REVENUE RULING 2023-2

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REVENUE RULING 2023-2

What Is the State of Basis Step Up?

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A Little Background About Grantor Trusts

Start with the Basics

Grantor Trust Background

- “To Divide Income Is to Reduce Income Tax”
- Hence, the Standard Plan Was to Give Income Producing Property to Many
- Each Recipient Would Get the Benefit of Bracket Ride, Exclusions, etc.
- Consider the $10,000 per person limit on state and local taxes
- Taxpayers Pushed the Envelope by Retaining Control and Beneficial Interests
- The IRS Essentially Argued that in Substance the Income Still Belong to the Donor

Then Came the Clifford Trust Rules

- Helvering v. Clifford, 309 U.S. 331 (1941) Indicated Only Partial IRS Success
- Grantor Trust Rules Were Adopted by Regulation under the 1939 Code
- The Rules Became Part of the Statutory Law in the IRC of 1954
- And Largely Adopted the “Clifford” Regulations Almost Without Change
- The Thrust of the Rules Was to Make the Trust’s Grantor (or a Beneficiary) the Owner of the Trust and to Cause the Income to be Attributed to the Grantor
- That Foreclosed the Division of Income, Caused the Trusts to be Viewed as Bad (Defective)
- Hence, the Name a “Defective Trust” (Intentional Defective Grantor Trust Is a Misnomer)

But the Tax Reform Act of 1986 Changed It All

- By Compressing Rates and Allowing Rules a Bracket Ride on only $7500 (now about $14,000), the Dividing Income with Even a Non-Grantor Trust Had Little Appeal
- So, a Crafty Lawyer Decided the Grantor Trusts Would be Good for Estate Planning
- This Arose Because the Lawyer Claimed the Grantor Would Have to Pay the Income Tax on the Trust Income Allowing the Trust to Experience Income Tax Free Compounding
- But the IRS in PLR 9444033 (not precedent) Said the Grantor Would Be Making a Gift by Paying the Income Tax on Income of the Trust Imputed to the Grantor
- Nonetheless, the IRS Threw in the Towel in Rev. Rul. 2004-64 and Admitted There Would Be No Gift by the Grantor Paying the Income Tax on Income Earned by the Trust
- A Further Benefit: Sales of Assets to Grantor Trust Allowed Appreciation to Inure to the Trust Beneficiaries Without Gain…But

Was There Gain at Death If the Note Was Still Outstanding?

- Two Published Articles Said the Installment Sale Strategy Was Fatally Flawed Because If the Note Was Still Outstanding at the Grantor's Death Gain Would be Recognized per Rev. Rul. 77-402
- In Blattmachr, Gans and Jacobson (Journal of Taxation 2002), Seven Reasons Were Presented on Why There Would Be No such Gain (the Other Lawyers Now Agree) and Note that ''nonrecognition on death is among the strongest principles inherent in the income tax.'' Estate of Backemeyer v. Commissioner, 147 T.C. 526, 544 (2016).
- The Article Also Dealt with What the Basis Would Then Be of the Assets in the (Formerly) Grantor Trust
- The IRS Had Taken Inconsistent Positions: CCA 200937028 and PLR 201245006 (Neither of Which May Be Cited or Used as Percent). Senator Bernie Sanders Introduced a Bill that Would Expressly Deny the Section 1014 Step-up ("the 99.5 Percent Act" -- S. 994).
- Which of Section 1012 (Purchase), 1014 (Passing from or Acquired from a Decedent) or 1015 (Gifted) Applies?

Section 1014

- Section 1014(a) Says: “the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall… be— (1) the fair market value of the property at the date of the decedent’s death….”
- Section 1014(b) Says: For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:
- (1) Property acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent; (2) 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 revoke the trust; (3) 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;***
- (9) Property acquired from the decedent by reason of death, *** if by reason thereof the property is required to be included in determining the value of the decedent’s gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939. ***This paragraph shall not apply to— (A) annuities described in section 72; (B) property to which paragraph (5) would apply if the property had been acquired by bequest; and (C) property described in any other paragraph of this subsection.

Revenue Ruling 2023-2
Summary of Presentation: Aspects-1

- Issues: Summary
  - Trust's basis? Does 1014 apply?
  - Rev. Rul. 2023-2 lays down general rule:
    - Section 1014 is inapplicable because no estate-tax inclusion and it is not a bequest under state law
  - Possible exception:
    - If there is debt between grantor and trust at death, ruling is inapplicable
    - What does this imply?

