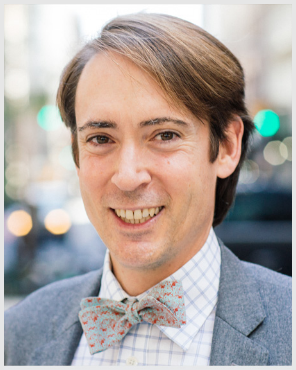
Basis of Grantor Trust Assets at Death: What Treasury Should Do

by Austin Bramwell and Stephanie Vara



Austin Bramwell

Stephanie Vara

Austin Bramwell is a partner in the trusts and estates group of Milbank, Tweed, Hadley & McCloy LLP in New York and an adjunct professor of law at New York University School of Law. Until earlier this year, he served as a senior adviser in Treasury's Office of Tax Policy. Stephanie Vara is an associate in Millbank's trusts and estates group in New York.

In this article, Bramwell and Vara argue that the IRS should issue a revenue ruling relying on section 1015(d) to determine the basis of grantor trust assets at death.

Two years have passed since Treasury and the IRS first announced that they were working on guidance relating to the basis of grantor trust assets at death.[1] The project is apparently approaching completion — although Treasury's 2017-2018 priority guidance plan omitted projects not expected to be completed by the end of plan year, the basis of grantor trust assets at death remains on the list.[2] Guidance, in other words, was expected to be issued by the end of June.

It is not surprising that Treasury remains committed to settling once and for all how the basis of grantor trust assets is determined after the grantor's death. Irrevocable grantor trusts, as described below, have become perhaps the premier vehicle whereby affluent Americans pass wealth free of gift and estate tax to the next generation. On top of their considerable estate tax planning benefits, grantor trusts may even qualify for a step-up in basis at death,[3] at least according to some attorneys and tax scholars.[4] At the same time, the IRS has vehemently rejected the theory that grantor trust assets receive a basis step-up at death.[5] The guidance project apparently aims to establish that grantor trusts do not receive tax-free step-up in basis when the grantor dies.

Yet Treasury and the IRS face significant technical obstacles to achieving their objective. For better or worse, the IRS's own prior rulings and regulations have interpreted the code in a way that leaves no obvious solution to the problem of how the basis of grantor trust property is determined at death. Further, any subregulatory guidance risks inadvertently contradicting prior guidance. To avoid that outcome, Treasury and the IRS might need to reassess and possibly revoke decades-old rulings.

Fortunately, there is a way out. Section 1015(b) is an ancient and seldom-cited section of the code. But though the law may sleep, it is not dead: By its

[1] *See* Treasury 2015-2016 priority guidance plan.

[2] *See* Treasury 2017-2018 priority guidance plan and quarterly updates.

[3] As discussed below, section 1014(a) generally provides that property acquired or passing from a decedent receives a basis equal to its fair market value on the date of the decedent's death or the alternate valuation date, if the estate tax alternate valuation date election is made. As most property tends to appreciate, and well-advised taxpayers typically realize losses before death, the fresh basis at death under section 1014(a) is commonly referred to, including in this article, as a basis "step-up."

[4] Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 *J. Tax'n* 149 (2002).

[5] ECC 200937028.

terms, section 1015(b) provides an answer to the vexed question of how the basis of grantor trust assets is determined after death. Specifically, under section 1015(b), the assets of a grantor trust after death have the same basis, once grantor trust status is turned off, as they had before death. In other words, consistent with the IRS view that grantor trusts do not qualify for a step-up in basis at death, section 1015(b) imposes a carryover basis.

Moreover, if Treasury and the IRS do rely on section 1015(b) to determine the basis of grantor trust assets at death, prior guidance would not need to be revoked or revised. Indeed, the IRS would merely have to reiterate the position it has already taken in an earlier ruling, Rev. Rul. 2008-41, 2008-30 IRB 170, and apply it in a different but analogous context. For those reasons, we argue, Treasury and the IRS should issue a revenue ruling holding that section 1015(b) governs the basis of trust property after an irrevocable grantor trust converts to a non-grantor trust at the death of the grantor.

I. Advantages of Irrevocable Grantor Trusts

A grantor trust is a trust that is treated as owned by the grantor or another person for income tax purposes under the rules of sections 671 through 679. Importantly, a gift can be considered complete for gift and estate purposes but still be treated as incomplete for income tax purposes. A wealthy individual, for example, can make a gift[6] to an irrevocable trust that will not be included in the donor's gross estate at death under one of the estate tax "string" sections.[7] As a result, all future investment returns on trust property from the date of the gift pass free of gift and estate tax.[8]

Even though the trust property passes outside the donor's gross estate for estate tax purposes, the trust can still be drafted as a grantor trust that is treated as owned by the donor for income tax purposes. For example, the grantor may retain the power (in a nonfiduciary capacity) to substitute property of an equivalent value[9] or may give a non-adverse person a power to make loans to the grantor for less than adequate interest or security.[10] Other techniques for triggering grantor trust status include designating the donor's spouse as a permissible beneficiary of the trust,[11] granting a power to expand the class of beneficiaries,[12] appointing a related or subordinate party as trustee,[13] or having the trust acquire life insurance policies on the grantor's life whose premiums can be paid out of the income or principal of the trust.[14] Even merely borrowing from the trust (or having the grantor's spouse borrow from the trust[15]) at some point during the year may cause grantor trust status for the entire year.[16]

