

Basis

Banal? Basic? Benign? Bewildering?

by

**Lester B. Law
Abbot Downing
Naples, Florida**

And

**Howard M. Zaritsky, Esquire
Radipan, Virginia**

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BASIS – Banal? Basic? Benign? Bewildering?¹

by

**Lester Law, Esquire
Director of Client Management
Abbot Downing
Naples, Florida**

and

**Howard M. Zaritsky, Esquire
Rapidan, Virginia**

I. INTRODUCTION

The American Taxpayer Relief Act of 2012 changed both income and estate tax rates, to the point where some taxpayers, particularly those residing in states with high income taxes and modest or low 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 income that is subject to the 3.8 percent 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

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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. 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. In General

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. What is "Cost"

a) 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 assets 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).

b) 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. § 1.1011-1.

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)(1)(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 *Indopco, 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.

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'g* 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); *U.S. 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 reduce gain on receipt of proceeds, and were not deductible as expenses in production of income); *Mosby v. Comm'r*, 86 T.C. 190, 198 (1986) (property owner's expenses incurred to increase a condemnation award are nondeductible capital expenditures that serve to reduce the amount of the taxable gain); *Casalina Corp. v. Comm'r*, 60 T.C. 694, 703 (1973), *acq.* 1974-2 C.B. 1, *aff'd per curiam* 511 F.2d 1162 (4th Cir., 1975) (same); *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.*

(a) **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).

(b) **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. U.S.*, 582 F.2d 1374 (6th Cir. 1978), (basis of air conditioner owned by coin laundry not actually claimed).

(c) 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).

(d) 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).

(e) 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).

(f) 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. 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).

4. Small Business Tax Revision Act of 1958 and Tax Reform Act of 1976

The Small Business Tax Revision Act of 1958 allowed donees to increase their basis by the gift tax paid on a gift. 72 Stat. 1640 (1958). The Tax Reform Act of 1976 §§ 1901(a)(122), 1906(b)(13)(A), reduced the basis adjustment to the gift tax paid on the net appreciation in a gift. 90 Stat. 1784, 1834, 1877 (1976)

5. Economic Recovery Tax Act of 1981

The basis limitation on reverse gifts in contemplation of death was enacted as part of the Economic Recovery Tax Act of 1981 § 442(d)(1). 95 Stat. 322 (1981).

6. Deficit Reduction Act of 1984

The Deficit Reduction Act of 1984 § 421(b)(5), provided the special rule of IRC § 1041 for treating inter-spousal 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 (FMV) 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 FMV 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).

1. 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.

2. 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. 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 about Gifted 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.

"Depreciated property" is property where the FMV is less than its adjusted basis. Thus, a gift of depreciated property arises when, at the time of the gift, the FMV 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 FMV 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 FMV 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 FMV 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).

(1) 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 FMV 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 FMV on date of sale of \$125 minus the donor's \$100 basis).

b) Scenario 2: No Gain – No Loss

In Scenario 2, the FMV of the property on the date of the later sale is between the donor's adjusted basis and the FMV 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 FMV of the stock is \$90. In this case, there is no gain and no loss, since the FMV on the date of the sale is greater than the FMV 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 FMV of the property on the date of the later sale is below both (1) the donor's adjusted basis and (2) the FMV on the date of gift.

IRC § 1015(a) requires that for purposes of determining the loss, the donee/seller would use the FMV 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 FMV of the stock was \$62. In this case, the basis to be used is the FMV 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.A.2.c)(2)(a)(iii), where these same examples are used to explain the holding period.

F. 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 FMV, 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 FMV) of the property given up; and (2) a gift for the balance.

1. Example III-6

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

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

$$\frac{\text{Amount of the Gift}}{\text{Total Taxable Gifts (plus exemption allowed)}} \times \text{Total Gift Taxes Paid}$$

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).

(3) 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 FMV of \$70,000. Donor files a timely gift tax return paying \$56,800 in gift tax, computed as follows:

FMV of RE transferred to Donee-1	\$100,000
Less: Annual Exclusion	(14,000)
Included amount of gift to Donee-1	\$86,000

FMV of painting transferred to Donee-2	\$70,000
----------------------------------------	----------

Less: Annual Exclusion	(14,000)
Included amount of gift to Donee-2	\$56,000

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:

$$\begin{array}{r}
 \$86,000 \\
 \text{-----} \\
 \$142,000
 \end{array}
 \times \$56,800 = \$34,400$$

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

$$\begin{array}{r}
 \$30,000 \text{ (net appreciation)} \\
 \text{-----} \\
 \$86,000 \text{ (FMV - gift)}
 \end{array}
 \times \$34,400 = \$12,000$$

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.

(4) **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]).

(5) **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).

(6) **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).

(7) **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?

(1) 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

Donor gives \$10 million of zero-basis shares to Donee on January 1, 2014. Donor pays the gift tax on April 15, 2015. Donee sells the property on December 31, 2014.

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 Gifts

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).

On QDOTs generally, see also Moore, "Practical Estate Planning Techniques for Noncitizen Spouses," 26 Estate Planning 205 (June, 1999); Mulligan, "Updated Planning for Marital Dispositions, Lifetime QTIPs and QDOTs," 26 Estate Planning 395 (Nov. 1999); Rosenberg, "Practical Tips for Dealing With Qualified Domestic Trusts," 39 Estate Planning 28 (Nov. 2012); Zeydel & Chung, "Estate Planning for Noncitizens and Nonresident Aliens: What Were Those Rules Again?" 106 J. Tax'n 20 (Jan. 2007).

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 FMV 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:

$$\begin{array}{r}
 \$20,000 \text{ (net appreciation)} \\
 \hline
 \$70,000 \text{ (distribution)}
 \end{array}
 \times \$28,000 \text{ (§2056A tax)}$$

= \$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. 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.

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. See section III.D above and III.E above. 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 (Dec. 11, 1992) (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.

IV. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT -- IRC § 1014.

A. 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.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) § 501 (P.L. 107-15, 115 Stat 38), proposed repeal of the estate and GST taxes for 2010, and replacement with modified carryover basis EGTRRA § 542 (P.L. 107-15, 115 Stat 38). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 § 301(a), (P.L. 111-312, 124 Stat. 3296), made the substitution of transferred basis for the estate tax elective.

B. 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 FMV 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 FMV 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 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 more subtle.

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 FMV on the date of death); PLR 201245006 (Nov. 15, 2012) (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.A.6 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 required. Reg. § 1.1014-2(b)(2); Rev. Rul. 56-215, 1956-1 C.B. 324.

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 computing taxable income for exhaustion, wear and tear, obsolescence, amortization, and depletion 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. 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.

(2) Where

(a) Generally

Community Property rules apply to property held by a married couple under the law of many foreign countries as well as the U.S. states of Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Tennessee, Texas, Washington, and Wisconsin. See Alas. Stat. §§ 34.77.010 to 34.77.995; Ariz. Rev. Stat. §§ 25-211 to 25-218; Calif. Fam. Code §§ 750 to 755; Idaho Code §§ 32-901 to 32-929; La. Rev. Codes, tit. 9 §§ 2801 to 2802, La. Civ. Code, arts. 2334 to 2369.8; Nev.

Rev. Stat. §§ 123.010 to 123.310; NM Stat. §§ 40-3-1 to 40-3-17; Tenn. Code §§ 35-17-101 to 35-17-108; Tx. Family Code §§ 3.001 to 3.410; Wash. Rev. Codes §§ 26.16.010 to 26.16.250; Wis Stat §§ 766.01 to 766.97.

