

Estate & Succession Planning Corner

By Lawrence I. Richman

Basis Step Up for Grantor Trust Assets Not Included in Grantor's Taxable Estate

Estate planners know that under Rev. Rul. 85-13¹ transactions between a grantor and a trust treated as taxable to such grantor are ignored for income tax purposes. Thus, a grantor and a grantor trust cannot engage in a sales transaction that is recognized for income tax purposes. Accordingly, for income tax purposes there has been no sale or exchange, and no gain is recognized under Code Sec. 1001 unless liabilities exceed basis and as a result of the disposition, the taxpayer has extinguished a liability in whole or in part. In such an event, the taxpayer recognizes income on account of release from such liability.²

But what about the basis of the property owned by the grantor trust?

It is fairly clear that during the lifetime of the grantor while the trust is a grantor trust, the trustee's basis in the property of the trust is the same as the grantor's basis. Planners know this because under the income tax rules, the grantor of a grantor trust is considered the owner of trust property for income tax purposes,³ effectively disregarding the trust as such.⁴

All property owned by a grantor trust eventually ceases to be treated as owned by the grantor. The grantor may die, cease having dominion or control during lifetime or the property may be transferred by sale to a third party or by distribution to one or more beneficiaries of the trust. A sale to a third party causes gain to be recognized to the grantor.⁵ In the case of a distribution from the grantor trust to a beneficiary during the grantor's lifetime, either the grantor trust basis rules or the gift tax basis rules apply. The repeal of Code Sec. 2511(c), which had held that the gift tax basis rules under Code Sec. 1015 do not apply to



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gifts to grantor trusts, supports the view that the gift tax basis rules apply to such transfers.

What then of the grantor trust that terminates by reason of the death of the grantor. In such an event, what occurs with respect to the basis of the assets in the trust? The recent release of LTR 201245006⁶ provides insight regarding how the basis of property acquired from a decedent rules of Code Sec. 1014 apply to the termination of a grantor trust where the property in such trust is not otherwise includable in the estate of the grantor.

In LTR 201245006, the representative of a nonresident alien grantor asked the IRS how to determine the basis of property upon the death of said grantor for property owned by an irrevocable non-U.S. situs trust. Significantly, the IRS determined in the LTR that said irrevocable non-U.S. situs trust was taxable as a grantor trust for U.S. income tax purposes. The IRS ruled that the basis of the property held in the trust would be the fair market value of such property at the date of the grantor/taxpayer's death, in accordance with Code Sec. 1014(a). The IRS reasoned that the usual basis step-up rule of Code Sec. 1014(b)(9) did not apply because "property does not include property that is not includable in the decedent's gross estate, such as property [in the instant situation] not situated in the United States acquired from a nonresident who is not a citizen of the United States."⁷

Instead, the IRS reasoned that upon the termination of the foreign grantor, grantor trust, "Taxpayer's issue will acquire, by bequest, devise or inheritance, assets from Trust at Taxpayer's death. The assets acquired from Trust are within the description of property acquired from a decedent under Section 1014(b)(1). Therefore, Trust will receive a step-up in basis in Trust assets under Section 1014(a) determined by the fair market value of the property on the date of Taxpayer's death."⁸ The IRS cited Rev. Rul. 84-139⁹ in support of its conclusion. That revenue ruling provided that a U.S. person will receive a basis adjustment under Code Sec. 1041(a) for foreign real estate inherited from a nonresident alien.

While the ruling does not explicitly say that assets passing to the beneficiaries of an irrevocable grantor trust upon the death of the grantor constitute property

acquired by bequest, devise or inheritance, it seems implicit that assets passing on account of the death of the grantor represent property acquired by bequest. The inherent symmetry of looking to Code Sec. 1015 for the basis of property received on account of lifetime distributions from irrevocable grantor trusts and Code Sec. 1014 for the testamentary determination of basis with respect to such trusts is logical.

LTR 201245006 is potentially an important step in the IRS's clarification of the basis rules as they relate to irrevocable grantor trusts. Previously, taxpayers had sought insight on the basis step-up issue from CCA 200937028, which expressed the opposite conclusion. Although taxpayers assumed that the trust in CCA 200937028 was a grantor trust because the taxpayer reserved the power to substitute assets, the IRS

never ruled on the income tax status of the trust. In CCA 200937028, the IRS quoted Reg. §1.1014-1(a) and stated "Property acquired from the decedent includes, principally ... property required to be included in determining the value of the decedent's

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gross estate under any one of the provisions of the [Internal Revenue Code]."¹⁰ One of the difficulties taxpayers had with CCA 200937028 was that it seemed to read Code Sec. 1014 as if the only provision providing for a basis step-up was Code Sec. 1014(b)(9), ignoring the several subsections that expressly allow for a basis step-up for property not necessarily included in determining the value of a decedent's gross estate. The conclusion stated in CCA 200937028 provided no guidance on the application of Code Sec. 1014(b)(1) to irrevocable grantor trusts. Said conclusion stated, "Based on my 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 Section 1014, unless the property is included in the gross estate for federal estate tax purposes as per Section 1014(b)(9)."¹¹

LTR 201245006 seems to recognize the limitations of CCA 200937028 when it cites Reg. §1.1014-2(b)(2) and notes that "Section 1014(b)(9) property does not include property that is not includible in the decedent's gross estate."¹² By expressly stating that upon termination of the irrevocable foreign situs grantor trust, "Taxpayer's issue will acquire by

bequest, devise, or inheritance, assets from Trust at Taxpayer's death. The assets acquired from Trust are with the description of property acquired from a de-

cedent under Section 1014(b)(1),¹³ the IRS provides taxpayers with guidance regarding the application of basis step-up rules to irrevocable grantor trusts.

ENDNOTES

¹ Rev. Rul. 85-13, 1985-1 CB 184.

² *B. Madorin*, 84 TC 667, Dec. 42,023 (1985).

³ Reg. §1.671-2(c).

⁴ *Estate of A.L. O'Connor*, 69 TC 165, Dec. 34,726 (1977).

⁵ Rev. Rul. 85-13, 1985-1 CB 184.

⁶ LTR 201245006 (July 19, 2012).

⁷ *Id.*

⁸ *Id.*

⁹ Rev. Rul. 84-139, 1984-2 CB 168.

¹⁰ Reg. §1.1014-1(a).

¹¹ LTR 200937028 (November 18, 2008).

¹² LTR 201245006 (July 19, 2012).

¹³ *Id.*

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