With grantor trust status achieved, several estate tax planning techniques become possible. Perhaps the most powerful is simply the donor's obligation under the code to pay the tax on the grantor trust's income. The shift of tax liability from the trust to the donor allows the trust to earn tax-free returns during the donor's lifetime, even as the donor's own estate is depleted. Despite the significant — oftentimes massive — transfers of wealth that thereby occur, the donor is not treated as having made additional gifts to the trust for gift tax purposes.[17]

Another technique is to sell assets that will earn returns that exceed those earned on the consideration received. For example, the donor could sell assets to an irrevocable grantor trust in

---

[6] Reg. section 25.2511-2. A gift is complete for gift tax purposes if the donor "has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another." Reg. section 25.2511-2(b).

[7] Sections 2035-2039 and 2041.

[8] The code gives the IRS no mechanism for taxing future outsized returns earned by the donee of the gift. *See* reg. section 25.2511-2(a) ("The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer.").

[9] Section 675(4); *see also* Rev. Rul. 2008-22, 2008-16 IRB 796.

[10] Section 675(2).

[11] Section 677(a)(1).

[12] Such a power, combined with trustee discretion to make distributions, may cause grantor trust status under section 674(a) by negating the otherwise broad exception of section 674(c).

[13] Like a power to add to the class of beneficiaries, the appointing of a related or subordinate party as trustee may cause grantor trust status under section 674(a) by negating the otherwise broad exception of section 674(c).

[14] Section 677(a)(3); Rev. Rul. 66-313, 1966-2 C.B. 245.

[15] Section 672(e).

[16] Rev. Rul. 86-82, 1986-1 C.B. 253.

[17] Rev. Rul. 2004-64, 2004-2 C.B. 7.

exchange for a promissory note bearing interest at no more than the applicable federal rate. If the value of the property transferred by the donor is equal to the value of the property received (that is, the note), no gift occurs for gift tax purposes.[18] Further, under section 7872, the value of the note is not discounted to reflect the relatively low interest rate.[19] Thus, the sale succeeds in passing wealth to the trust free of gift and estate tax as long as the assets earn returns that exceed the low interest rate.

Meanwhile, the IRS has for decades taken the position that grantor trusts are ignored for all income tax purposes.[20] The sale, therefore, is ignored for income tax purposes and the grantor recognizes neither gain on the sale nor interest income on the note.[21] In short, through a sale to a grantor trust, a wealthy individual can freeze the value of property transferred to a trust and cause future investment returns (above a relatively low interest rate) to pass to descendants, all without gift, estate, or income tax cost.

II. Do Grantor Trusts Also Get Basis Step-Up?

According to some attorneys, grantor trusts should qualify for another benefit as well: The basis of grantor trust assets should receive a stepped-up basis at death under section 1014.[22] Section 1014 generally provides that property acquired or passing from a decedent receives a basis equal to its fair market value on the date of the decedent's death or the alternate valuation date, if the estate tax alternate valuation date election is made.[23] As most property tends to appreciate in value, and well-advised taxpayers typically realize losses before death, the fresh basis at death under section 1014(a) is commonly referred to, including in this article, as a basis "step-up." The basis step-up at death eliminates inherent gain free of tax.

Section 1014 may apply even though property does not pass under the decedent's will or as part of the decedent's probate estate. Property held in most revocable trusts, for example, is deemed to have been acquired from a decedent under section 1014(b)(2) or section 1014(b)(3).[24] Also, under a catchall provision enacted in 1954, almost all property included in the decedent's gross estate for estate tax purposes is considered to have passed from the decedent for purposes of section 1014(a).[25] Reg. section 1.1014-1(a) even describes the "purpose of section 1014" as "to provide a basis for property acquired from a decedent that is equal to the value placed upon such property for purposes of the federal estate tax."

In contrast to the forms of ownership covered by section 1014(b), an irrevocable grantor trust is designed to pass outside the grantor's gross estate for estate tax purposes.[26] Indeed, the property of an irrevocable trust does not "pass" at the decedent's death at all. Rather, after the grantor's death, property of the trust continues to be administered and disposed under the same irrevocable trust terms that existed before the decedent's death. Thus, it might seem that any argument that the assets of an irrevocable grantor trust pass from the deceased grantor and

[18] Section 2512(b); reg. section 25.2512-8.

[19] *See* LTR 9535026 (holding that the value of secured notes bearing interest at the rate prescribed by section 7872 of the code was equal to the value of the property transferred); *cf.* LTR 9644053 (holding that a secured right to an annuity was equivalent in value to the property transferred); *see also* reg. section 25.2504-2(d), Example 3; *Frazee v. Commissioner*, 98 T.C. 554, 590 (1992); *True v. Commissioner*, T.C. Memo. 2001-167. *But see Dallas v. Commissioner*, T.C. Memo. 2006-212 (valuing promissory notes with self-canceling provisions at less than the value of the property sold).

[20] ILM 201343021 ("We conclude that a trust that is treated as a grantor trust is ignored as a separate entity apart from the owner for all federal income tax purposes."); Rev. Rul. 85-13, 1985-1 C.B. 184; Rev. Rul. 2007-13, 2007-1 C.B. 684. *Cf.* reg. section 1.1001-2(c), Example 5 (stating that the grantor of a grantor trust "is treated as the owner of the entire trust"); *but see Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984).