(i) Spanish / French Origins

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

(ii) 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 only one state, but perhaps it should just remain a testimony to the optimism of the National Conference of Commissioners on Uniform State Laws, who proposed this “uniform” state law in 1983. Even then, the comments to the Uniform Marital Property Act state of the Wisconsin legislation that: “While the Wisconsin act is a substantial adoption of the major provisions of the Uniform Act, it departs from the official text in such manner that the various instances of substitution, omission, and additional matter cannot be clearly indicated by statutory notes.” For more on the Uniform Marital Property Act, see also Cantwell, “Drafting Uniform Marital Property Act: Issues and Debate,” 21 Hous. L. Rev. 669 (1984); Furrh, “Divorce and the Marital Property Act,” 62 Wisc. Law. 23 (Jan. 1989); Furrh, “Is Marital Property Act Retroactive?,” 57

Wisc. B. Bull. 15 (July, 1984); Graham, "Uniform Marital Property Act: A Solution for Common Law Property Systems?," 48 SD L.Rev. 455 (2003); Horton, "Real Estate and Conveyancing Under Marital Property Act," 57 Wisc. B. Bull. 25 (July, 1984); Sampson, "Uniform Family Laws and Model Acts," 42 Fam. L. Q. 673 (Fall, 2008); Wadlington, "Uniform Marital Property Act," 57 Wisc. B. Bull. 25 (July, 1984); Sampson, "Uniform Family Laws and Model Acts," 42 Fam. L. Q. 673 (Fall, 2008); Wadlington, "Uniform Marital Property Act Symposium,," 21 Hous. L. Rev. 595 (1984); Wenig, "Marital Property Act," 69 Women Law. J. 9 (1983); Winter, "UMPA Fights for Recognition," 70 ABA J. 76 (1984).

(iii) Tennessee and Alaska - Opt-In Community Property

Alaska and Tennessee more recently 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. See discussion of the elect-in regime and its utility below.

(b) 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.

(3) 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)

6. Largely Superfluous Rules

a) Retained Income Interests and Retained Right to Revoke

(1) 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. U.S.*, 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.

(2) 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.

b) 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 which 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 FMV 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 FMV 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 they 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'g* 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. U.S.*, 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 FMV). 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) Reg.

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 Examples

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. IR 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 FMV 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 carryover 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.

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.” H.R. Rep. No. 201, 97th Cong., 1st Sess. 188–189 (1981).

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.” HR Rep. No. 201, 97th Cong., 1st Sess. 188–189 (1981). The IRS has adopted this same language in its IRC § 1014(e) rulings. Priv. Ltr. Ruls. 9026036, 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.” HR 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 (June 29, 1990), 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 (Jan. 5, 2001), 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 descendants.

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 (March 8, 2002).

(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 nonmarital 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 (April 11, 1986), 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. HOLDING PERIOD

A. Generally

1. 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 25 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.

2. When Does the Holding Period Begin?

a) In General

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.

b) 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. §1223; Rev. Rul. 70-598, 1970-2 C.B. 168. Thus, the time clock begins running on the day after acquisition.

(1) Example V-1

X purchased a capital asset, CA, on January 1, 2013. X sells CA on January 1, 2014. X has held the property for exactly one year (i.e., from January 2, 2013 to January 1, 2014; thus, gain or loss will be short-term.

(2) **Example V-2**

Same facts as **Example V-1**, however, X sells CA on January 2, 2014. 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. U.S.*, USTC ¶ 9195 (ED 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.

c) **“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.

(1) **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 a § 1231 asset, then the new owner could use the exchanged asset's holding period.

(a) Common Estate Planning Situations Where Exchange Basis Transactions Occur

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.

(i) 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 § 721(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.

(ii) 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.

(b) 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, 2014, 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, 2014 (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 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)).

(2) Transferred Basis Transactions

(a) In General

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 (FMV) of the gifted property is greater than its adjusted basis), and gifts of depreciated property (i.e., where the FMV of the gifted asset is less than its adjusted basis).

(i) 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.

(ii) Example V-4

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 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, 2014.

(a) 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).

(iii) 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 FMV 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 FMV of the property at the date of the gift.

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

(a) Scenario 1 – Gain Recognized

In Scenario 1, the FMV 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 § 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, 2013. Donor gives the stock to Donee on March 1, 2014, when the FMV 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, and Donee is allowed to tack Donor's holding period from January 1, 2013. Thus, Donee would recognize a long-term capital gain.

(b) Scenario 2: No Gain – No Loss

In Scenario 2, the FMV of the property on the date of the later sale is between the adjusted basis and the FMV 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 FMV of the stock is \$90. In this case, there is no gain and no loss, since the FMV on the date of the sale is greater than the FMV on date of the gift, but less than the adjusted basis was in Donor's hands.

(c) Scenario 3: Loss Recognized

In Scenario 3, the FMV of the property on the date of the later sale is below both the adjusted basis and the FMV on the date of gift. IRC § 1015(a) requires that for purposes of determining the loss, the donee/seller would use the FMV 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 FMV of the stock was \$62. In this case, the basis to be used is the FMV 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, 2014 to October 1, 2014).

(b) 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*”.

(3) 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 FMV, 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 FMV) 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’s son) for \$80, when the widget’s true FMV is \$100, then there is a sale of 80% (i.e., $\$80 \div \100) of the asset, and a gift of 20% (i.e., $\{100\% - 80\%$ } or $\{[\$100 - \$80] \div \$100\}$) of the asset. In this example, since the basis is bifurcated, 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).

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. U.S.*, 417 F.2d 675 (5th Cir. 1969)

(4) **Inherited Property – Deemed Holding Period**

(a) **General Rule – 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, 2013, P dies leaving his entire estate to his son, S. The estate distributed all of P's assets to S on February 1, 2013. On February 2, 2013, 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, 2013, 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."

(b) 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 property.” 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 decedent’s holding period, or whether it begins at the decedent’s date of death. Fortunately, 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.

3. 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 purchase order is fully executed. Rev. Rul. 70-598; Rev. Rul. 70-344, 1970-2 CB 50.

VI. 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(f)(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 tenant's 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. Reg. §§ 1.1001-1(f)(3), 1.1014-5(a)(3), 1.1015-1(b).

a) 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 (48.420% 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).

b) 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 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).

a) 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.

b) 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).

a) 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).

b) 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), 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).

a) 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 (48.420% 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 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.

b) 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.

c) **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.

d) **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 (Aug. 15, 2008) (net income charitable remainder unitrust), 200827009 (July 4, 2008) (net income charitable remainder unitrust), 200733014 (Aug. 17, 2007) (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 (Sept. 9, 2011), 201026014 – 201026017 (July 2, 2010).

2. 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.

3. 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 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).

4. **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 (Sept. 9, 2011) (noncharitable trust), 201136015 (Sept. 9, 2011) (noncharitable trust), 201136014 (Sept. 9, 2011) (noncharitable trust), 201136013 (Sept. 9, 2011) (noncharitable trust), 201136012 (Sept. 9, 2011) (noncharitable trust), 201026027 (July 2, 2010) (noncharitable trust), 201026026 (July 2, 2010) (noncharitable trust), 201026025 (July 2, 2010) (noncharitable trust), 201026024 (July 2, 2010) (noncharitable trust), 200833012 (Aug. 15, 2008) (net income charitable remainder unitrust), 200827009 (July 4, 2008) (net income charitable remainder unitrust), 200733014 (Aug. 17, 2007) (net income charitable remainder unitrust), 200648017 (Dec. 1, 2006) (noncharitable trust), 200648016 (Dec. 1, 2006) (noncharitable trust), 200443023 (Oct. 22, 2004) (noncharitable trust), 200442020 (Oct. 15, 2004) (noncharitable trust), 200231011 (Aug. 2, 2002) (nonqualifying split-interest charitable remainder trust), 200210018 (March 8, 2002) (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).

