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Curing Basis Discrepancy: Sales and Substitutions of Trust Property

by Matthew S. Beard

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In this report, Beard proposes three approaches to cure the discrepancy between sections 1014 and 1015 and accomplish a step-up in basis under section 1014 for appreciated property transferred from a trust to a grantor and then held by the grantor at death.

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Traditional estate planning for large estates focuses on reducing estate tax by a grantor transferring property to an irrevocable trust with few retained powers so that the property and future appreciation are excluded from the grantor's gross estate at death. However, an unfortunate consequence of sections 1014 and 1015 is that the transfer will not lead to favorable income tax results because the property's basis is not adjusted when transferred to the trust or at the grantor's death. Years after funding the trust, the grantor may desire stepped-up basis for appreciated property held by the trust to reduce future income tax. This report presents three approaches focused on reducing income tax by the grantor reacquiring appreciated property of the trust for stepped-up basis at death.

The IRC contains an income tax discrepancy between testamentary and lifetime transfers. For testamentary transfers, section 1014 generally provides that the basis of property acquired from a decedent is the fair market value of the property at the decedent's death, without recognition of gain under section 102. For lifetime transfers, section 1015 generally provides that the basis of property acquired by gift is the same as it would be in the hands of the donor, without recognition of gain under section 102.[1] Thus, a testamentary transfer of appreciated property results in stepped-up basis, but a gift does not.[2]

This discrepancy is not favorable to the grantor who transfers property to an irrevocable trust during life. Although the transfer may reduce estate tax because the property of the trust

[1] Section 1015(a), (b); reg. section 1.1015-1(a)(1), -2(a)(1) (For transfers in trust, section 1015(b) generally provides that if property was acquired by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on that transfer. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property is in the hands of the trustee or the beneficiary, and whether acquired before the termination of the trust and distribution of the property or thereafter.).

[2] "Appreciated property" means property in which the FMV exceeds its adjusted basis.

and future appreciation are excluded from the grantor's gross estate, the trust will have a carryover basis in the property under section 1015 that will not step up under section 1014 at the grantor's death. Without further action, the grantor sacrifices stepped-up basis under section 1014 to reduce estate tax. This trade-off may be satisfactory at trust funding for a grantor with a large estate who anticipates an estate tax rate (40 percent in 2020) that outweighs the income tax rate (23.8 percent in 2020 for long-term capital gain combined with net investment income).[3]

Nevertheless, the grantor, regardless of the size of his estate, may later wish to reacquire appreciated property of the trust so that the property will receive a stepped-up basis at the grantor's death under section 1014, and thus cure the discrepancy between sections 1014 and 1015. This article examines three approaches to accomplish this goal: (1) the grantor purchases appreciated property from the trust; (2) the grantor purchases appreciated property from the trust by borrowing without adequate security; and (3) the grantor substitutes appreciated property of the trust.

All three approaches transfer appreciated property from the trust to the grantor. This is the opposite direction compared with transfers under traditional estate planning. The grantor intentionally subjects appreciated property to potential estate tax for the benefit of stepped-up basis under section 1014 to reduce future income tax. The transfer could be beneficial where a grantor anticipates a taxable estate less than the basic exclusion amount ($11.58 million in 2020).[4] For larger estates, the transfer could be beneficial to harvest appreciation of trust property before a decline in value, as well as to avoid uncertain income tax implications for the conversion from a grantor trust to a non-grantor trust at the grantor's death.

I. Purchase Trust Property

The simplest structure for acquiring appreciated property of a trust involves a bona fide sale for adequate consideration. Under this approach, the grantor purchases appreciated property from the trust in exchange for cash. The trust is not treated as a grantor trust.[5] This approach serves as the starting point for comparing tax implications under the three approaches. In practice, however, this approach would rarely be implemented because of adverse tax consequences.