[21] Rev. Rul. 85-13.

[22] Blattmachr, Gans, and Jacobson, *supra* note 4.

[23] Section 1014(a) and (b). In limited cases, basis is determined differently if a special use valuation election is made under section 2032A or if a qualified conservation easement is excluded from the gross estate. *Id.* Section 1014(a)(3) and (4). Section 1014(c), (d), and (e) carve out exceptions to the step-up in basis, such as for income in respect of a decedent under section 1014(c). *Id.* Other code sections also in some cases limit the benefit of a basis step-up. *See, e.g.*, section 1291(e) (reducing section 1014(a) basis in passive foreign investment company shares to the basis of the shares immediately before the decedent's death, unless the decedent was a nonresident alien at all times during his holding period).

[24] *See, e.g.*, Rev. Rul. 58-395, 1958-2 C.B. 398; Rev. Rul. 57-287, 1957-1 C.B. 517.

[25] *Id.* Section 1014(b)(9).

[26] In some cases, however, a family might prefer for property to be pulled back into the gross estate in order to obtain the basis step-up. *See generally* Austin W. Bramwell and Elisabeth O. Madden, "Toggling Gross Estate Inclusion On and Off: A Powerful Strategy," 44 *Estate Planning* (2017).

therefore qualify for a section 1014 basis step-up is far-fetched.

Yet the conclusion that grantor trusts enjoy a basis step-up at death is supported by the IRS's own rulings and pronouncements. At least in some cases, it is clear that property may acquire a new basis at death even though it is not included in the decedent's gross estate. For example, as the IRS confirmed in Rev. Rul. 84-139, 1984-2 C.B. 168, property passing from a nonresident alien decedent may qualify for a fresh basis at death, even though it is not included in the decedent's gross estate for U.S. estate tax purposes.[27]

Also, the IRS has repeatedly affirmed that during the grantor's lifetime, the property of a grantor trust is treated as owned by the grantor for all income tax purposes. In a seminal ruling, Rev. Rul. 85-13, 1985-1 C.B. 184, the taxpayer purchased stock from a grantor trust that he had created for $40 per share. After acquiring the shares from the grantor trust, the taxpayer sold the shares to a third party for $50 per share. Before the grantor's purchase, the stock had a basis of $20 per share. The IRS ruled that the taxpayer had $30 of gain, measured by the trust's original $20 basis rather than the grantor's cost of $40 a share.

In reaching this conclusion, the IRS held that the sale between the grantor and the grantor trust had not occurred at all for income tax purposes. Rather, according to Rev. Rul. 85-13, a grantor trust does not "retain its vitality as a separate entity." Rejecting the contrary holding of the Second Circuit in *Rothstein*,[28] the IRS held instead that the grantor of a grantor trust is the "owner of the trust's assets." Thus, the grantor and the grantor trust were not capable of entering into a sale that could cause the stock to acquire a new basis for income tax purposes.

The IRS has since emphatically reiterated that the grantor is the owner of grantor trust assets for all income tax purposes[29] and has applied the principle in a wide variety of contexts.[30] On one occasion, the IRS even held that a grantor trust is ignored for purposes of an excise tax.[31] If there are any exceptions to the principle that grantor trusts are ignored, they are few and narrow.[32] Section 1014, meanwhile, is an income tax provision. The holding of Rev. Rul. 85-13 and subsequent rulings applies to section 1014 as much as to any other income tax provision of the code. Indeed, a regulation under the same chapter of the code as section 1014, reg. section 1.1001-2(c), Example 5, provides that the grantor of a grantor trust "is treated as the owner of the entire trust," thereby apparently giving the position of Rev. Rul. 85-13 the force of law.[33]

If grantor trusts are ignored for all income tax purposes, consider what that implies when grantor trust status ends at death. Section 1014 again generally provides that property acquired from a decedent receives a basis at death equal to its then-FMV. Under Rev. Rul. 85-13, grantor trust assets are treated as belonging to the decedent up until the moment of death. At the moment of death, when grantor trust status ends, the property passes from its prior owner, namely, the decedent. Thus, the logic of Rev. Rul. 85-13 and its IRS progeny seems to compel the conclusion that

[27] Under section 2103, property of a nonresident alien decedent is not included in the gross estate unless it is situated in the United States.

[28] *Rothstein*, 735 F.2d 704.

[29] *E.g.*, ILM 201343021 ("Grantor trusts are disregarded as entities separate from their owners for all federal income tax purposes.").

[30] *See, e.g.*, Rev. Rul. 88-103, 1988-2 C.B. 304 (involuntary conversions under section 1033); Rev. Rul. 2004-86, 2004-2 C.B. 191 (tax-free exchanges under section 1031); Rev. Rul. 2008-13, 2008-10 IRB 518 (transfers of life insurance for value under section 101); LTR 9152011 (exemption from tax on interest income under section 871(i)); LTR 200104005 (exclusion of gain from the sale of a residence under section 121); LTR 9031022 (characterization of interest under sections 163(h) and 469); LTR 9141046 (nontaxable acquisition of qualified replacement property under section 1042).