1. 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.

2. 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.

3. Example VI-15

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).

2. Property in a Trust or Estate

a) Generally

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)

(a) 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 percent of (\$50,000–\$20,000)). Beneficiary-1 is allocated \$15,000 of the total deduction.

(b) 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.

3. 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. 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); Treas. Reg. § 1.1015-1(a)(3).

2. Cases

a) Initial Burden on Taxpayer – 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 on 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. 1030), 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 the *Cinelli* and *Ternovsky* cases, 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. Commission*, T.C. Memo 1966-112, and *Alameda Realty Corporation*, 42 T.C. 273 (1955).

In other cases, taxpayers have approximated the basis based on facts and circumstances. *Magness v. Comm’r*, T.C. Memo 1965-260, and *Jones v. Comm’r*, 24 T.C. 525 (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

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.

VIII. BASIS AND PORTABILITY – PERHAPS THE MOST IMPORTANT QUESTION IN MARITAL DEDUCTION PLANNING

A. In General

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 inception² 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 VIII.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, Franklin and Law, *Clinical Trials with Portability*, 48th Heckerling Institute (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

² See, e.g., *Portability – Part One*, written on behalf of the ABA-RPTE section, http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/heckerling/2013/portability_the_game_changer_2013_01_15_paper_2.authcheckdam.pdf, 2012; Franklin, Law and Karibjanian, *Portability - The Game Changer*, http://meetings.abanet.org/webupload/commupload/RP512500/otherlinks_files/TheGameChanger-3-12-13v11.pdf, 2013; Franklin, Law and Karibjanian, *Portability – The Regulations*, http://meetings.abanet.org/webupload/commupload/RP512500/otherlinks_files/portability_the_regulations_2013_01_14_paper_1.authcheckdam.pdf, 2013; Franklin and Law, *Clinical Trials in Portability*, 48th Heckerling Institute, 2014; Franklin, Creative Intervivos QTIP Planning, ABA-RPTE / Tax 2014 Joint Fall Meeting, Denver, Sept. 2014; and Karibjanian and Law, *Portability and Prenuptials; A Plethora of Preventative, Progressive and Precautionary Provisions, Probate and Property*, Vol. 27, No. 3, May/June 2013; Franklin and Law, *Portability’s Role in the Evolution Away from Traditional By-Pass Trusts to Grantor Trusts*, BNA Tax Management Trusts and Estates Journal, March, 2012; and Blattmachr, *Bramwell and Zeydel, Portability or No: The Death of the Credit Shelter Trust?*, J. Tax’n (May 2013).

basic exclusion amount (BEA) (currently \$5.34 million at the time of the writing of this paper in October 2014).

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 entirety), 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 BEA, but less than two BEAs, 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 accomplish a basis adjustment (under IRC § 1014) in the assets that pass to the QTIP trust upon the first spouse's death, and also accomplish 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. 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 reticent to 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 look to 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 other(s).

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 have to 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 have to 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 that 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).

E. Adjusting Basis in a Non-Marital Trust

The following discussion is almost entirely derived from the paper, Clinical Trials with Portability.³

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-

³ Most of the information written in this part of this paper (i.e., basis adjustment in non-marital trusts) was taken from Franklin and Law, *Clinical Trials in Portability*, 48th Heckerling Institute (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 herein.

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.

1. Independent Trustee Power of Distribution

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).

a) Benefits

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

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

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.

Alternatively, explaining formula or springing GPOAs or the Delaware Tax Trap will be more challenging. Therefore, the simplicity of this approach should not be dismissed lightly.

b) Risks

The risks are 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. Another risk is that any distributed assets might be exposed to the surviving spouse's creditors.

2. Contingent Formula General Power of Appointment

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 ("GPOA") over all, or a portion, of the by-pass trust the GPOA will cause inclusion in the estate of the surviving spouse for Federal estate tax purposes. IRC § 2041.

If the surviving spouse exercises a testamentary GPOA, 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 GPOA, 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 GPOA 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 GPOA 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.

a) Is it Possible to Create a Contingent GPOA?

This section of the paper addresses whether it is possible to create a formula GPOA 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 possible to structure the GPOA 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.

(1) Can a GPOA be Based on a Formula Limited to the Surviving Spouse's Remaining Unused Applicable Exclusion Amount?

(a) PLRs – 200403094 and 200604028

The Service has approved of formula GPOAs based on the remaining estate tax exclusion of the decedent spouse. In PLRs 200403094 (Jan. 16, 2004) and 200604028 (Jan. 27, 2006), the decedent spouse was granted a formula GPOA 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 GPOA 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 GPOA 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.

(b) Regulations that Sanction Formulas

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 GPOA 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 *Est. 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* GPOA. 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 GPOA. The surviving spouse's beneficial interests in and the testamentary GPOA over the by-pass trust are

generally considered vested. Perhaps the testamentary GPOA could be vested subject to divestment based on the trustee's exercise of fiduciary discretion to make distributions.

(c) Sample Formula GPOA over Share that Will Not Increase Federal Estate Tax

Consider the following sample language in drafting a formula GPOA 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.”

(d) Can a GPOA be Granted Over Particular Assets rather than a Portion or Fractional Share of a Trust?

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)(emphasis added).”

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)(emphasis added).”

The following example illuminates the issues presented in the regulations:

(i) Example VIII-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 GPOA 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 GPOA.

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 GPOA.

(ii) Example VIII-2

Same facts as **Example VII-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 GPOA should be granted.

(2) Drafting of Clauses

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 tool.

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 FMV 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.

b) The Issue of Independent Significance

(1) *Estate of Kurz* and Contingent GPOAs

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 GPOA (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 GPOA 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 GPOA 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 effect the scope of the GPOA would cause the contingent GPOA to lack independent significance.

For instance, the surviving spouse could enlarge the scope of the GPOA 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.

(2) **Initial Conclusion About *Kurz* and Contingent GPOAs**

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) **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 GPOA 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.

3. Independent Power to Grant a General Power of Appointment

Another basis-adjustment alternative is to grant an independent trustee broad authority to grant the surviving spouse a general power of appointment. For the reasons discussed in section VIII.E.2 above, it appears that the independent trustee 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 GPOA 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.

a) Benefits

This method allows the independent trustee to pick and choose the appreciated assets to be subject to the GPOA. Loss assets can be excluded from the GPOA preserving the existing basis and preventing a step-down in basis to fair market value. Not being on

autopilot, the independent trustee can take all factors into considering when granting a GPOA. It may not be possible to draft a contingent GPOA that can do that.

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

b) Risks

The risks are that the independent trustee may be shy in exercising the authority and that the surviving spouse's death may occur unexpectedly. In the latter case, the independent trustee may not have had the opportunity to grant the GPOA.

c) Sample Forms Language

For sample form language, see, *Clinical Trials in Portability*.

4. Delaware Tax Trap

a) It is Complicated!

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 bypass 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 the 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?

b) How it Works!

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 (RAP). Thus, assets that would otherwise have to be distributed and vest in a non-charitable

beneficiary within the RAP could be held in trust for a longer period of time (or indefinitely) simply by exercising the power and creating another non-general POA. Historically, since donees of non-general POAs 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 POAs in those cases would be considered the exercise of a general POA and thus be subject to gift and estate taxes, respectively. Thus, if the non-general POA 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.

c) The Planning Approach

IRC § 2041(a)(3) provides that a non-general POA will be taxed as if it were a GPOA if the non-general POA is exercised to create another POA that can be exercised to postpone vesting beyond the RAP applicable to the original special POA.