A. Tax Implications of Purchase

The purchase results in stepped-up basis with recognition of gain. For the grantor, section 1012 provides that the grantor's basis for the appreciated property is the cost of that property.[6] For the trust, section 1001 requires it to recognize gain from the sale equal to the amount realized over the adjusted basis of the appreciated property.[7] If the appreciated property sold by the trust is a capital asset held for over one year, then gain is taxed as long-term capital gain.[8] The combined long-term capital gain and NII tax rate is generally 23.8 percent.[9]

B. Tax Implications of Grantor's Death

At the grantor's death, the grantor's gross estate includes the value of the appreciated property held by the grantor at death, taxable at the estate tax rate of 40 percent.[10] The appreciated property receives a corresponding step-up in basis. The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent that is equal to the value placed on that property for purposes of the federal estate tax.[11] Thus, section 1014(a) generally provides that the basis of property acquired from a decedent is the FMV of the property at the date of the decedent's

[3] Paul S. Lee, "Run the Basis and Catch Maximum Tax Savings — Part 1," 42 *Est. Plan. J.* 1 (Jan. 2015).

[4] Section 2010(c); and Rev. Proc. 2019-44, 2019-47 IRB 1093 (providing inflation-adjusted basic exclusion amount in 2020).

[5] A grantor trust is a trust described under sections 671-677 and 679. Under section 671, when the grantor is treated as owner of all or a portion of a grantor trust, all items of income, deductions, and credits attributable to that portion of the trust are taken into account for computing the taxable income and credits of the grantor.

[6] Section 1011(a); and section 1012(a).

[7] Section 1001(a), (c).

[8] Section 1221(a); and section 1222(3).

[9] Section 1(h); and section 1411.

[10] Section 2033; and section 2001.

[11] Reg. section 1.1014-1(a).

death.[12] Section 1014(b) includes several circumstances in which property is considered to have been "acquired from the decedent," including property acquired by bequest, devise, or inheritance.[13] Also included is property acquired from the decedent by reason of death or other conditions if the property is required to be included in the decedent's gross estate for the estate tax.[14] Basis under section 1014 cannot exceed the final value determined for estate tax purposes.[15] Finally, under section 102, gross income does not include the value of the appreciated property acquired by bequest, devise, or inheritance.[16] These rules reflect the principle that testamentary transfers should generally be free of income tax, and coordinate the estate tax and income tax so that both taxes are not triggered at death.[17]

In contrast, the property of the trust is not included in the grantor's gross estate if the purchase was a bona fide sale for adequate and full consideration.[18] To constitute a bona fide sale for adequate and full consideration, the transfer must have been made in good faith, and the price must have been an adequate and full equivalent reducible to a monetary value.[19] Further, property of the trust should not receive a basis adjustment under section 1014 because it should not be considered to have been acquired from or to have passed from a decedent.[20]

II. Borrow Without Adequate Security

The second structure for acquiring appreciated property of the trust involves borrowing without adequate security. Under this approach, the grantor purchases appreciated property of the trust in exchange for the grantor's unsecured promissory note. The trust agreement does not provide the grantor with any retained powers for grantor trust treatment.

The tax implications under this approach are generally favorable to the grantor. If the grantor takes the affirmative act of borrowing from the trust without adequate security, then the trust will be converted to a grantor trust under section 675(3); transactions between the grantor and the grantor trust will be disregarded under Rev. Rul. 85-13, 1985-1 C.B. 184; and offsetting estate tax results will follow the grantor's death. However, in light of a risk that the IRS challenges the genuineness of the grantor's debt because it is unsecured, a cautious grantor should consider this option if the anticipated taxable estate of the grantor combined with the trust is less than the grantor's remaining basic exclusion amount ($11.58 million in 2020).

A. Tax Implications of Borrowing

1. Loan proceeds.

Gross income broadly includes all income from whatever source derived.[21] An exclusion exists for loan proceeds because the temporary economic benefit of income is offset by a corresponding obligation to repay.[22] For genuine indebtedness to be present there must be both good-faith intent on the part of the borrower to repay the debt and good-faith intent by the lender to enforce payment of the debt.[23] Whether a transaction constitutes a loan for income tax purposes is a factual question involving several considerations, and a distinguishing

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[12] Section 1014(a)(1); and reg. section 1.1014-1(a).

[13] Section 1014(b)(1); and reg. section 1.1014-2(a)(1).

[14] Section 1014(b)(9); and reg. section 1.1014-2(b).

[15] Section 1014(f)(1)(A); and reg. section 1.1014-10(a)(1).

[16] Section 102(a); and reg. section 1.102-1(a).