[31] Rev. Rul. 87-61, 1987-2 C.B. 219.

[32] *See* reg. section 1.108-9(c)(1) and (2) (cancellation of indebtedness rules only apply if the grantor, not the grantor trust, is bankrupt or insolvent); T.D. 9829 (declining to expand definition of eligible partner to include grantor trusts for purposes of section 6221(b); concerning partnership audits); LTR 200920031 (holding that gain is recognized by the grantor upon an in-kind satisfaction of a charitable annuity by a charitable lead annuity trust, even though it was a grantor trust for income tax purposes; and distinguishing Rev. Rul. 55-410, 1955-1 C.B. 297, which holds that gain is not recognized by an individual upon satisfying a charitable pledge obligation in kind).

[33] Although reg. section 1.1001-2(c), Example 5, was issued before Rev. Rul. 85-13 was published, it effectively established by regulation the position in an earlier ruling, Rev. Rul. 77-402, 1977-2 C.B. 222, which also states that the grantor of a grantor trust is "the owner of all the trust property for Federal income tax purposes." That said, the theory that a grantor trust is indeed ignored for all income tax purposes was rejected by the Second Circuit in *Rothstein*, 735 F.2d 704, *non-acq.*, 1985-1 C.B. 184.

grantor trust assets are acquired from a decedent and therefore should qualify for a step-up in basis under section 1014.

In any event, Rev. Rul. 85-13 makes it trivially easy to obtain the benefits of a step-up in basis artificially. Under the ruling, transactions between a grantor trust and the grantor are ignored; to adopt a common metaphor, they are treated as if the grantor moved property from one pocket to another. Thus, to achieve a basis step-up at death, the grantor need only purchase low-basis assets from the grantor trust before death — including in a deathbed transaction — and swap in cash or high-basis assets in exchange. The grantor can then die holding the low-basis assets, which will qualify for a basis step-up as property passing from the decedent within the meaning of section 1014.

The substitution of assets before death, in short, achieves artificially what Rev. Rul. 85-13 implies should occur even without a deathbed swap: a step-up in basis. (Indeed, the artificial step-up is more favorable, insofar as the grantor can choose which assets to swap out of the grantor trust, and thus may leave any depreciated property in the hands of the trust, while only swapping out the appreciated property.) Given that well-advised taxpayers may achieve a basis step-up for grantor trust assets artificially, it is unclear why, as a policy matter, the IRS should not grant the same benefit automatically to all grantor trust assets.

III. The Textual Difficulty

That all said, the theory that grantor trusts should always qualify for a step-up in basis has no obvious support in the language of the code. Section 1014(b) defines 10 categories of the property that "shall be considered to have been acquired from or to have passed from the decedent." Three categories have either been repealed or no longer apply,[34] while one provides an (inapplicable) special rule for a surviving spouse's share of community property.[35] Of the six others, five apply to property that is clearly included in the gross estate of a U.S. citizen or resident decedent.[36]

That leaves one remaining category of property considered to have passed from a decedent. Under section 1014(b)(1), property is considered to have passed from a decedent if it was "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." Property that passes at the decedent's death in accordance with the terms of an irrevocable trust is not bequeathed, devised, or inherited, nor is it acquired by the decedent's estate.[37] The regulations under section 1014(b)(1) simply take it for granted that it applies only when property passed under the decedent's will or by the laws of descent.[38] Section 1014(b)(1), therefore, does not by its terms apply to property held in an irrevocable grantor trust at death. Proponents of the view that grantor trust assets qualify for a basis step-up are left to contend that, in light of Rev. Rul. 85-13, grantor trust assets should simply be deemed to have been bequeathed from the deceased grantor, even though in reality they are not.[39]

IV. IRS Gives Comfort to Proponents

Astonishingly, in one nonprecedential letter ruling,[40] the IRS appears to have adopted the

[34] Section 1014(b)(5), (7), (8).

[35] Section 1014(b)(6). The rule provides that the surviving spouse's one-half share of community property (if it is community property under the laws of any state, U.S. possession, or foreign country) is deemed to have passed from the deceased spouse. The purpose of this rule, enacted in 1948, was to equalize the treatment of community and non-community property. *Bath v. United States*, 211 F. Supp. 368, 370 (S.D. Tex. 1962), *aff'd per curiam*, 323 F.2d 980 (5th Cir. 1963).

[36] Section 1014(b)(2) and (3) apply to revocable trusts, which are included in the gross estate under section 2038. Section 1014(b)(4) applies to property passing by the exercise of a general power of appointment, which is included in the decedent's gross estate under section 2041. Section 1014(b)(9) and (10) expressly only apply to property included in the decedent's gross estate.

[37] ECC 200937028.

[38] Reg. section 1.1014-2(a)(1).

[39] An alternative theory, not expressly advanced by the proponents of the position, is that section 1014(b) is not exhaustive. In this view, grantor trust assets should be considered to have passed from the decedent within the meaning of section 1014(a), even though they are not described anywhere in section 1014(b) as property that shall be considered to have passed from a decedent.