The planning idea is that the surviving spouse as a beneficiary of the by-pass trust is granted a non-general POA that can be exercised to create another POA in a potential appointee that could extend the trust beyond the RAP applicable to the by-pass trust. The surviving spouse would then have an option to spring the trap by exercising the special POA 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 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 POA from operating in a manner that could postpone

vesting beyond the originally applicable RAP. Many form trust instruments also have provisions designed to do the same. Additionally, many states have also abolished the RAP and the precise operation of the Trap in these jurisdictions is in doubt. Attached, as Appendix B, is a sample RAP clause under Missouri that contemplates the possibility of springing the Trap, complements of Steven B. Gorin.

It appears that, to accomplish the basis adjustment mechanism goal, the design of the by-pass trust could be structured to grant the surviving spouse a non-general POA that could be exercised to create in a possible appointee a presently exercisable GPOA. Under this structure, the second POA is a GPOA 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.

F. Asset Protection Concerns for Basis Adjustment Mechanisms

Initially, when designing the estate plans, compare the asset protection issues involved with using a traditional by-pass trust to using 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.

1. 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.

2. General Power of Appointment

Whether creditor protection is lost if the surviving spouse is granted a general testamentary power of appointment is dependent on state law and a distinction is made as to whether the surviving spouse actually exercises the power. The traditional rule is the donee's creditors cannot reach the appointive assets covered by an unexercised GPOA if the power was not created by the donee. The idea is that until the donee exercises the power, the donee has not accepted sufficient control over the property to be equivalent to ownership. The newer Restatement Third, however, provides that property subject to an unexercised GPOA is reachable by creditors to the extent the donee's property or the donee's estate upon death is insufficient satisfy the donee's creditors or the creditors of the donee's estate. The donor of the power cannot overcome the new rule by stating an intent otherwise. California, Michigan and New York all have specific statutory provisions following the pattern of the Restatement Third. One possible solution to overcome the new rule is to require the consent of another person (for tax purposes the person must be nonadverse).

3. 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 donee of the power is granted a presently exercisable GPOA, the assets subject to the power are likely exposed to the donee's creditors. See the discussion above on GPOAs.

IX. 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.

1. 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, the uniform basis of the property, as well as the basis of each of the several interests. Reg. § 1.1014-6(b)(2).

Example IX-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).

2. Property Partially Included in Gross Estate

a) 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 IX-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
+	Increase in uniform basis	40,000 ⁴
		\$140,000

Reg. § 1.1014-6(b)(3)(i).

b) Basis for Cost Recovery Purposes

⁴ Determined by the following formula:

Increase in uniform basis (to be determined)		\$8,000 (value of property included in gross estate)
-----	=	-----
\$10,000 (total appreciation)		\$20,000 (value of entire property)

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.

(1) **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).

(2) **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.

c) **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).

(1) **Example IX-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 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.

(2) **Example IX-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 ⁵		\$ 33,333
		<hr/>
		\$133,000
- Deductions allowed prior to Decedent's death--taken into account under IRC § 1014(b)(9) ⁶		(6,667)
		<hr/>
Uniform basis		\$126,666
		<hr/> <hr/>

⁵ The reduction is determined by the following formula:

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

⁶ These deductions taken into account are determined by the following formula:

Prior deductions taken into account (to be determined)	=	\$100,000 (value of property included in gross estate)
-----		-----
\$10,000 (total deductions allowed prior to decedent's death)		\$150,000 (value of entire property)

X. BASIS AND BARGAIN SALES (PART-SALE/PART-GIFTS)

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 X-1

Son wishes to buy Mom's closely held stock that has a fair market value (FMV) 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 FMV 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 X-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 X-2

Daughter wishes to buy Dad's closely held stock that has a fair market value (FMV) 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 FMV 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 X-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.

a) Example X-3

This is the same fact pattern as **Example X-1**, except here we discuss Son's basis in the stock. Recall that Son purchased the stock with a FMV 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:

Consideration paid by Son	\$150,000
<u>or</u>	
Mom's basis, plus gift taxes paid	50,000
Son's basis	\$150,000

b) Example X-4

This is the same fact pattern as **Example X-2**, except here we discuss Daughter's basis in the stock. Recall that Daughter purchased the stock with a FMV 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:

Consideration paid by Daughter	\$150,000
<u>or</u>	
Dad's basis, plus gift taxes paid	200,000
Daughter's basis	\$200,000

4. Holding Period in non-charitable transaction

As discussed above in section V.A.2.c)(3) 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. U.S.*, 417 F.2d 675 (5th Cir. 1969).

Thus in each of the four examples, the donee (i.e., Son in Examples X-1 and X-3, and Daughter in Examples X-2 and X-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 X-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:

$$\begin{aligned} & \$300,000 \text{ adjusted basis} \times (\$400,000 \text{ amount} \\ & \text{realized} \div \$1 \text{ million value of property}) \end{aligned}$$

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 nonrecourse 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 TD 8176 (1988).

XI. 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, McKee, Nelson and Whitmire, *Federal Taxation of Partnership and Partners*, Thomson Reuters/ Tax & Accounting, 4th Ed. (2007 & Supp. through 2014-3).

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.

For a detailed discussion of the aggregate and entity theories, see Federal Taxation of Partnerships and Partners, ¶1.02, Thomson Reuters/ Tax & Accounting 4th Ed. (2007 & Supp. through 2014-3) and Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, ¶86.1, Thomson Reuters/Tax & Accounting, 2nd / 3rd Ed., 1993 - 2014, 2013 & 2014 Cum. Supp. N. 2).

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 XI.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

(c) Example XI-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 FMV 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 FMVs of the assets contributed. Reg. § 1.1223-3(b)(1). For an example, see also Reg. § 131223-3(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(b) 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.

(c) Examples

(i) Example XI-2

Assume the same facts as **Example XI-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.

(ii) Example XI-3

Assume the same facts as **Example XI-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.

(iii) Example XI-4

Assume the same facts as **Example XI-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 ($2/5^{\text{ths}}$), 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 ($3/5^{\text{ths}}$), 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 XI.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 DCA – 1983), *aff'g*, T.C. Memo 1981-184; and Rev. Rul. 80-235, 1980-2 CB 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.*

(2) To a Subchapter C Corporation – A Different Rule

It should be noted that in *Peracchi v. Comm'r*, 143 F.3d, 487 (9th DCA – 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. § 7.704-1; 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. § 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)(1); 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 in section XI.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) In General

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 XI.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).

Note: 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).

(d) Example XI-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 FMV 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, McKee, Nelson and Whitmire, *Federal Taxation of Partnerships & Partners*, Chapter 25.

(c) Example XI-6

Assume the same facts of **Example XI-5**, with regard to the partnership, no gain was recognized on its transfer of the cash (of \$5,000) or the property (with a FMV of \$15,000 and inside basis of \$5,000) to Janet.

Note: When Janet later sells the property, assuming the same FMV 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 FMV 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.

For a complete discussion of the intricacies of gain / loss recognition when distributions are made, see generally McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners*, Chs. 19 – 21.

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.

Note: 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)

(a) **Example XI-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).

(b) **Example XI-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: It should be noted 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) **In General**

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 XI.E.2.a)(2) below.

(a) **Basis**

(i) **Outside Basis**

The outside basis will disappear as a result of the liquidating distribution(s) 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.

(iv) Example XI-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 FMV 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).

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 section XIII below titled, *Basis and Grantor Trusts – Lots of Questions Not so Many Answers*, for a full 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

Note: If the contributing partner originally contributed property with a basis in excess of its FMV 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) Example 5. In other words, the donee-partner does not succeed in the donor-partner's 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 or death of the partner. Thus, inside basis is generally not affected by gifts.