[17] *Backemeyer v. Commissioner*, 147 T.C. 526, 544-545 (2016) ("Nonrecognition on death is among the strongest principles inherent in the income tax. . . . When an individual dies, his assets are not taxed under the income tax but rather under the estate tax. Upon the assets' distribution to the decedent's heirs, section 102(a) explicitly provides that the heirs' 'gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.' And, as discussed above, section 1014 operates to provide a step-up in basis of the inherited property in the hands of the decedent's heirs; if an heir subsequently disposes of the property, gain is realized only to the extent the proceeds exceed the stepped-up basis. Sec. 1001(a).").

[18] Section 2036(a) ("The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise."); section 2043; reg. section 20.2043-1(a) ("The transfers, trusts, interests, rights or powers enumerated and described in sections 2035 through 2038 and section 2041 are not subject to the Federal estate tax if made, created, exercised, or relinquished in a transaction which constituted a bona fide sale for an adequate and full consideration in money or money's worth.").

[19] Reg. section 20.2043-1(a).

[20] Section 1014(b)(9).

[21] Section 61(a).

[22] *Todd v. Commissioner*, T.C. Memo. 2011-123, *aff'd*, 486 F. App'x 423 (5th Cir. 2012).

[23] *Id.*

characteristic of a loan is the intention of the parties that the money advanced be repaid.[24] Important factors considered by the courts in finding a bona fide debt are whether: (1) the promise to repay was confirmed by a note or other instrument; (2) interest was charged; (3) a fixed schedule for repayments was established; (4) collateral was given to secure payment; (5) repayments were made; (6) the borrower had a reasonable prospect of repaying the loan and the lender had sufficient funds to advance the loan; and (7) the parties conducted themselves as if the transaction was a loan.[25] Further, if interest is payable on the loan at a rate equal to or more than the applicable federal rate, then the loan should not be considered a below-market loan with imputed interest under section 7872.[26]

2. Grantor trust treatment under section 675(3).

By borrowing from the trust without adequate security, the grantor causes the trust to be treated as a grantor trust. Section 675(3) provides that the grantor is treated as the owner of any portion of a trust for which the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the tax year.[27] This rule does not apply to a loan that provides for adequate interest and adequate security if that loan is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor.[28] Section 675(3) addresses those situations in which the grantor has exercised "dominion and control" over a trust by borrowing from it without giving adequate security for the promise to repay the loan.[29] The image most immediately conveyed by the statutory language is that of a grantor who has obtained an asset from the trust, whether money or otherwise, in exchange for a promise to return the same asset at some future time.[30]

3. Rev. Rul. 85-13.

In Rev. Rul. 85-13, the taxpayer created an irrevocable trust with his wife as trustee.[31] The trust agreement did not provide the taxpayer with a power over the trust that would cause the trust to be treated as a grantor trust. The taxpayer funded the trust with a contribution of stock with a basis of $20x. The following year, when the FMV of the shares was $40x, the trustee transferred the shares to the taxpayer in exchange for an unsecured promissory note with a face amount of $40x, bearing an adequate interest rate payable semiannually with principal to be paid in 10 equal annual installments. A few years later, the taxpayer sold the shares to an unrelated party for $50x.

The IRS first addressed grantor trust treatment. Acknowledging that section 675(3) requires an affirmative act (borrowing) rather than a retained power before it applies, the agency ruled that the taxpayer is treated as the owner of the portion of the trust represented by the taxpayer's promissory note. The justification for treating the grantor as owner is evidence of substantial grantor dominion and control over the trust. Therefore, transfer of shares by the trust to the taxpayer is not recognized as a sale for federal income tax purposes because the taxpayer is both the maker and owner of the promissory note. A transaction cannot be recognized as a sale for federal income purposes if the same person is treated as owning the consideration both before and after the transaction.

The IRS next addressed basis. It ruled that the taxpayer's basis in the shares received from the trust is equal to the taxpayer's basis in the shares at the time the taxpayer funded the trust because the basis of the shares was not adjusted during the period that the trust held them. The taxpayer did not acquire a cost basis. Thus, when the taxpayer sold the shares of stock to a third party in the later year, the taxpayer recognizes gain of $30x (amount realized of $50x less adjusted basis of $20x).