[40] Under section 6110(k)(3), private letter rulings may not be cited as precedent.

construction of section 1014(b)(1) urged by the proponents of the theory that grantor trusts qualify for a basis step-up at death. In LTR 201245006, the taxpayer, a nonresident alien, proposed to transfer assets to an irrevocable trust. Although the trust was irrevocable, the taxpayer retained the right to all income of the trust and a special testamentary power of appointment, and was eligible to receive distributions of principal during his lifetime. Unsurprisingly, the IRS ruled that in light of the grantor's retained strings, the trust was a grantor trust regarding the taxpayer.[41] The IRS further noted that the property of the trust would not be included in the taxpayer's gross estate for estate tax purposes to the extent that the trust consisted of property not situated in the United States.[42]

Nevertheless, the IRS ruled that the property would qualify for a step-up in basis at death. Intriguingly, the IRS reasoned that the beneficiaries after the taxpayer's death "will acquire, by bequest, devise, or inheritance, assets from Trust at Taxpayer's death." In other words, even though the trust assets were, in reality, to pass outside the decedent's will and probate estate, the IRS still deemed them to have passed "by bequest, devise, or inheritance." The hidden assumption, perhaps, was that grantor trust property is deemed to have passed from a decedent under section 1014(b)(1).[43]

V. The IRS Reaction

Despite the favorable hint in LTR 201245006, it seems clear that the IRS will not agree that grantor trust assets qualify for a basis step-up at death. In ECC 200937028, an attorney in the IRS chief counsel's office stated that the office "strongly disagree[s]" with the view that grantor trust assets qualify for a step-up in basis. "Since the decedent transferred the property into trust," the attorney reasoned, section 1014(b)(1) does not apply. On the contrary, "the general rule is that property transferred prior to death, even to a grantor trust," is not subject to section 1014 unless it is included the decedent's gross estate.

In 2015 the IRS added the issue of "whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not included in the gross estate of that owner" to the list of areas under study on which the IRS will not normally rule.[44] It is widely expected that the guidance the IRS publishes will deny that grantor trust assets qualify for a section 1014 basis. The only question is on what grounds and by what form of guidance.

VI. The Missing Code Provision

The technical problem that the IRS faces is that there is no code section — putting aside section 1015(b) — that, as interpreted by the IRS, obviously applies when determining the basis of grantor trust assets at death. We assume that Treasury and the IRS have already made up their minds that, as stated in ECC 200937028, grantor trust assets do not qualify for a fresh basis at death under section 1014. That leaves as other possible candidates sections 1012 and 1015(a). We discuss each below.

A. Section 1012(a) Cannot Apply

Section 1012(a) sets forth the fundamental principle that except as otherwise provided in the code, the basis of property equals its cost. "Cost" is simply the amount paid in cash or other property.[45] During the grantor's lifetime, there are no particular difficulties in determining the cost basis of grantor trust property. The cost basis attributed to the grantor, as the deemed owner of grantor trust assets, is simply whatever the grantor paid for the property before transferring the property to the trust or whatever the trust paid for the property (in a transaction treated as if the grantor himself had acquired the property). The cost basis is then subject to adjustment under

[41] Section 672(f)(1) generally prohibits trusts from being treated as owned by persons who are not citizens or residents of the United States. However, the trust in the ruling qualified for an exception to this rule under section 672(f)(2)(A)(ii).

[42] *See* section 2103 (providing that the estate of a nonresident, noncitizen is only subject to estate tax on property situated in the United States).

[43] Attorneys involved in obtaining the ruling have suggested that when the ruling refers to section 1014(b)(1), the IRS made a mistake and actually meant to refer to section 1014(b)(3). The view that the reference to section 1014(b)(1) is a typographical error is difficult to square with the actual text of the ruling, which quotes the language of section 1014(b)(1).

[44] Rev. Proc. 2015-37, 2015-26 IRB 1196.

[45] Reg. section 1.1012-1(a).

section 1016 or may be determined under one of the exceptions provided in the code.[46]

Once the grantor dies, however, section 1012 no longer determines the basis of the trust property. For income tax purposes, under Rev. Rul. 85-13, the trust is ignored up until the moment of death. The trust then springs into existence as a separate taxpayer once ownership can no longer be attributed to the grantor.[47] The trust at that moment will often have assets of considerable value. Yet the trust, as a new taxpayer, could not have paid anything for those assets. Nor is death a taxable event that causes the decedent or a grantor trust to recognize gain.[48] Like Athena in Greek mythology, who sprang miraculously from the head of Zeus, a former grantor trust comes into separate existence at the grantor's death fully formed and well funded. Because the trust is a new taxpayer at the moment of death, it cannot have paid anything for its initial assets and therefore cannot have a section 1012 cost basis.

For comparison, consider how a deceased taxpayer's estate acquires both assets and income tax basis in those assets. An estate, like a former grantor trust, is a new taxpayer that comes into being at the grantor's death[49] and succeeds to the decedent's property.[50] The transfer from the decedent to the decedent's estate is not a disposition that triggers gain or loss.[51] By the same token, section 1012 does not apply in determining the basis of the estate's property. Nevertheless, the inapplicability of section 1012 does not cause any particular difficulties. Rather, as property of an estate is considered to have been acquired from a decedent,[52] the property generally qualifies for a fresh basis under section 1014(a). Alternatively, if an exception to section 1014(a) applies, a different provision determines basis.[53]

By contrast, when a trust ceases to be a grantor trust at the decedent's death, there is no code section that, like section 1014(a) and its various exceptions, intervenes and determines basis. (This assumes, of course, that the IRS is correct that section 1014(a) does not govern the basis of grantor trust assets at death.) Many assume that the basis of grantor trust property during lifetime simply carries over to the trust after the grantor's death. Section 1012, however, is not a carryover basis provision that, like the many carryover basis rules in the code,[54] causes the basis of property in the hands of one taxpayer to become the basis in the hands the transferee.[55] The hypothetical provision that causes the property of a grantor trust to acquire a carryover basis after the grantor's death is rather like the Higgs boson in particle physics: an entity that ought to exist in theory but is difficult to identify in practice.