Revenue Ruling 2023-2
Summary of Presentation: Aspects-2

- What is the trust's basis in case of sale to grantor trust if 1014 is inapplicable?
  - Ruling does not address this.
  - If Section 1014 does not apply, the possibilities are
    - Section 1015(a), 1015(b) or 1012
    - Is there gain at death?
    - Ruling does not answer this question
    - But see Backemeyer 147 T.C. 526, 544 (2016)
      - "nonrecognition on death is among the strongest principles inherent in the income tax"
    - And Levine, 634 F.2d 12 (2nd Cir. 1980)

Revenue Ruling 2023-2
Summary of Presentation: Aspects-3

- Can the grantor still repurchase assets from trust for cash or other assets on a tax-free basis under Rev Rul 85-13 and thereby secure a step-up?
- Yes, Rev. Rul. 85-13 remains intact
- Which provides a planning route to avoid the ruling
- Our critique of the ruling
- Example 5 and Rev. Rul. 85-13 establish a deemed-ownership principle
- Consistent application of the principle would lead to the application of Section 1014
- Questionable to impose a deemed-ownership principle in inter vivos context to trigger gain while refusing to apply it in the Section 1014 context, where it would favor the taxpayer
- Deference
- IRS has been inconsistent
- IRS failed to grapple with deemed-ownership principle
- Penalty implications

IRS Deemed Ownership Position and Rev. Rul. 2023-2

- Section 671 Provides, in part: Where it is specified in this subpart that the grantor or another person shall be treated as the owner of … a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to … the trust….
- Note It Does Not Say the Trust and Its Assets Are Treated As Owned by the Grantor.
- But Rev. Rul. 85-13 and Example 5 of Reg. 1.1001-1(c) say: the grantor is "considered the owner of all the trust property for Federal income tax purposes…."
- Rev. Rul. 2023-2 Says that It Does Not Apply to a Sale by the Grantor to the Trust or to a Situation Where There Is Debt on the Property

IRS Deemed Ownership Position and Rev. Rul. 2023-2

- Rev. Rul. 2023-2 Relies on Baaciocco (1961) and Collins (1970) that the meaning of “bequest” in Section 1014(b)(1) means a bequest under State Law and Since the Assets in the Grantor Trust Won’t be Passing “In Probate” under State law, Section 1014(b)(1) Cannot Apply
- But on Account of the Fiction that the Grantor Owns the Assets in a Grantor Trust, the Assets, Perhaps, Should be Treated as Passing Through Probate
- Rev. Rul. 2023-2 Should Not Get the Normal Deference Revenue Ruling Get from Courts. So a Taxpayer Can Take the Step Up at Death Position But Disclosure Should Be Made to Avoid Penalty

Questions from ILS Subscribers

- We have received a couple of questions from ILS subscribers that indicate there may be some misunderstanding as to the application of this Ruling. The attorneys who posed the questions seemed to be concerned that the Ruling would prevent the step-up in basis for assets in an irrevocable trust, even if the trust includes provisions intended to bring the trust property into the grantor's estate at death.
- In one context, the attorney was drafting a trust intended to allow the grantor to qualify for Medicaid, but the grantor was given a testamentary general power of appointment for the purpose of triggering estate inclusion. In the other context, the attorney was drafting an incomplete-gift asset protection trust. They both expressed concern that the trust assets would not get the step-up, even though the trust terms trigger inclusion, because the trusts were also grantor trusts. In other words, they seemed to believe the Ruling indicates that you can no longer receive the step-up for assets in a grantor trust, even if there is inclusion in the taxable estate. That is not correct. The Ruling clearly states that the trust at issue did not trigger inclusion and thus did not fall within 1014(a)(9) or (10).

What to Do?

- Have the Grantor Borrow Cash and Buy the Assets Back from the Trust Before Death (Or Substitute the Grantor's High Basis Assets for Low Basis Assets in the Trust)
- There Will Be No Income Tax Recognition. Rev. Rul. 85-13
- And the Taxpayer Can Pick and Choose Which to Buy Back
- That's Better Than a Step Up/Step Down under Section 1014

Conclusion and Additional Information

Summary

Conclusion

- The IRS position in Rev. Rul. 2023-2 according to some interpretations may just not be incorrect. Therefore, some practitioners might still choose to take the position of a basis step up is such situations. Just be mindful if you do of the heightened risk as a result of a Ruling on point and consider making appropriate disclosures of that position.
- A safer approach would be to swap assets out of the trust to obtain a basis step up. Practitioners should endeavor to educate clients about the importance of regular monitoring of basis and appreciation of assets inside grantor trusts.
- Consideration should be given to pre-papering swap or other documentation and arranging for lines of credit to fund a substitution, that may be useful to effectuate a swap on short notice if health status deteriorates.

Additional information

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