[24] *Id.*, citing *Moore v. United States*, 412 F.2d 974, 978 (5th Cir. 1969).

[25] *Todd*, T.C. Memo. 2011-123, *aff'd*, 486 F. App'x 423.

[26] Section 7872(e)(1)(A) (for demand loan); prop. reg. section 1.7872-3(c)(1); and LTR 9535026 ("Thus, in general, under section 7872, a promissory note for a term longer than nine years is not treated as a below-market loan if the interest rate on the note is equal to or higher than the applicable federal long-term rate, compounded semiannually.").

[27] Reg. section 1.675-1(b)(3).

[28] Section 675(3); and reg. section 1.675-1(b)(3).

[29] *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984).

[30] *Id.*

[31] Rev. Rul. 85-13.

Finally, the IRS rejected *Rothstein*, which was issued by the Second Circuit in the prior year and determined that the taxpayer acquired a cost basis under a transaction that was in substance identical to Rev. Rul. 85-13. In *Rothstein*, the taxpayer contributed shares in a closely held corporation holding real property to an irrevocable trust he established for the benefit of his three children. The taxpayer's wife was trustee. Seven years later, the taxpayer purchased the trust's shares in exchange for an unsecured promissory note bearing adequate interest, and interest payments were duly made. The IRS's theory was that, under section 675(3), the taxpayer was to be treated as the "owner" of the trust assets, and thus transactions involving trust assets were to be reanalyzed after substituting the taxpayer (as the "owner" of those assets) for the trust. Thus, the IRS's view was that the taxpayer could not claim a full "cost" basis in stock acquired in a sale that involved nothing more than a transfer of the property from the taxpayer (as "owner" of the stock) to himself. The Second Circuit held that there can be no doubt that the extension of credit in *Rothstein*, made without adequate security by a subservient trustee, would fall within the scope of the statute, and thus the court deemed it a "borrowing" or "loan" under section 675(3). The court drew no distinction between (1) an extension of credit in which the proceeds are actually delivered to and received by the grantor, and (2) one in which they are immediately applied to the purchase of an asset from the trust. However, the court recognized that nowhere does section 671 direct that the grantor's basis in property purchased from the trust be different from what it would be otherwise — namely, his cost in acquiring it per his promissory note.[32] To reconcile the result in *Rothstein* with the IRS's position of treating the owner of a trust as the owner of the trust's assets, the agency stated that it will not follow the decision of *Rothstein* insofar as it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor.

[32] *Rothstein*, *supra* note 29 ("Nothing in section 671 says that a grantor shall not be entitled to his usual cost basis in property purchased from a trust of which other sections direct he shall be treated as 'owner'; it says only, so far as here relevant, that if his purchase results in taxable gain to the trust, he is taxable on the gain.").

B. Tax Implications of Grantor's Death

Like the first approach discussed above, the appreciated property held by the grantor at death should receive a stepped-up basis under section 1014 without recognition of gain under section 102. In contrast, the grantor's unsecured promissory note results in offsetting estate tax effects. The appreciated property held by the grantor at death is included in the grantor's gross estate.[33] The grantor's taxable estate is then determined by deducting from the value of the gross estate any indebtedness regarding property in which the value of the decedent's interest, undiminished by that indebtedness, is included in the value of the gross estate.[34] That deduction is, when founded on a promise or agreement, limited to the extent that they were contracted bona fide and for an adequate and full consideration in money or money's worth.[35]

There is a risk that the IRS argues that trust property should be included in the grantor's gross estate because the grantor's loan is without adequate security.[36] Whether the loan is genuine indebtedness is a fact question, and collateral to secure payment is a factor considered by the courts in finding a bona fide debt.[37] To reduce this risk, the grantor may be willing to agree to a premium interest rate to compensate the trust for lack of security. Assuming trust property is excluded from the grantor's gross estate, that property should not receive a basis adjustment under section 1014 at the grantor's death because the property is not subject to estate tax, and therefore should not be considered to have been

[33] Section 2033.

[34] Section 2053(a)(4).

[35] Section 2053(c)(1)(A).

