust rules in Code Sections 671 to 679]" (*emphasis added*).

Principles of Taxation of Transfers to Grantor Trusts

The principles of the income taxation of transfers to grantor trusts are most clearly set forth in Rev. Rul. 85-13, 1985-7 I.R.B. 28, 1985-1 C.B. 184, which holds that property transferred gratuitously to a grantor trust retains the grantor's cost basis. Rev. Rul. 85-13 was issued by the I.R.S. in direct reaction to Rothstein v. U.S., 735 F.2d 704, which remains the only unreversed case ruling that a grantor trust has a separate taxable existence, enabling a grantor to receive a basis equal to the purchase price in stock he purchased from a grantor trust.

Rev. Rul. 85-13 states that a transaction such as an asset sale between the grantor and a grantor trust cannot give rise to any taxable income because the transaction is treated as a transfer between the grantor and him/herself. *See generally* Dobson v. Commr, 1 B.T.A. 1082 (1925); PLR 9230021; PLR 9535026; PLR 9525032; PLR 9519029; and PLR 9345035 (all concluding that no gain or loss is realized on transfers by a grantor to a grantor trust and that transfers are disregarded for income tax purposes). There is no change in the adjusted basis and holding period of stock "sold" by a grantor to a grantor trust. PLR 9508007; PLR 9535026. *See also* Rev. Rul. 88-103, 1988-2 C.B. 304 (grantor trust's purchase of replacement property can qualify the individual's gain for nonrecognition treatment under I.R.C. § 1033) and Rev. Rul. 87-61, 1987-2 C.B. 219 (transfer of appreciated property to foreign trust is not subject to the tax under I.R.C. §1491 (1954) (repealed 1997) when grantor treated as the owner of the trust under I.R.C. §§ 671-679).

Similarly, no gain or loss is realized on sales between trusts that are treated under the grantor trust rules as owned by the same grantor. Rev. Rul. 2007-13, 2007-11 I.R.B. 684.

It follows, then, that property which had been gratuitously transferred to grantor trust can take on a new basis for income tax purposes only at the time when the grantor gives up dominion or control over the property, or when the property is no longer held by trust.[iv] The relinquishment of dominion and control can be a realization event for the grantor. For example, if the property is sold, the gain on the sale is taxed to the grantor. Rev. Rul. 85-13. When the property is no longer taxable to the grantor, it must assume a new basis in the hands of its current owner. In the case of a gratuitous transfer, where there has been no sale, the property retains the grantor's basis in the hands of the new non-grantor owner. Here are some examples of when and how the new basis is determined:

1. Change in status of the trust.

   When the grantor of a trust renounces the power that causes the trust to be a grantor trust, the grantor is deemed to have transferred the assets and liabilities in the trust to the trust, for income tax purposes. The grantor has given up dominion and control, and the trust is now a separate taxable entity. Madorin v. Commr., 84 T.C. 667 (1985). *See also* Treas. Reg. 1.1001-2(c), Example 5 (1980), Rev. Rul. 77-402, 1977-2 C.B. 222 and TAM 200011005, G.C.M. 37228 (Aug. 23, 1977). (Note that the transfer is deemed to occur only for income tax purposes and does not result in a taxable gift to the trust.)

2. Distribution of property from an irrevocable grantor trust to a non-grantor beneficiary.

   The basis of property distributed to a beneficiary is the grantor's basis, rather than the fair market value at the time of distribution. Newman v. Commr.., 4 T.C. 226 (1944) (distribution from grantor trust to grantor's child is not to be viewed as effecting a gift to the child on the date of distribution). This holding was based on I.R.C. § 113(a) (3) (1938).[v]
   Newman, whose explanation of the grantor trust basis rules remains the most expansive in the case law, cites Regulations 103, sec. 19.113(a) (3) (1), which states that the grantor's basis "applies whether the property be in the hands of the trustee or the beneficiary and

whether prior to the termination of the trust and distribution of the property or thereafter." 4 T.C. 228. The facts that the income of the trust may be taxable to the grantor and that the gift is not complete for gift tax purposes does not enter into the determination of the proper basis.

3. Transfer of appreciated property to a foreign trust.

The transfer of appreciated property to foreign trust results in deemed sale of property for its fair market value. I.R.C. § 684; Treas. Reg. 1.684-2(e)(2), Example 1 (ii) and Example 3 (ii).

4. Reversion of property to the hands of the grantor.

When property transferred to a grantor trust is reconveyed to the grantor under the terms of the trust instrument at the termination of the trust, its basis for gain or loss is the same as the cost basis of the property in the hands of the grantor upon the original conveyance to the trust. Rev. Rul. 72-406, 1972-2 C.B. 462; Pierre S. DuPont v. Commr., 18 B.T.A. 1028 (1930).

To be sure, these examples do not cover the universe of possible transfers from grantor trusts to non-grantors. Nevertheless, they serve to confirm the nonrecognition treatment of property gratuitously transferred to a grantor trust that is set forth in Rev. Rul. 85-13. They also confirm that this treatment is consistent with the treatment of grantor trust basis questions since the early decades of the twentieth century. Although the holding of Rothstein still stands in the Second Circuit, it has been ignored by other circuits and sidestepped by the I.R.S.

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[ii] Note also that the income of a grantor trust is not taxed to the grantor if it is taxable to the grantor's spouse under IRC § 71 (alimony and separate maintenance) or IRC § 682 (income of estate or trust payable to spouse in case of divorce or separate maintenance).

[iii] The common law definition of a "gift" to a grantor trust is limited to gratuitous transfers to irrevocable trusts: where the settlor of an irrevocable inter vivos trust reserves an interest in him/herself, the trust is not a "gift" for income tax purposes, but where the settlor does not reserve any interest in him/herself, the trust is a "gift." Russell v. Bowers, 27 F. Supp. 13 (D.C. New York, 1939).

[iv] This is consistent with the rules defining the time of a donee's acquisition of gifted property in I.R.C. 1015. The time of acquisition is defined as the date "when the donor relinquishes dominion over the property." Treas. Reg. §1.1015-1(c). The loss of dominion or control over property also determines the completion of a gift and the donor's concomitant liability for gift tax. A gift is completed "when the donor has so parted with dominion and control as to leave him no power to change its disposition whether for his or her own benefit or for the benefit of another." Treas. Reg. §§ 25.2511-2(b); *see also* Burnet v. Guggenheim, 228 U.S. 280 (1933).

[v] "Transfer in trust after December 31, 1920 – If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a bequest or devise) the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made."