However, if the gift is 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 XII.1.1 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:

$$\begin{array}{r} + \text{FMV p'ship interest at date of death or alternate valuation date} \\ + \text{Partner's share of partnership liabilities assumed} \\ - \text{Share of partnership's IRD} \\ \hline = \text{Inheriting Partner's new outside basis} \end{array}$$

b) Inside Basis

(1) In General

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 FMV 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 XI.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) General Rule

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 XI.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 XII.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 IRC § 743(a)'s general rule mandates that the inside basis is not to be adjusted on the happening of those events. However, IRC §§ 743(a) and (b) provides that adjustments may be made to the inside basis of asses 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 and not the partners. 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 §§ 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 § 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 § 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 FMV 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 §§ 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 XI.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-partner(s) 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.⁷

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.”

Note: 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.

⁷ 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.

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.

The authors believe that 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 is 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. Would a §643 Election change the result? Arguably it would. 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: Let’s assume that Jordan is the life income beneficiary of a GST Exempt Trust created in Delaware, where 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*. And, the descendants trusts have the same provisions in perpetuity. Assume that Jordan has many descendants and those descendants have many descendants, too. Let’s assume that there is nothing that will cause inclusion in any beneficiary’s estate upon a beneficiary’s death.
- Non-GST Trust With Contingent GPOA Example: Let’s assume in this example that Jordan is also a life income beneficiary of a Non-GST Exempt Trust with the same provisions as the GST Trust, however, there is a contingent general power of appointment (GPOA) that allows inclusion in the beneficiary’s estate for Federal estate tax purpose.
- Non-GST Trust Example: Let’s assume in this example that 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 GPOA).

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 GPOA 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 FMV. Thus, since the outside basis is adjusted, a 754 Adjustment appears to be warranted. See the discussion in section XIX below, titled "*Basis and the GST Tax.*"

XII. BASIS AND PASSIVE ACTIVITY ASSETS – IRC § 469

A. Overview of Passive Activity Loss Rules

The passive activity rules (relating to the limitations on deductions for passive activity losses (PALs) and passive activity credits (PACs)) were added to the Code, as IRC § 469, as part of the Tax Reform Act of 1986. PL 99-514 (enacted October 22, 1986). Those PAL/PAC 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 PAL and PAC 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 PAL / PAC 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 PAL/PAC limitations apply at the ultimate owner’s level. Generally, an owner’s PALs from all passive activities can be offset from passive activity income from other passive activities, however, if there is a net loss, such net PALs cannot be used against other income, instead those net PALs are suspended. The aggregation, netting and then allocation of the PALs are very complex and beyond the scope of this paper. For details of this see, Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, Ch. 28., Federal Taxation of Income, Estates and Gifts, ¶86.1, Thomson Reuters/Tax & Accounting, 2nd / 3rd Ed., 1993 - 2014, 2013 & 2014 Cum. Supp. N. 2); 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 PALs 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

PALs and PACs may not be deducted. IRC § 469(a). However, disallowed PALs and PACs 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 PALs 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 PALs/PACs 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 PALs allocable to such interest. IRC § 469(j)(6)(A). Under this rule, the suspended PALs are merely added to basis and the donee is unable able 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 PAL 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 FMV of such property, the rules about “gifts of depreciated property” under 1015(a) would apply, so that the basis (after adjustment) would be limited to the FMV 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 PAL rules will apply to that transferred interest.

D. Disposition of Passive Activity by Death

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 PALs can offset income. In death, however, some of the suspended PALs may be non-deductible.

There is a three step process to determine the amount of the allowable PAL:

- First, determine the amount of the PAL 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 FMV 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 PAL 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 PAL is deductible to the extent it is greater than the excess (determined in the second step). The rationale for this rule is to prevent PALs from exceeding true economic loss. Death eliminates any built-in-gains because of the basis adjustment under IRC § 1014. By disallowing PALs equal to built-in gains it prevents losses from exceeding the economic loss.

The deductible PAL 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).

1. Examples

a) Example XII-1 – Fully Utilized PALs

X dies on July 1, 2014, with a passive activity (PA) that he leaves to B. X's suspended PAL with respect to PA was \$235,000 immediately before his death. X's basis immediately before death was \$250,000. B's § 1014 basis is \$100,000 (i.e., PA's date of death adjusted basis).

The results will be as follows:

- First, X's PAL attributable to PA 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 PAL is \$235,000 to be used to offset X's income on his final income tax return.

Note 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 PAL could be fully utilized to offset the decedent's income.

b) Example XII-2 – Partially Utilized PALs

Assume the same facts as **Example XII-1**, except B's IRC § 1014 basis is \$350,000.

The results will be as follows:

- First, X's PAL attributable to PA 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 PAL is \$135,000 (i.e., the PAL is deductible to the extent of the excess).

c) Example XII-3 – Totally Non-Deductible PALs

Assume the same facts as **Example XII-1**, except B's IRC § 1014 basis is \$510,000.

The results will be as follows:

- First, X's PAL 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 PAL (of \$235,000), there is no deductible PAL.

Note: In this case, there was a built-in-gain at the time of death (i.e., the FMV 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 PAL, the PAL 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 V.A.2.c)(4)(b) above, Rev. Proc. 2011-41, 2011-35 IRB 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 XII.C above would apply.

XIII. 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

The nature of the grantor's relationship with the grantor trust began to seriously considered in *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984), *rev'g* 574 F.Supp. 19 (D. Conn. 1983), *nonacq.* Rev. Rul. 1985-13, 1985-1 C.B. 184.

(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**

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**

The IRS nonacquiesced in *Rothstein* in Rev. Rul. 85-13, 1985-1 C.B. 184.

(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:

“[i]t 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?**

The IRS has relied on this ruling as the basis for no fewer than five other revenue rulings, two notices, and over 125 private letter rulings, chief counsel advisories, field service advice and technical advice memoranda. See Rev. Rul. 2007-13, 2007-11 I.R.B. 684 (Feb. 16, 2007); Rev. Rul. 2004-86, 2004-2 C.B. 191; Rev. Rul. 90-7, 1990-1 C.B. 153; Rev. Rul. 88-103, 1988-2 C.B. 304; Rev. Rul. 87-61, 1987-2 C.B. 219; Notice 97-34, 1997-1 C.B. 422; Notice 97-24, 1997-1 C.B. 409; Notice 90-1, 1990-2 C.B. 297.

(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.

(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 (Nov. 30, 1990), 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 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 XI.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 (Sept. 11, 2009). 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, 1977-2 C.B. 222, 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 (Aug. 23, 1977), 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) of the regulations 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) General Rule

The income tax law has long viewed death as not a recognition event.

(a) Crane

The Supreme Court held in *Crane v. Comm'r*, 331 U.S. 1 (1947), 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 recodification 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.”

See also H. Rep. No. 1337, 83rd Cong., 2d Sess., 1954 U.S.C.A.N. 4017, 4331 (1954) and S. Rep.

No. 1622, 83rd Cong., 2d Sess., 1954 U.S.C.A.N. 4621, 4981 (1954).

(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.”

H. R. Rep. No. 107-84, 107th Cong., 1st Sess. 113 (2001). See also F. L. Boyle & J. G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* § 4:8.2 (PLI 15th ed.); and 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).

(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 in 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 C.C.A. 200937028 (Sept. 11, 2009), 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*, C.C.A. 200923024 (June 5, 2009) (“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 perceives a transfer to have occurred at the moment before death and 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.

(a) 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).

(iii) 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.

(iv) 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 the estate taxes attributable to the net appreciation in the note on the date of death. IRC § 691(c).

(v) 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.

(b) 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'g in part, rev'g 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.

(c) Does the IRS Really Believe This?