[36] *Compare* Howard M. Zaritsky, *Tax Planning for Family Wealth Transfers During Life: Analysis With Forms*, section 3.02[3][d][ii] (For section 675(2), "this should not cause any portion of the trust to be included in the grantor's gross estate, unless the nonadverse party can be shown to be acting as the grantor's agent."), *with* Peter Spero, *Asset Protection: Legal Planning, Strategies and Forms*, section 5.07(3)(e) ("At least one commentator [Zaritsky] recommends granting a nonadverse party the right to lend the grantor corpus and income 'without adequate interest or without adequate security' as a way of creating a grantor trust without causing the trust to be included in the grantor estate, i.e., Section 675(2). There is little judicial authority to support this position, and none on point; accordingly, reliance on the provision seems risky.").

[37] *Todd*, T.C. Memo. 2011-123, *aff'd*, 486 F. App'x 423 (5th Cir. 2012); *Moore*, T.C. Memo. 2020-40, 51 ("The promissory notes signed by Moore's children were not secured — this weighs strongly against a finding of *bona fide* debt.").

acquired from or to have passed from a decedent.[38]

III. Substitute Trust Property

Under a typical substitution power, the trust agreement provides the grantor with the retained power to reacquire any property held by the trust by substituting other property having equivalent value, exercisable by the grantor in a nonfiduciary capacity, without the consent or approval of any person in any capacity. The substitution power has been a popular grantor trust power since 2008 because the IRS issued Rev. Rul. 2008-22, 2008-16 IRB 796, in that year and made clear that a substitution power results in grantor trust treatment without gross estate inclusion. If the grantor retained a substitution power, then a third structure is available in which the grantor exercises the power to substitute appreciated property of the trust for other property of equivalent value.

In addition to accomplishing the goal of transferring appreciated property from the trust to the grantor so that the appreciated property receives a stepped-up basis under section 1014 at the grantor's death without recognition of gain under section 102, this approach also provides greater tax certainty. For estate tax, the trust is excluded from the grantor's gross estate because the substituted property is of equal value. For income tax, the grantor, by substituting property of the trust in exchange for cash or high-basis property, practically avoids uncertain income tax implications regarding the termination of grantor trust status upon the grantor's death.

A. Tax Implications of Substitution

1. Grantor trust treatment under section 675(4)(C).

Retention of the substitution power causes the trust to be treated as a grantor trust. Section 675(4)(C) provides that the grantor shall be treated as the owner of any portion of a trust in which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, including a power to reacquire the trust corpus by substituting other property of an equivalent value.[39]

The substitution of property of equivalent value between the grantor and the grantor trust should not be recognized as a sale for federal income tax purposes.[40] In LTR 200001013, the IRS cited Rev. Rul. 85-13, which addressed borrowing under section 675(3), to address a proposed substitution under section 675(4)(C).[41] In that private letter ruling, the taxpayer proposed to establish an irrevocable trust holding S corporation stock with the taxpayer's spouse as trustee. The trust agreement provided the taxpayer with the power, exercisable in a nonfiduciary capacity, without the consent or approval of any person in any capacity, to reacquire any property held by the trust by substituting other property having the same FMV. The IRS ruled that the taxpayer will be treated as the owner of the trust for purposes of section 671, and that neither the taxpayer nor the trust will recognize gain or loss as a result of the substitution by the taxpayer of assets of the taxpayer for assets of the trust.

2. Renunciation of substitution power.

If the grantor renounces the substitution power during the grantor's lifetime, then grantor trust status terminates and the grantor is considered to have transferred ownership of property then held by the trust to the trust.[42] Renunciation has been problematic under facts involving a partnership with significant debt. When a transfer of an interest in a partnership occurs and the transferor's share of partnership liabilities is reduced or eliminated, the transferor is treated as having sold the partnership interest

[38] Section 1014(b)(9).

[39] Reg. section 1.675-1(a); and reg. section 1.675-1(b)(4)(iii).

[40] Rev. Rul. 85-13 ("Further, this holding would apply even if the trust held other assets in addition to A's promissory note if A, under any of the grantor trust provisions, was treated as the owner of the portion of the trust represented by the promissory note because A would be treated as the owner of the purported consideration (the promissory note) both before and after the transaction.").

[41] LTR 200001013; *see also* LTR 200434012 and LTR 200842007.