B. Section 1015(a) Cannot Apply

To solve the problem, the IRS might be tempted to invoke section 1015(a). Section 1015(a) has the advantage, at least, of being a carryover basis provision. It generally provides that the basis of property acquired by gift is the same as its basis in the hands of the donor, if, for purposes of determining loss, the basis of the property is the FMV at the time of the gift if the FMV exceeded

[46] For example, if property is acquired in a nonrecognition transaction, the basis of the property acquired is normally the same as the basis of the property transferred. *See*, *e.g.*, section 358(a)(1).

[47] Rev. Rul. 57-51, 1957-1 C.B. 171; *cf.* reg. section 1.671-4(h)(2).

[48] ILM 200923024 ("Death of the owner . . . is generally not treated as an income tax event."); *see also* Rev. Rul. 73-183, 1973-1 C.B. 364; *Crane v. Commissioner*, 331 U.S. 1 (1947) (assuming, as a premise of its holding, that an encumbered property received a basis under the predecessor to section 1014 without recognition of gain).

[49] Section 641(a). An unresolved question is whether the estate begins on the date of the decedent's death or the day after. The better view seems to be that the estate begins the day after death. *See* reg. sections 1.443-1(a)(2) and 1.691(a)-1(b) (stating that a decedent's final tax year ends on the decedent's date of death).

[50] Rev. Rul. 73-183 (describing the decedent's property as "passing" to the estate).

[51] *Id.*

[52] Section 1014(b)(1).

[53] For example, in the case of income in respect of a decedent, section 1014(a) does not apply, under section 1014(c), and income is instead determined under section 691. Other exceptions include shares of domestic international sales corporations, specific property transferred to the decedent within one year of death, and, in a way, shares of PFICs. *See* sections 1014(c), 1014(d), and 1291(e), respectively.

[54] *See*, *e.g.*, section 1015(a) (property transferred by gift); section 362(a).

[55] On the other hand, perhaps the IRS could take the position that section 1012(a) is itself a carryover basis provision. After all, section 1012(a) states merely that the basis of property "shall be the cost of such property." It does not require that the taxpayer who holds the property must be the same taxpayer who paid for it. In this view, if the basis of grantor trust property can be identified during the grantor's lifetime, that basis becomes the trust's basis under section 1012 after the grantor dies.

basis. Further, a grantor can only become the owner of a grantor trust for income tax purposes by making a gratuitous transfer to the trust.[56] Thus, it might seem a straightforward conclusion that section 1015(a), which applies to property transferred by gift, determines the basis of grantor trust property.

That straightforward conclusion, however, is at loggerheads with Rev. Rul. 85-13. Under Rev. Rul. 85-13, the grantor continues to be treated as the owner of trust property for income tax purposes. Thus, the trust does not acquire the property for income tax purposes until grantor trust status ends, such as at death. A transfer at death, however, is not a transfer "by gift," as the regulations implicitly confirm.[57] It is especially difficult to treat a transfer at death as a transfer "by gift" for purposes of section 1015(a) given that section 1015's counterpart, section 1014, already governs transfers of property at death.

To force section 1015(a) to apply, the IRS might be tempted to incorporate gift tax completion concepts into section 1015(a). Specifically, the IRS might consider taking the position that a gift is considered to have been made for purposes of section 1015(a) if it is a completed gift for gift tax purposes. Under reg. section 25.2511-2, a gift is considered complete when the donor "has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another." To fix the value of property transferred in trust for estate tax and gift tax purposes, and thereby to obtain the estate tax benefits of irrevocable grantor trusts, wealthy individuals must necessarily relinquish sufficient dominion and control to make a completed gift for gift tax purposes. Thus, if gift tax completion concepts are imported into section 1015(a), it would seem that the IRS's policy goal will have successfully been achieved. That is, section 1015(a) will impose carryover basis on the assets of irrevocable grantor trusts and deny any step-up in basis at death under section 1014(a).

[56]Reg. section 1.671-2(e)(1).

[57]Reg. section 1.1015-1(e) provides that for purpose of section 1015(a)'s loss limitation rule, the FMV of property is its value as determined for gift tax purposes. The federal gift tax, however, does not apply to transfers of property at death. Reg. section 25.2511-2(f).