In C.C.A. 200923024 (June 5, 2009), 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 (IPO). 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).

(ii) Formation of Partnership and Trusts

Each taxpayer transferred his or her shares of stock to a partnership, and also formed an irrevocable nongrantor 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.

(iii) 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. Code § 674(c).

(iv) 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.

(v) Partnership Goes Public

The partnership then sold the shares in an IPO, 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.

(vi) 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).

(vii) 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, 1985-1 C.B. 184.

(viii) 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 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 IPO that they had reported, but the grantor trusts and their family member-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 IPO over their original low basis in the stock.

(c) 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.

(ix) 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.”

(x) 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. GRATs and QPRTs

1. Trustee'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 terminates 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 (June 6, 1969).

XIV. 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); McGraph, *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, 1969-1 C.B. 43.

(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 Repudiated, 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 his or her adjusted basis in the property exchanged for the annuity and all gain realized at the time of the annuity sale.

b) 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).

(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) (Oct. 18, 2006);
- 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) (Oct. 18, 2006); 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) (Oct. 18, 2006).

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 (Oct. 18, 2006).

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 (Oct. 18, 2006).

(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. U.S.*, 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).

3. 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.

XV. BASIS AND SELF-CANCELLING INSTALLMENT NOTES (SCINS)

A. In General

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 assets from an individual’s gross estate for estate tax purposes, while simultaneously providing that individual with a lifetime source of income. It is favorable, from a gift and estate tax perspective, when the transferor dies before his or her life expectancy. However, if the transferor outlives his or her life expectancy, the 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 Versus Private Annuities Briefly

The Service, in GCM 39503 (May 7, 1986), distinguished a private annuity from a SCIN, by concluding that a transaction will be treated as an installment note, if the total payments (including interest) for the transferred property is anticipated to 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 XIV).

2. SCINs Versus Ordinary Installment Notes (OINs)

SCINs are similar to OINs in that they both have the installment feature that defers the income recognition, thus, deferring income tax liability on the date of the sale. IRC § 453(b)(1). The regulations permit SCINs since 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 the possibility that the transferor may not survive the payment period.

SCINs and OINs are also similar in that they both can be effective in freezing estate values, they may convert illiquid assets to liquid assets, and the income tax treatment is similar.

SCINs are different from OINs in that with the typical SCIN the transferee is not obligated to make any further payments after the transferor's death. To avoid gift and estate tax implications, to compensate the transferor / seller for the death contingency, a 'risk premium' must be paid by the transferee.

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 are for full and adequate consideration. This is especially true when discounted assets (for instance limited liability company interests 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. Thus, in this respect, sales involving SCINs are no different than 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. Currently, it is 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, Wojnaroski, and Gassman, *IRS Puts More Skin in the Game of Using SCINs*, Est. Plan. (Jan 2014). *See also*, CCA 20133033 (8/5/13) 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*, Zaritsky & Aucutt, *Structuring Estate Freezes: Analysis with Forms* (Thompson Reuters/ Tax & Accounting, 2nd ed. 1997 & Supp June 2014), ¶ 12.02[3].

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 has recently taken 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.*, T.C. Memo 2006-212, it appears that the IRS may have used the IRC § 7520 rate to determine the SCIN's value. *See*, Zaritsky & Ault, *Structuring Estate Freezes: Analysis with Forms*, ¶ 12.02[3].

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.*, T.C. Memo 2006-212.

For a more detailed discussions about the gift tax consequences, *see*, Malin, *Self-Cancelling Installment Note Maintain Planning Usefulness*, 65 Practical Tax Strategies 141 (Sept. 2000), Rapkin, *Freezing Estates with Private Annuities and Self-Cancelling Installment Notes*, 12 J Tax'n Investments, 22, 41 (1994), and Zaritsky & Aucutt, *Structuring Estate Freezes: Analysis with Forms*, ¶ 12.02 [3].

2. Estate Tax

a) General Rule - No Estate Tax Inclusion

Properly structured, the SCIN (i.e., the note receivable) is not included in the transferor's gross estate. *Est. of Moss v. Comm'r.*, 74 T.C. 1239 (1980). Technically, the note is cancelled at the moment of death, thus, it has no value at death.

b) Include Payments Received

Although the note is not included in the transferor's estate, if the transferor received any payments from the time of the sale through his or her death, those payments (including any appreciation thereon) will however 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/or have estate tax consequences. *Est. of Musgrove v. U.S.*, 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. *Est. 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 XV.D below, and for a general discussion about sales between a grantor and his or her irrevocable grantor trust, see section XIII above.

Generally, there is one income tax issue facing the transferor / seller, which is the recognition of income; whereas there are two income tax issues that affect the transferee / buyer, which are: (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 a 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. However, deductibility may be limited by some of the provisions of IRC §163. 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 transaction, 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 would support 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 *Est. of Frane v. Comm'r.*, 98 T.C. 341 (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. *Est. of Frane v. Comm.*, 98 T.C. 341, *aff'd in part, rev'd in part*, 998 F.2d 567 (8th Cir. 1993). The Appeals Court affirmed the Tax Court 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 reached 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 majority of the Tax Court's decision in *Frane* was met with a strong five-judge dissent, 98 TC 341. Judge Halpern, writing for the dissent, took the position that there should be no recognition event. Judge Halpern, agreeing with the taxpayer, felt that there was no cancellation 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.

(b) *Frane's* Majority Inconsistent With *Est. of Moss*

Judge Halpern, on behalf of the Tax Court's dissenting judges, argued that the majority's holding is inconsistent with *Est. of Moss v. Comm.*, 74 T.C. 1239 (1980), where the Tax Court held that since the decedent had "no interest in the notes" there could be no inclusion in the gross estate. The dissenting opinion points out to the majority, "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 Applicability*

Under the rule established in *Golsen v. Comm.*, 445 F.2d 995 (10th Cir.) (commonly referred to as the *Golsen* rule), *Frane* is precedent for the Eighth Circuit. Thus, if the taxpayer faces the same issue in a different circuit, perhaps one could use Judge Halpern's dissenting argument.

c) *Planning Pointer*

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*, Est. Plan. (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. See discussion on grantor trusts in Section XIII above.

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*

Recall 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 XIII.A.5, above, discussing, Treas. Reg. 1.1001-2(c), Ex. 5; Rev. Rul 77-402, 1977-2 C.B. 222; and *Madorin v. Comm’r*, 84 T.C. 667 (1985).

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*, in section XIII.A.6 above.

XVI. 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 (Feb. 26, 1993).

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 (Jan. 5, 2001), 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 (Sept. 24, 2004) and PLR 200604028 (Jan. 27, 2006), reaffirming the same points as PLR 200101021, except not addressing IRC § 1014(e).

D. The Joint Estate Step-Up Trust (JEST)

A recently devised variation on the tax-basis revocable trust is the joint estate step-up trust, or JEST. See Gassman, Denicolo, & Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses – Parts 1 and 2*, 40 Est. Plan. 3, 14 (Oct., Nov. 2013).

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, in essence, 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 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. U.S.*, 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.

XVII. BASIS AND THE ALASKA OR TENNESSEE COMMUNITY PROPERTY TRUST— PERHAPS THE BEST BASIS PLAY IN ESTATE PLANNING

A. Generally

Two states, Alaska 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. Both Alaska and Tennessee permit 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. Alas. Stat. §§ 34.77.010 to 34.77.995; and 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 States

Oklahoma enacted an opt-in community property system in 1939 and Oregon enacted one in 1943. 32 Ok. Stat. of 1941, §§ 51 *et seq.*; Ore. Laws of 1943, ch. 440.

2. Alaska

Alaska enacted an opt-in community property system in 1998. Alas. State Laws of 1998, ch. 42.

