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# I.R.C. Section 1014(e) and Gifted Property Reconveyed in Trust

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## **I.R.C. SECTION 1014(E) AND GIFTED PROPERTY RECONVEYED IN TRUST**

*Mark R. Siegel\**

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### I. INTRODUCTION

The taxpayer’s method of property acquisition is significant in determining the proper income tax or adjusted basis in the property. Distinct adjusted basis rules apply to the transferee of property acquired by purchase, gift, and inheritance. A buyer who purchases property for cash receives an adjusted basis in the property acquired equal to its cost.<sup>1</sup> For property acquired by gift, the general rule is that the donee’s adjusted basis equals the donor’s adjusted basis immediately prior to the transfer.<sup>2</sup> A third income tax basis regime applies to the taxpayer who

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1. I.R.C. § 1012 (2006 & Supp. III 2010).

2. I.R.C. § 1015(a) (2006). Because the donor’s adjusted basis becomes the donee’s adjusted basis, § 1015 is referred to as a carryover basis provision. The general rule that the donee receives a carryover basis in the property is subject to an important exception effectively precluding the donor from shifting losses to the donee. If the donor’s adjusted basis is greater than the fair market value of the property at the time of the gift, then for purposes of determining loss the donee’s adjusted basis equals the fair market value of the property (rather than the donor’s adjusted basis). § 1015(a) (last clause of first sentence).

happens to acquire property by inheritance upon the death of a decedent.<sup>3</sup>

The adjusted basis for income tax purposes of property acquired from a decedent is its value determined on the estate tax valuation date. In general, under § 1014, the adjusted basis is the fair market value of the property determined as of the date of the decedent's death.<sup>4</sup> Because the property may be worth more than the decedent's adjusted basis in the property immediately prior to death, § 1014 is often referred to as permitting a step up in basis to the beneficiary, the new owner succeeding to the property. For property that has appreciated in value since its original acquisition, § 1014(a) provides for a step up in basis. The provision may also provide for a step down in basis if the property depreciates or declines in value after it is acquired. This stepped up basis rule for property acquired from a decedent supplants the cost basis rule found in I.R.C. § 1012 and the carryover basis rule for gifts in § 1015.

The adjusted basis rules contained in § 1014(a) require that the property be acquired from a decedent. § 1014(b) contains a number of different categories of property that are considered to be acquired from, or to have passed from, a decedent. As one would expect, property

3. The term "inheritance" is used broadly to signify that the transfer of the property was triggered by the death of the preceding owner.

4. I.R.C. § 1014(a) (2006). To put some numbers on this, the property, though acquired for \$100 several years ago, has a fair market value of \$300 at the date of decedent's death. The beneficiary's income tax basis equals the \$300 fair market value. The \$200 appreciation in value from the date of acquisition to the date of death escapes income taxation. This numerical example illustrates the potential for § 1014 to step up the adjusted basis in the successor owner's hands. Had the property instead declined in value to \$50 at the date of decedent's death, the adjusted basis equals \$50, an example illustrating the adjusted basis step down potential contained in § 1014. The decline in value the property experiences does not produce a loss deductible for income tax purposes.

The date of death fair market value general rule is not the exclusive adjusted basis provision governing the estate tax valuation date applicable to property acquired from a decedent. § 1014 contains three additional possible provisions to determine the adjusted basis of property acquired from a decedent. The fair market value at the date of death applies unless the executor instead elects to value the property on the alternate valuation date under § 2032. I.R.C. § 1014(a)(2) (2006). Generally, the alternate valuation date is the date that is six months after the date of death. I.R.C. § 2032(a)(2) (2006). However, if property is distributed, sold, exchanged, or otherwise disposed of within the six-month period, the property shall be valued as of the date of such event. *Id.* § 2032(a)(1). If the executor makes a § 2032A special use property valuation election for qualifying family businesses and farms, the reduced value for estate tax inclusion purposes becomes the beneficiary's adjusted basis in the property. I.R.C. § 1014(a)(3). Finally, if the executor elects to exclude a portion of the value of land subject to a qualified conservation easement from the gross estate under § 2031(c), the decedent's basis for the excluded portion becomes the successor's basis. *Id.* § 1014(a)(4).

acquired by bequest, devise, intestacy or passing to the decedent's estate is considered as acquired from a decedent for adjusted basis purposes.<sup>5</sup> However, the categories are not limited to probate assets. An additional category includes property the decedent transfers during life in trust to pay the income to, or on the order or direction of, the decedent, with the right reserved to the decedent at all times before death (i) to revoke the trust<sup>6</sup> or (ii) to make any change in its enjoyment through the exercise of a power to alter, amend, or terminate the trust.<sup>7</sup> Property received without full and adequate consideration under a general power of appointment exercised by the decedent's will is included under § 1014(b).<sup>8</sup> The surviving spouse's one-half share of community property held by the decedent and the surviving spouse, if at least one-half of the total value of the property, is includible in the decedent's gross estate.<sup>9</sup> Property is includible in the decedent's gross estate because the decedent acquired it from the decedent's predeceasing spouse whose estate elected to treat the property under the § 2056(b)(7) qualified terminable interest property (QTIP) estate tax marital deduction provisions.<sup>10</sup> Property acquired by reason of the decedent's death, form of ownership, or other conditions (including the exercise or non-exercise of a power of appointment), is includible in the decedent's gross estate.<sup>11</sup> Under this category, property held as joint tenancy or tenancy by the entirety is included as is property acquired during life for which the decedent retained an interest or power sufficient to cause estate tax inclusion of the value of the property. The combination of §§ 1014(b)(1) and (b)(9) operate to include both probate and non-probate assets under the definitional scheme delineating "property acquired from a decedent."