Despite those apparent advantages, it would be a mistake for the IRS to apply section 1015(a) to the property of grantor trusts. The most obvious problem is that any such position would be contrary to existing law. It is well established that the gift and income tax systems are not *in pari materia*.[58] In *Beck's Estate*,[59] for example, the grantor was taxed on the income of an irrevocable trust, yet was still held liable for gift tax upon funding the trust. The taxpayer argued that it would be "unbearably inconsistent" to tax the funding of the trust as a gift yet continue to tax the income to the grantor. The court, however, held that a transfer can indeed "be a completed gift for one purpose and an incomplete gift for another," and joked that "to assuage the feelings and aid the understanding of affected taxpayers, Congress might use different symbols to describe the taxable conduct in the several statutes, calling it a 'gift' in the gift tax law, a 'gaft' in the income tax law, and a 'geft' in the estate tax law." The Tax Court later confirmed that the predecessor of section 1015(a) and the gift tax are not *in pari materia*.[60]

Meanwhile, as discussed, under Rev. Rul. 85-13 and reg. section 1.1001-2(c), Example 5, a grantor trust is not a separate entity for income tax purposes. Thus, a grantor trust is no more capable of receiving a gift from the grantor for income tax purposes than, as in the facts of Rev. Rul. 85-13, entering into a sale transaction. To apply section 1015(a), the IRS would have to revoke or amend Rev. Rul. 85-13 and its progeny, thereby, at a minimum, upending decades of law that taxpayers previously considered well settled.[61]

Perhaps the IRS could sidestep current law by creating a narrow exception to Rev. Rul. 85-13

[58]*Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-1 C.B. 5 (denying that the predecessor to section 1015 is *in pari materia* with the gift tax system).

[59]*Commissioner v. Beck's Estate*, 129 F.2d 243 (2d Cir. 1942).

[60]*Post*, 26 T.C. 1055. *Post* held that the predecessor to section 1015(a) applied despite the gift being incomplete for gift tax purposes. The position of *Post* was even adopted by regulation. *See* reg. section 1.1015-1(c). Given how the law has since developed, however, the opposite result is now more likely: Under Rev. Rul. 85-13 and reg. section 1.1001-2(c), Example 5, a gift may be complete for gift tax purposes but does not cause section 1015 to apply.

[61]For example, grantor trusts that purchase life insurance on the life of the grantor had previously been able to rely on Rev. Rul. 2007-13's holding that such a purchase qualified for an exception to the transfer-for-value rule of section 102(a)(2).

principles for sections 1014 and 1015(a). That is, the IRS could take the position that grantor trusts are ignored, except for purposes of determining basis, in which case gift tax completion principles apply. At a minimum, that approach would create additional technical complexity for taxpayers and advisers. Moreover, it would leave the IRS guidance vulnerable to attack and exploitation. Taxpayers could attack the IRS guidance on the grounds that it applies grantor trust principles only as convenient for the IRS and therefore is invalid as an arbitrary and unreasonable exercise of Treasury's authority.[62]

Conversely, taxpayers could exploit the guidance by arguing that it should be extended into other areas. Section 1202(h)(2)(A), for example, allows a capital gain exclusion to qualified small business stock (QSBS) that is transferred "by gift." A taxpayer wishing to increase QSBS exclusions artificially might take the position that stock transferred by gift to a trust qualifies for a QSBS exclusion even if the trust is an irrevocable grantor trust. Under current law, the additional exclusion would not be available, because a grantor trust is ignored for all income tax purposes. But if the IRS instead incorporates gift tax completion principles into the meaning of the term "by gift," the taxpayer could plausibly argue that that irrevocable grantor trust is indeed eligible for an additional exclusion under section 1202.

Moreover, applying section 1015(a) to the basis of grantor trusts, without revoking Rev. Rul. 85-13, would not even solve the problem of whether section 1014(a) applies at death. Consider two different taxpayers, Peter and Katie. Peter funds an irrevocable grantor trust with $1,000 of zero-basis stock. If section 1015(a) applies, the grantor trust's basis would be zero, including after Peter dies. Katie, by contrast, transfers $1,000 of cash, which the trust then uses to purchase from her $1,000 of zero-basis stock. Under Rev. Rul. 85-13, the basis of the stock continues to be zero after the purchase, because the sale transaction is ignored. Section 1015(a), if it is interpreted using gift tax completion principles, would not apply because Katie's sale is not a transfer by gift. Thus, through the device of transferring cash and then swapping in property, Katie would avoid section 1015(a), even with gift tax principles incorporated, and would preserve the ability to apply another provision, perhaps section 1014(a), to determine basis after her death.

Finally, it is worth noting that if the IRS were to apply section 1015(a) to grantor trusts, it would be solving one mystery only to create another. Suppose that Katie's trust distributes the zero-basis stock to its beneficiary, Sean. Under the theory of Rev. Rul. 85-13, the trust is ignored for income tax purposes and the transfer from the trust to Sean would be deemed a gift from Katie.[63] Sean, therefore, would have a basis determined under section 1015(a).

If instead the IRS revokes or amends Rev. Rul. 85-13 and takes the position that the trust has a section 1015(a) basis, the transfer from the trust to Sean is not a gift but rather a distribution from the trust. There is no code provision that governs the basis of property received *as a distribution* from a grantor trust.[64] Just as under current law there is no code provision that obviously governs the basis of grantor trust property at death, if the IRS took the position that section 1015(a) applies to the basis of grantor trust property at death, there would be no code provision that obviously governs the basis of grantor trust property distributed to a beneficiary.