3. Tennessee

Tennessee enacted its opt-in community property system in 2010. Tenn. State Laws of 2010, ch. 658.

B. The Community Property Trust

Both Alaska 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. Alas. Stat. § 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. Alas. Stat. § 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. Alas. Stat. § 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. Alas. Stat. § 34.77.100(a);
- The trust is signed by both spouses. Alas. Stat. § 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.

Alas. Stat. § 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. Alas. Stat. § 34.77.100(d)(1);
- the management and control of the property transferred to the trust. Alas. Stat. § 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. Alas. Stat. § 34.77.100(d)(3);
- the choice of law governing the interpretation of the trust. Alas. Stat. § 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. Alas. Stat. § 34.77.100(d)(5);

- Provisions respecting the right to amend or revoke. Alas. Stat. § 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 revoked 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 subsection, "surviving spouse's property" means the property that consists of the surviving 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. Alas. Stat. § 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. Alas. Stat. § 34.77.100(h).

d) Conditions of Enforcement

An Alaska community property trust is not enforceable if the spouse against whom enforcement is sought proves that

- the trust was unconscionable when made. Alas. Stat. § 34.77.100(f). Whether or not a community property trust is unconscionable is determined by a court as a matter of law. Alas. Stat. § 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. Tennessee

Tennessee provide for the ownership of community property in Tennessee only in 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(1);
- 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, INCLUD-

ING, 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.

Tenn. Code § 37-15-103(4).

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 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 situs 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 and Tennessee Community Property Trusts

The requirements for an Alaska Community Property 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, Alaska courts should have jurisdiction over matters involving the administration of an Alaska Community Property 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 (2d) 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 (2d) 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 (2d) 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. 110, 106 N.E.2d 36 (1952), *aff'g* 278 App.Div. 806, 927, 104 N.Y.S.2d 804 (1st Dep't 1951), *aff'g* 278 App.Div. 806, 927, 104 N.Y.S.2d 804 (1st Dep't 1951), *aff'g* 96 N.Y.S.2d 798 (1950). A few others have applied the law designated by the grantor in construing a trust on real estate. *Greenwood v. Page*, 138 F.2d 921 (D.C.Cir.1943); *Guerard v. Guerard*, 73 Ga. 506 (1884); *Brown v. Ramsey*, 74 Ga. 210 (1884); *Keith v. Eaton*, 58 Kan. 732, 51 P. 271 (1897); *Houghton v. Hughes*, 108 Me. 233, 79 A. 909 (1911); *Martin v. Eslick*, 229 Miss. 234, 90 So.2d 635 (1956); *Zombro v. Moffett*, 329 Mo. 137, 44 S.W.2d 149 (1931); *Applegate v. Brown*, 344 S.W.2d 13 (Mo. 1961); *Cary v. Carman*, 116 Misc.

463, 190 N.Y.S. 193 (1921). The law of the situs almost certainly controls issues of construction only in the absence of a designation in the instrument of the governing law.

(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.”

2. Application of basis rules for community property.

The major tax advantage of creating an Alaska 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 (Aopt out@) state laws or under elective (Aopt in@) state laws. Furthermore, significant authority strongly suggests that community property under an Aopt in@ law, such as that adopted in Alaska or Tennessee, would be eligible for the basis adjustment at death under IRC § 1014(b)(6).

a) *Harmon*

In *Comm’r v. Harmon*, 323 U.S. 44 (1944), however, 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.* Mr. and Mrs. Harmon, residents of Oklahoma, filed a written election 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.

(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. 323 U.S. 44, at 46 (1944).

(b) **Court Refuses to Allow Opt-In Community Property to Assign Income**

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. Some commentators focus on this holding to conclude that the Alaska/Tennessee opt-in community property would not 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. 2014); (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).

(c) ***Harmon* Court Also Finds Opt-In Community Property to be, Well, Community Property**

The Court stated that Oklahoma had not implemented a new policy as an incident of marriage by adopting its opt-in community property system, but it made that statement only to reinforce its conclusion that community property income under the Oklahoma system arose out of contract, and not as a matter of mandatory state law. The Court 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). Again, the Court appeared to recognize that the income was community property, but it 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 Tax Court and the circuit court] 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. 323 U.S. 44, at 45-46 (1944).

One can, therefore, read *Harmon* to indicate 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) **Federalism Argument**

One might argue that community property under IRC § 1014(b)(6) is a federal concept and that only mandatory community property qualifies, but 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).

(4) **Practicality Argument**

Justice Douglas (joined by Justice Black) dissented, 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. 323 U.S. 44, at 51-53.

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. U.S.*, 1958 WL 10206 (N.D. Okla. 1958), is also instructive.

(1) Facts

The taxpayers, a married couple, elected in 1943 to treat their assets as community property under Oklahoma’s opt-in statute. In 1945, after *Harmon*, Oklahoma changed from a consensual community property regime to a mandatory

community property regime. Under the later Oklahoma act, 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 constituted community property.

Mr. McCollum died after the 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 Applies Predecessor to IRC § 1014(b)(6)**

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. The Alaska and Tennessee opt-in community property systems should produce the same result; community property under those two 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 opt-in community property should be respected under IRC § 1014(b)(6).

(1) **Facts**

In Rev. Rul. 77-359, Husband and Wife were residents of the State of Washington. Each presently owned separate property and expected to acquire more separate property in

future years. In 1975, the taxpayers agreed in writing that all presently owned property and all property to be acquired thereafter, both real and personal, would be community property.

(2) **Ruling**

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.

(3) **Analysis**

(a) **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 had 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 *Merri-man v. Curl*, 8 Wash. App. 894, 509 F.2d 765 (1973).

(b) **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. See *Comm'r v. Harmon*, 323 U.S. 44 (1944), 1944 C.B. 166.

d) PLR 199917025

In PLR 199917025 (April 30, 1999), the IRS treated as community property separate property that was converted into community property by an agreement between the spouses, which agreement was enforceable under applicable state law. See, e.g., Cal. Fam. Code § 850(b); also recommendation of such agreements in 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). H and W held stock in an account under H's name. Subsequently, H and W "executed a marital property declaration and agreement confirming that all property they held, either separately or jointly, was community property." W then died and a county superior court found the stock to be community property, based on state law. The IRS stated that H was entitled to the full step up under IRC § 1014(b)(6). The IRS noted, however, that the result would change if the state court order were reversed.

e) 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 or Tennessee Community Property Trust, the property will be community property under the law of that state. Such property appears literally to fall under the section.

D. Drafting and Planning

1. Generally

The Alaska and Tennessee community property trusts have not been tested in any court opinion, but they should work well under the existing law. In particular, the Code focuses on whether property is community property

under applicable state law, and both Alaska and Tennessee make this relatively easy to accomplish.

2. Situs Issues

Both Alaska and Tennessee make it quite easy for a trust to adopt those states as the relevant situs, but the importance of assuring that Alaska or Tennessee laws apply suggests that practitioners should urge their clients to do more than the minimum required to create an Alaska or Tennessee trust. In particular, it is suggested that taxpayers do the following:

- Give the situs (Alaska 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 couple divorces, the trust assets will be distributed in equal shares, one 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, *Tax Planning for Family Wealth Transfers at Death*, ¶¶ 4.08[11] and 4.08[12] (Thomson-Reuters/WG&L, 2014), for sample forms for Alaska and Tennessee Community Property trusts.

XVIII. 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, 2013-47 I.R.B. 537 (Nov. 18, 2013).

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.