[42] Rev. Rul. 77-402, 1977-2 C.B. 222; and reg. section 1.1001-2(c), Example 5. Note, however, that the authorities do not appear to require the conversion from grantor trust to non-grantor trust to result in the taxable transfer of property from the trust to the grantor.

for an amount equal to the share of liabilities reduced or eliminated.[43] Further, the disposition of property that secures a nonrecourse liability discharges the transferor from the liability, and the amount realized from the disposition includes the amount of liabilities from which the transferor is discharged as a result of the disposition.[44]

In Example 5 of reg. section 1.1001-2(c), an individual creates an irrevocable trust that is treated as a grantor trust. The trust purchases an interest in a partnership. Three years later, the individual renounces the powers retained that caused the trust to be treated as a grantor trust. Consequently, the trust ceases to be a grantor trust and the individual is no longer considered to be the owner of the trust. At the time of renunciation, the individual is considered to have transferred ownership of the interest in the partnership to the trust, now a separate taxable entity independent of the individual. On the transfer, the taxpayer's share of partnership liabilities is treated as money received, thus leading to the individual's realization of gain to the extent that the individual's share of partnership liabilities exceeds the adjusted basis of the partnership interest held by the trust.

The taxpayer challenged the validity of this example in *Madorin*.[45] In that case, the taxpayer established irrevocable trusts with a non-adverse trustee. The trust agreement included a power that caused the trust to be treated as a grantor trust. Each trust was funded with a gift of approximately $5,000, which was then contributed to a partnership that contributed to another partnership that performed motion picture services to Warner Bros. Entertainment Inc. To finance the performance of services, the partnership obtained a nonrecourse loan of $3.27 million. The partnership reported losses for two years, and income in the third year. In the following year, the grantor trust power was renounced.

The IRS, relying on Example 5 of reg. section 1.1001-2(c), determined that the taxpayer 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 taxpayer argued that the grantor of a trust should be treated as the owner only for the limited purpose of attributing to him items of income, deductions, and credits. The Tax Court agreed with the IRS and recognized that there is an interplay between section 671 and the partnership provisions of subchapter K, along with the recognition of gain or loss provisions of section 1001, that provide for potential recapture regarding debt.[46] This scheme of taxation is frustrated if the taxpayer is allowed to escape recapture through a formalistic, piecemeal application of the law.

The taxpayer in *Madorin* also contended that even if the grantor is the owner of the trust assets, a mere change in the trust's status is not a disposition triggering the recognition of gain because a sale or other disposition did not occur. No transfer documents were executed, nor was there any other method of conveyance. The Tax Court responded that although this is true in form, a different event took place in substance.

B. Tax Implications of Grantor's Death

1. Stepped-up basis under section 1014.

After substitution, appreciated property held by the grantor at death receives a stepped-up basis under section 1014 without recognition of gain under section 102. Thus, substitution provides the same favorable income tax results for the appreciated property as the other two approaches discussed earlier.

2. Trust excluded from grantor's gross estate.

The trust is excluded from the grantor's gross estate because the substitution power has neutral economic effect. "Substitution" includes the process by which one thing takes the place of another.[47] The typical substitution power permits

[43] Rev. Rul. 77-402; and section 752(d).

[44] Reg. section 1.1001-2(a)(1), (4).

[45] *Madorin v. Commissioner*, 84 T.C. 667 (1985).

[46] *Id*. at 677 ("These sections require 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. The basis of a partnership interest includes the partner's share of partnership liabilities. Secs. 722 and 752. As the adjusted basis of the partnership interest is often reduced by partnership losses resulting from depreciation and other writeoffs, the goal is to force a recapture upon disposition. This is accomplished by including, as amounts realized, liabilities previously included in basis. *Crane v. Comm'r*, 331 U.S. 1 (1947).").

[47] *Black's Law Dictionary* 1161 (7th ed. 2000).

the grantor to substitute appreciated property of the trust for other property, provided that the other property is of equivalent value.[48] Thus, the grantor is prohibited from increasing or decreasing the value of the trust by substituting appreciated property.

