

IRS Chief Counsel Advice 200937028
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Recent Developments

American Bar Association
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On September 11, 2009, the IRS released Chief Counsel Advice 200937028 (the “CCA”), which consists merely of a copy of a redacted email dated November 18, 2008. A copy is attached. Because of the redaction, we do not know who it is from or to whom it was directed. Few facts are disclosed in the CCA, but it appears that a taxpayer was taking the position that the assets of a grantor trust should receive a basis adjustment under Section 1014 of the Code, presumably a step-up, equal to their fair market value as of the grantor’s death. The CCA states that the taxpayer transferred assets to the trust and reserved the power to substitute assets. It does not say whether the transfer was a gift or a sale or a combination of the two or whether there was a note outstanding on the grantor’s death. What is clear is that the chief counsel “strongly disagree[s]” with the taxpayer’s contention that the assets of the trust are entitled to a basis adjustment under Section 1014 of the Code.

Section 1014(a) provides that the basis of property acquired from a decedent is the fair market value of the property on the date of the decedent’s death. Section 1014(b) describes the circumstances under which property is considered to be acquired from a decedent.¹ Section 1014(b)(1) provides that property acquired by bequest, devise, or inheritance is considered to have been acquired from the decedent. The chief counsel concludes that Section 1014 does not apply because the decedent made a lifetime transfer of property to the trust and the trust property was not included in the decedent’s gross estate for federal estate tax purposes.

¹ See Section 1014(b)(1)-(10).

The chief counsel's analysis is simple, and it reaches a logical conclusion. So why would the taxpayer take a contrary position? Perhaps it is not so simple. In 2002 Jonathan Blattmachr, Mitchell Gans, and Hugh Jacobson published an article in the *Journal of Taxation*² that discussed the income tax consequences of the death of a grantor with a purchase money promissory note outstanding from a grantor trust. After concluding that the grantor's death does not trigger gain and that post-death payments on the promissory note are not income in respect of a decedent, the authors explore the issue of how the trustee of the once grantor trust determines the basis of assets purchased from the decedent. There are three possible ways to characterize the trustee's acquisition of the assets—a bequest or devise, a purchase, or a gift. If the acquisition is viewed as a bequest or devise, then basis is determined under Section 1014. If it is characterized as a purchase, then basis is determined under Section 1012. If it is deemed to be a gift, then basis is determined under Section 1015.

The authors concede that at first blush it seems implausible that the transfer of assets to an inter vivos trust the assets of which will not be includible in the transferor's gross estate could be considered a bequest or devise for purposes of Section 1014(b)(1). They observe, however, that although certain provisions of Section 1014(b)³ would require or result in estate tax inclusion, there is no such requirement for Section 1014(b)(1). If a grantor trust's assets are deemed to be owned by the grantor for income tax purposes, the authors state that "a good argument can be made that assets held in such a trust should be viewed as passing as a bequest or devise when the trust ceases to be a

² Income Tax Effects of Termination of Grantor Trust Status By Reason of The Grantor's Death, 97 J. Tax'n 149 (2002).

³ E.g. 1014(b)(2),(3), and (9).

grantor trust at the moment of death.”⁴ The authors pose an interesting question from a policy standpoint. A well-advised taxpayer who can predict the timing of his death can achieve a stepped-up basis by purchasing the grantor trust’s assets for cash (or an asset with no appreciation) immediately before death. The trust ends up with cash (or an asset with no gain), and the repurchased asset receives a basis step-up in the grantor’s estate under Section 1014. Why should the result be different for a taxpayer who is advised poorly or unable to predict the timing of his death?

If the acquisition is characterized as a purchase by the trustee in exchange for the note, effective as of the grantor’s death, then under Section 1012, the trustee’s basis would be equal to cost. This results in an “asymmetrical effect” because, as the authors argue, there is no authority for treating the decedent or his estate as having made a sale. Notwithstanding this conceptual asymmetry, this is a plausible outcome that produces symmetry between the estate tax inclusion value of the note (and other consideration received by the grantor in the sale) and the basis adjustment of the trust’s assets.

Finally, the acquisition could be treated as a gift with the basis consequences determined under Section 1015. There are three possible outcomes under Section 1015. First, if the acquisition is viewed as a pure gift (i.e. the note and other consideration are ignored), Section 1015(a) would apply, and the trustee would use the grantor’s basis for determining gain or the lesser of the donor’s basis or fair market value as of the “gift”⁵ for determining loss.

⁴ A complete discussion of this argument is beyond the scope of this short summary. The authors use statutory construction, legislative history, and policy considerations in their argument. It is well worth reading.

⁵ The authors pose the question of when the gift occurs for purposes of determining fair market value—the date of the sale or the date the trust is no longer a grantor trust. If it is the date of the sale, isn’t that contrary to the principle that transactions between a grantor and a grantor trust are disregarded for income tax consequences? Section 1015 is after all an income tax section.

Second, Section 1015(b) might apply. This subsection applies to transfers in trust other than by gift, bequest, or devise and where there is some consideration received by the donor. Here the trust's basis is equal to the grantor's basis increased by any gain or decreased by any loss the grantor recognizes in the transaction.

Third, the part gift/part sale rule of Reg. §1.1015-4 could apply. Here the trust's basis would be the greater of the grantor's basis or the amount paid by the trustee. The authors note that in a normal case this would produce a basis for trust assets equal to the sum of the grantor's basis and the amount of gain recognized by the grantor. But with a sale to a grantor trust, the grantor recognizes no gain. Does this mean that the trust receives a cost basis in the asset acquired from the grantor?

This basis issue is not as easy to sort through as the chief counsel advice would suggest. Ruling out Section 1014 does not answer the question of how the trustee of the former grantor trust determines the basis of assets acquired from the deceased grantor. Presumably, the chief counsel would argue that Section 1015 applies, not Section 1012. We see, however, with the assistance of Messrs. Blattmachr, Gans, and Jacobson, that the application of Section 1015 in the grantor trust context is not without questions.

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We strongly disagree with taxpayer's contention. 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 my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9).