XIX. 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 XIX-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.

XX. 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. Danforth, N. Lane, & H. Zaritsky, *Federal Income Taxation of Trusts and Estates* ¶ 4.11[1][d] (Thomson-Reuters/WG&L, 3d ed.) (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 Distribution 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, "Estate and Trust Distributions of Property in Kind After the Tax Reform Act of 1984," 40 *Tax L. Rev.* 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, "Revised Distribution Rules Change Tax Planning for Estates and Trusts," 14 *Tax'n Law.* 4 (July/Aug., 1985).

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 purposes, 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 immediately 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 a fiduciary to make a late election or revocation. Rev. Proc. 92-85, 1992-2 CB 490, and Rev. Proc. 93-28, 1993-2 CB 344, set out the standards the IRS will use to determine whether to grant a discretionary 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 Prob. Prac. Rep. 1 (July 1993).

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 purposes 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 election to recognize loss, however, because 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 (June 3, 1988), 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 (Oct. 11, 1996), 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.

XXI. 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,⁶ 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.

a) Example XXI-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. Proposed Regulations Offer a Solution

In Reg-154890-03, 79 Fed. Reg. 3142 (Jan. 16, 2014), Treasury proposes to amend 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. Prop. Reg. § 1.1014-5(c). The proposed regulations reduce the Grantor's basis by a share of the trust's undistributed net ordinary income and its undistributed net capital gains.

1. Example XXI-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 $\frac{2}{3} \times (\$110x - \$100x)$, or \$6.67x, and Grantor will recognize a \$93.33x gain on the sale of the annuity or unitrust interest. Prop. Reg. § 1.1014-5(d), Ex. 7.

C. Other Changes

The IRS and the Treasury Department stated that they may consider whether there should be any change in the treatment of the charitable remainder beneficiaries who participate in such a transaction. The IRS also asked for comments about whether similar rules should be adopted for other tax-exempt trusts.

D. Effective Date

The proposed regulations will apply to sales and other dispositions of interests in charitable remainder trusts after January 15, 2014, except for those occurring under a binding commitment entered into before January 16, 2014. Prop. Reg. § 1.1014-5(c)(4).

XXII. 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, (Jan. 28, 2005), 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.

4. National Office Analysis and Rulings

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*, 69 F.2d 967 (3d Cir. 1934); 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

The IRS addressed the calculation of the adjusted basis in life insurance policies in two revenue rulings issued in 2009. See also Gorin, "IRS Takes Formal Position on Income Taxation of Certain Transfers of Life Insurance Policies," 34 Tax Mgmt. Estates, Gifts & Tr. J. 17 (July 2009); and Leimberg & Zaritsky, "IRS Finally Explains the Income Taxation of the Sale of a Life Insurance Policy," 21 Prob. Pract. Rep. 1 (June 2009).

1. Rev. Rul. 2009-13

Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 (May 26, 2009) involved the income tax treatment of the surrender of a cash value life insurance policy.

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 B 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*, 80 F.2d 230, 231 (2d Cir. 1935), cert. denied, 298 U.S. 63 (1936); *Century Wood Preserving Co. v. Comm'r*, 69 F.2d 967, 968 (3d Cir. 1934), 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 A substitute for ordinary income doctrine,⁶ which converts part of the gain on a sale into ordinary income, because neither "property" nor A capital asset⁷ includes A 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

B 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) Effective Date

Rev. Rul. 2009-13 states that the holdings of this revenue ruling with respect to Situations 2 and 3 will not be applied adversely to sales occurring before August 26, 2009.

(1) So What?

This assurance might not be a complete protection for taxpayers who have sold policies to life settlement companies in the past. This declaration promises that the ruling will not be applied retroactively, but an IRS agent might take the same positions espoused in this ruling, based on the underlying precedents, and merely not take advantage of the additional weight that a revenue ruling affords.

(2) Weight of the Ruling

It is not entirely clear what the weight of the ruling might be. Revenue rulings generally receive deference from the courts. See, e.g., *Davis v. U.S.*, 495 U.S. 472 (1990) (Although the Service's interpretive rulings do not have the force and effect of regulations, . . . we give an agency's interpretations and practices considerable weight where they involve the contemporaneous construction of a statute and where they have been in long use); *AMP, Inc. v. U.S.*, 185 F.3d 1333, 1339 (Fed. Cir. 1999) (A revenue ruling issued at a time when the I.R.S. is preparing to litigate is often self-serving and not generally entitled to deference by the courts . . . This is especially true when the ruling cites no authority and is inconsistent with regulations and other pronouncements of the I.R.S.); *Estate of McLendon v. Comm'r*, 135 F.3d 1017, 1023 (5th Cir. 1998) (Revenue rulings are odd creatures un conducive to precise categorization in the hierarchy of legal authorities. They are clearly less binding on the courts than treasury regulations or Code provisions, but probably (and in this circuit

certainly) more so than the mere legal conclusions of the parties); *Wood v. Comm'r*, 955 F.2d 908 (4th Cir. 1992), *cert. granted*, 504 U.S. 972 (1992), *cert. dismissed*, 505 U.S. 1231 (1992) (court first reached same result as ruling, and then stated that "considerable weight is to be given to an agency's construction of a statute that it is charged with administering); *Indiana Nat'l Corp. v. U.S.*, 980 F.2d 1098 (7th Cir. 1992), *cert. denied*, 508 U.S. 907 (1993) (It is proper to consider a relevant revenue ruling, . . . although they are not definitive). The Tax Court and at least one other court, however, have viewed revenue rulings as little more than the statement of position by one of the litigants. *Stubbs, Overbeck & Assocs. v. U.S.*, 445 F.2d 1142, 1146B47 (5th Cir. 1971) (rulings are merely the opinion of a lawyer in an agency); *Norfolk S. Corp. v. Comm'r*, 104 T.C. 13 (1995) (A ruling or other interpretation by the Commissioner is only as persuasive as her reasoning and the precedents upon which she relies); *Stark v. Comm'r*, 86 T.C. 243, 250 (1986) (Absent special circumstances, a revenue ruling merely represents the Commissioner's position with respect to a specific factual situation, [and] typically [is not] substantive authority for a position); *Reinhardt v. Comm'r*, 85 T.C. 511, 520 (1985) (revenue ruling merely represents the position of one of the litigants in this case, the Commissioner of Internal Revenue, and does not necessarily even represent the view of the Treasury Department).

d) Analysis and Critique

The IRS determination that the initial owner's basis in a life insurance policy must be reduced by the cost of insurance protection received by the insured before the sale is one of the most controversial features of either ruling. The IRS reliance on the cash surrender value as the primary determinant of basis appears to be reasonable, however, and certainly administratively convenient. All cash value life insurance policies reduce the cash surrender values to reflect both the costs of current insurance protection and the agent's commissions. It is not clear from the rulings whether the IRS views the agent's commissions as a proper charge against the seller's adjusted basis.

e) **Legislative Proposals**

(1) **S. 1813 (2012)**

S. 1813, 112d Cong., 2d Sess. (Passed Senate, March 15, 2012), would include an amendment to IRC § 1016(a)(1) to require an adjustment to basis “for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract.” This provision would have applied to transactions entered into after August 25, 2009.

(2) **Senate Finance Committee Tax Reform Proposals (2013)**

A release by the staff of the Senate Finance Committee released a “weekly options paper” summarizing some of the proposals that would be considered as part of the current tax reform debate. Among these tax changes was clarifying that there is an adjustment to basis in insurance policies “for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract.” Staff of the Senate Finance Committee, “Economic Security: Health, Retirement, Life Insurance, Fringe Benefits and Executive Compensation,” 113th Cong., 1st Sess. (May 23, 2013)

2. **Rev. Rul. 2009-14**

In Rev. Rul. 2009-14, 2009-21 I.R.B. 1031 (May 26, 2009), 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 AB 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.