VII. Section 1015(b): The Solution

Fortunately, there is a way out of the grantor trust basis conundrum. Authority for the position that the former grantor trusts receive a carryover

[62] The guidance would be vulnerable, perhaps, even under the highly deferential "step two" test of *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984). If the guidance is issued in the form of a revenue ruling, it would likely be entitled merely to so-called *Skidmore* deference. *Taproot Administrative Services Inc. v. Commissioner*, 679 F.3d 1109 (9th Cir. 2012) ("As both parties concede, I.R.S. revenue rulings are entitled to the degree of deference articulated by the Supreme Court in *Skidmore*."). The rule of *Skidmore* deference has been called "an empty truism and a trifling statement of the obvious: A judge should take into account the well-considered views of expert observers." *United States v. Mead*, 533 U.S. 218 at 295 (2001) (Scalia, J. dissenting).

[63] The gift should be excluded from gross income under section 102(a). *See* Rev. Rul. 69-70, 1969-1 C.B. 182 (holding that income distributions from foreign grantor trust to U.S. resident beneficiary were not taxable to the beneficiary); *cf.* reg. section 1.671-2 (treating items of income, deduction, and credit as if received or paid directly by the grantor).

[64] Section 643(e) generally provides that the basis of property received as a distribution by a beneficiary is equal to its basis in the hands of the trust. That section likely does not apply, however, to grantor trusts.

basis at the death of the grantor can be found directly in the code. Specifically, section 1015(b) provides that the basis of property acquired by a transfer in trust, "other than by gift, bequest, or devise," is the same as it would be in the hands of the grantor. The basis is also increased by any gain or decreased by any loss recognized to the grantor.

The application of section 1015(b) to the basis of irrevocable grantor trusts at the death of the grantor is wonderfully straightforward. Under the principles of Rev. Rul. 85-13, a transfer from the grantor to the trust occurs for income tax purposes when grantor trust status is turned off, such as at death. The transfer is not a transfer by gift because it is a transfer occurring at death. Further, property that passes at the grantor's death under the terms of an *inter vivos* trust does not pass by bequest or devise. ECC 200937028 concluded on this basis that section 1014(b)(1) does not provide a basis step-up for grantor trust assets. By that same reasoning, section 1015(b), because it applies to transfers "other than by gift, bequest, or devise," does apply. The basis of grantor trust assets after the grantor dies is the same as its basis immediately before death.

If the application of section 1015(b) to the basis of grantor trust assets at death is so straightforward, why has it received so little attention? The reason is that section 1015(b), whose predecessor dates to 1920, was not drafted with the grantor trust situation in mind. When section 1015(b) is cited at all, it is usually in the context of sales to trusts or other taxable dispositions.[65] In *Malone*,[66] for example, the taxpayer transferred encumbered land to a trust and the trustees assumed the debt. The court held that the taxpayer realized gain to the extent that the debt on the property exceeded its basis and remarked that the trust's basis would be increased by the grantor's gain recognized under section 1015(b).

That said, nothing in section 1015(b) requires that it must apply only to transfers for consideration. On the contrary, its application is defined negatively: It applies to any transfer of property in trust "*other than* by a transfer in trust by a gift, bequest, or devise"(emphasis added). As long as a transfer is in trust but not by gift, bequest, or devise, section 1015(b) applies. That the transfer is not for consideration, by the terms of the statute, is irrelevant.

Indeed, the IRS already has interpreted section 1015(b) to apply even when a transfer in trust was for no consideration and even when there is no adjustment for gain or loss. In Rev. Rul. 2008-41, the IRS considered a situation in which a charitable remainder trust for multiple income beneficiaries was divided into separate charitable remainder trusts, each for a different income beneficiary. Each asset was divided pro rata between the resulting trusts. The IRS held that the division would not produce gain or loss. Nevertheless, under section 1015(b), the basis of each trust's share of each asset was the same as its share of basis immediately before the division.

To determine the basis of grantor trust assets at death, the IRS need only adopt an interpretation of section 1015(b) that is similar to the one it already adopted in Rev. Rul. 2008-41. That is, even though the termination of grantor trust status at death is not a transfer for consideration and does not trigger gain or loss,[67] section 1015(b) applies to the deemed transfer at death. Thus, the trust, upon termination of grantor trust status, receives a carryover basis under section 1015(b).

VIII. Conclusion

The basis of grantor trust assets at death is a thorny problem with a surprisingly easy solution. Treasury and the IRS do not need to reconsider Rev. Rul. 85-13. They certainly do not need to concede that grantor trust assets qualify for a step-up in basis under section 1014. All that Treasury and the IRS need to do is issue guidance, in the form of a revenue ruling, announcing a modest extension of its prior rulings on section 1015(b). That is, the IRS need only hold, consistent with Rev. Rul. 2008-41, that when section 1014(b) does not cause grantor trust property to be treated as passing from the decedent, section 1015(b) provides for carryover basis at death. ■

[65] *See* LTR 201303003 (applying section 1015(b) to a net gift situation in which the donees were liable to gift tax on the donor's gift).

[66] *Malone v. United States*, 326 F. Supp. 106 (D.C. Miss. 1971), *aff'd*, 455 F.2d 502 (5th Cir. 1972).

[67] ILM 200923024; *see also* Rev. Rul. 73-183.