In *Estate of Jordahl*, a taxpayer created an irrevocable trust with the taxpayer, the taxpayer's wife, and a corporate trustee serving as co-trustees.[49] The trust was funded with securities and life insurance policies on the taxpayer's life. The trust agreement expressly reserved the taxpayer the right to substitute property of the trust, provided that the property substituted was of equal value to the property replaced. Following the taxpayer's death, the IRS determined that all the trust assets were includable in the taxpayer's gross estate because the substitution power permitted the taxpayer to exchange property with the trust so as to "alter, amend, or revoke" the trust within the meaning of section 2038(a)(2). The Tax Court disagreed with the IRS because the substituted property had to be of "equal value" to the replaced property, and thus the taxpayer was prohibited from depleting the trust corpus.

The facts in Rev. Rul. 2008-22 are similar to the facts in *Estate of Jordahl*, but the substitution power was held in a nonfiduciary capacity.[50] To exercise the power of substitution, the taxpayer had to certify in writing that the substituted property and trust property for which it was substituted were of equivalent value. The IRS ruled that the taxpayer's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includable in the grantor's gross estate under section 2036 or 2038, provided that the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of the power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. The IRS recognized that, unlike the situation presented in *Estate of Jordahl*, the substitution power was not held in a fiduciary capacity, but, under the terms of the trust, the assets the taxpayer transferred to the trust had to be equivalent in value to the assets the taxpayer received in exchange. Also, the trustee had a fiduciary obligation to ensure that the assets exchanged were of equivalent value.[51] Thus, the taxpayer could not exercise the power to substitute assets in a manner that would reduce the value of the trust corpus or increase the taxpayer's net worth. The IRS concluded that, under these circumstances, the taxpayer's retained power did not cause the value of the trust corpus to be included in the taxpayer's gross estate under section 2036 or 2038.

3. Termination of grantor trust status.

Uncertainty exists regarding the income tax implications of termination of grantor trust status upon the grantor's death. Should the trust recognize gain for any appreciated property held by the trust at the grantor's death? Should trust property receive stepped-up basis under section 1014? Perhaps this is attributable to Rev. Rul. 85-13 serving as authority for disregarding a transaction between a grantor and grantor trust, rather than the code.[52] There are no specific statutory provisions for a transaction when grantor trust status is terminated.[53] The IRS has declined to rule on the issue, and its current position is to not rule on whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those

[48]The code and regulations do not define what constitutes equivalent value.

[49]*Estate of Jordahl*, 65 T.C. 92 (1975); *see* LTR 200842007.

[50]Rev. Rul. 2008-22.

[51]*Id*. ("In situations where the grantor of a trust holds a nonfiduciary power to replace trust assets with assets of equivalent value, the trustee has a duty to ensure that the value of the assets being replaced is equivalent to the value of the assets being substituted. If the trustee knows or has reason to believe that the exercise of the substitution power does not satisfy the terms of the trust instrument because the assets being substituted have a lesser value than the trust assets being replaced, the trustee has a fiduciary duty to prevent the exercise of the power. See Restatement (Third) of Trusts section 75 (2007) and Uniform Trust Code sections 801 and 802 (2005).").

[52]For example, section 1031 provides nonrecognition treatment for like-kind exchanges, and section 1041 provides nonrecognition treatment for transfers between spouses or incident to divorce.

[53]*Madorin*, 84 T.C. at 676.

assets are not includable in the gross estate of that owner.[54] Guidance on the basis of grantor trust assets at death under section 1014 is listed as item one for gifts and estates and trusts priorities for Treasury and the IRS.[55]

Even though testamentary transfers are generally free of income tax, the IRS may be tempted to extend the result under Example 5 of reg. section 1.1001-2(c), which addresses the lifetime renunciation of a grantor trust power, to the grantor's death.[56] If so, then upon the trust ceasing to be a grantor trust at the grantor's death, the IRS would presumably argue that the grantor will be considered to have transferred ownership of property then held by the trust to the trust, and that the deemed transfer results in recognition of gain. The IRS may also be tempted to argue that, upon the trust ceasing to be a grantor trust at the grantor's death, the trust property should not receive a step-up in basis under section 1014 because the trust is excluded from the grantor's estate under *Estate of Jordahl* and Rev. Rul. 2008-22, and thus the trust property should not be considered to have been acquired from or to have passed from the decedent under section 1014(b)(9).[57]

Nevertheless, if there is no difference between the FMV and adjusted basis of property held by the trust at the grantor's death, then gain recognition and basis adjustment issues are immaterial. Therefore, the retained substitution power provides the grantor with a powerful planning opportunity to avoid tax uncertainty at the grantor's death by exercising the power to substitute appreciated property of the trust for other property of equal value that has no built-in gain, such as cash, or a high basis.[58]

IV. Conclusion

All three of the approaches discussed in this article accomplish stepped-up basis under section 1014 for appreciated property transferred from a trust to a grantor and then held by the grantor at death, and thus cure the discrepancy between sections 1014 (stepped-up basis) and 1015 (carryover basis). Other tax implications under the approaches are significantly different. Until guidance is provided by Congress or the IRS, the substitution approach should be the generally preferred approach because of favorable income and estate tax results and avoidance of uncertainty regarding the termination of grantor trust status.

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[54] Rev. Proc. 2020-3, 2020-1 IRB 131, section 5.01(9); Rev. Proc. 2015-37, 2015-26 IRB 1196 (This issue was added in 2015 so that the IRS would not issue letter rulings until it resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise.); LTR 200434012 ("When either Trust 1 or Trust 2 ceases to be treated as a trust owned by A under section 671 by reason of A's death or the waiver or release of any power under section 675, no opinion is expressed or implied concerning whether the termination of such grantor trust treatment results in a sale or disposition of any property within the meaning of section 1001, a change in the basis of any property under section 1012 or section 1014.").

[55] Treasury, "2019-2020 Priority Guidance Plan" (Oct. 8, 2019).

[56] *See, e.g.*, reg. section 1.684-2(e)(2), Example 2 (for death of grantor of foreign trust).

[57] ECC 200937028 ("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).").

[58] Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 *J. Tax'n* 3 (Sept. 2002) ("Under an alternative strategy, the grantor would repurchase the assets from the trust prior to death for cash or by substituting other high-basis assets for the assets in the trust. This strategy would not only undercut any gain-at-death argument — given the grantor's high basis in the assets deemed sold to the trust, there would be little or no gain — but also, as a practical matter, would eliminate any concern about the basis issue."); Gary C. Randall and Susan L. Megaard, "Defective Grantor Trusts Can Be Effective Education Funding Vehicles After RRA '93," 81 *J. Tax'n* 3 (Sept. 1994) ("If the power to be waived is a power of substitution under Section 675(4)(C), the grantor may avoid the *Madorin* problem by reacquiring those assets (in anticipation of the waiver) that would otherwise cause the gain.").

V. Appendix

Curing Basis Discrepancy Under Sections 1014 and 1015: Sales and Substitutions of Trust Property

	At Transaction		At Death of Grantor	
	Grantor	Trust	Grantor	Trust
Appreciated property remains in trust				No step-up in basis (Section 1014(b)(9)) Not included in gross estate
Grantor purchases appreciated property from trust	Cost basis (Section 1012)	Gain rec. (Section 1001) Non-grantor trust	No gain rec. (Section 102) Step-up in basis (Section 1014) Included in gross estate (Section 2033)	No step-up in basis (Section 1014(b)(9)) Not included in gross estate
Grantor purchases appreciated property from trust by borrowing without adequate security	Carryover basis (Rev. Rul. 85-13)	No gain rec. (Rev. Rul. 85-13) Grantor trust (Section 675(3))	No gain rec. (Section 102) Step-up in basis (Section 1014) Included in gross estate (Section 2033) Ded. for debt (Section 2053(a)(4))	No step-up in basis (Section 1014(b)(9)) Risk included in gross estate
Grantor substitutes appreciated property of trust	Carryover basis (Rev. Rul. 85-13)	No gain rec. (Rev. Rul. 85-13) Grantor trust (Section 675(4)(C))	No gain rec. (Section 102) Step-up in basis (Section 1014) Included in gross estate (Section 2033)	Assume gain rec. for term. of grantor trust status (reg. section 1.1001-2(c), Example 5) Assume no step-up in basis (Section 1014(b)(9)) Not included in gross estate (*Estate of Jordahl*; Rev. Rul. 2008-22)

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