I.R.C. § 1014(e) provides a statutory exception<sup>12</sup> to the general stepped up basis rule contained in § 1014(a). Under § 1014(e), if

5. I.R.C. § 1014(b)(1). This provision assures that all probate assets of decedent's estate are covered. The bequest or devise of property, whether left outright or in trust for the named beneficiaries, would be subject to the rules contained in § 1014.

6. *Id.* § 1014(b)(2).

7. *Id.* § 1014(b)(3).

8. *Id.* § 1014(b)(4).

9. *Id.* § 1014(b)(6).

10. *Id.* § 1014(b)(10). As a consequence of the estate tax marital deduction under § 2056(b)(7), § 2044 requires the surviving spouse to include the value of the QTIP assets in the federal gross estate.

11. *Id.* § 1014(b)(9).

12. The § 1014 basis rules are also inapplicable to property which constitutes a right to receive an item of income in respect of a decedent (IRD) under § 691. *Id.* § 1014(c). As a consequence, IRD items retain the decedent's adjusted basis which may typically be zero. Examples of IRD include a decedent's claim for unpaid wages or uncollected fees for services

appreciated property is acquired by gift by the decedent within the one-year period ending on the date of the decedent's death and the property is acquired by (or passes from the decedent to) the donor or the donor's spouse, rather than receiving a basis step up, § 1014(e) provides the adjusted basis in the hands of the donor (or donor's spouse) equals the decedent's adjusted basis immediately before death.<sup>13</sup> For § 1014(e) to apply, the property gifted to the decedent must be appreciated. Appreciated property is statutorily defined as property having a fair market value on the day it was transferred by gift to the decedent in excess of the donor's adjusted basis in the property.<sup>14</sup> The exception under § 1014(e) was enacted to deter deathbed transfers of appreciated property to a donee-decedent in the hope of receiving the property back upon the death of the decedent with a higher adjusted basis.<sup>15</sup> § 1014(e) does not preclude a basis step up under § 1014(a); however, if the appreciated property passes from the decedent to someone other than the donor or donor's spouse even though the decedent died within one year of receiving the gift.

During former President George W. Bush's first term, Congress passed the 2001 Economic Growth Tax Relief Reconciliation Act ("EGTRRA") that enacted § 1022 to address the basis of property acquired from a decedent.<sup>16</sup> This section provides that property acquired from a decedent dying after December 31, 2009 has a basis equal to the decedent's basis, subject to certain adjustments, modifications, and exceptions.<sup>17</sup> Technically, the general rule provides that the beneficiary

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rendered and the unpaid balance due on an installment promissory note arising from the sale of a business or other property. These items would have been required to be included in income had the decedent lived.

13. I.R.C. § 1014(e) provides:

**(e) Appreciated property acquired by decedent by gift within 1 year of death.**

**(1) In general.**

In the case of a decedent dying after December 31, 1981, if-

(A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and

(B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor),  
the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

14. *Id.* § 1014(e)(2)(A).

15. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

16. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501(a), 115 Stat. 38, 69 (2001).

17. With the starting point being the beneficiary's adjusted basis equal to the decedent's basis, the new rules signal a shift to the carryover basis regime. *See* I.R.C. § 1015 (2006) (carryover basis for property acquired by gift). The concept of carryover basis for property acquired from decedents

receives an adjusted basis for the property equal to the lesser of (a) the decedent's adjusted basis or (b) its fair market value on the date of decedent's death.<sup>18</sup> There are two upward basis adjustments an executor may utilize for appreciated property owned by the decedent at death. The aggregate adjusted basis of decedent's property may be increased by an amount equal to \$1.3 million irrespective of the identity of the recipient.<sup>19</sup> A second and additional \$3 million adjustment is provided for property transferred to the surviving spouse in the qualifying manner.<sup>20</sup>

Certain property is ineligible to receive the preceding basis adjustments. Property the decedent acquired by gift<sup>21</sup> during the three-year period, ending on the date of decedent's death cannot receive any adjustment.<sup>22</sup> However, the adjustment preclusion does not apply to property acquired from the decedent's spouse unless that spouse acquired the property during the three-year period specified above in whole, or in part, by gift or by inter-vivos transfer for less than adequate and full consideration.<sup>23</sup>

The modified carryover basis rules of § 1022 are scheduled for repeal under the EGTRRA sunset legislation effective as of January 1, 2011. The provisions of § 1022 were enacted as part of the temporary repeal of the federal estate tax for 2010. Under EGTRRA, both § 1022 and the repeal of the estate tax apply only for decedents dying in 2010.

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA 2010").<sup>24</sup> In a complex section of the new law, the tax code is to be interpreted as though the EGTRRA provisions repealing the estate and generation skipping tax and enacting the modified

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has been attempted by Congress prior to the enactment of § 1022. In enacting former § 1023 in 1976, there was a congressional attempt to abandon the traditional fair market value at date of death basis. Following criticism to the carryover basis provision, Congress responded by first postponing its effective date and thereafter repealed them effective for decedent's dying after December 31, 1976.

18. I.R.C. § 1022(a)(2) (repealed 2010).

19. *Id.* § 1022(b)(2).

20. *Id.* § 1022(c)(2)(b). Because appreciated property left to a surviving spouse may qualify for both the general basis increase and the spousal basis increase, an aggregate of \$4.3 million basis increase may be available. *Id.* § 1022(c)(1).

21. A lifetime transfer of property to the decedent for less than adequate and full consideration is also covered. *Id.* § 1022(d)(1)(C)(i).

22. *Id.* § 1022(d)(1)(C)(i).

23. *Id.* § 1022(d)(1)(C)(ii).

24. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (2010).

carryover basis rules had not been enacted.<sup>25</sup> The provision is to be applied retroactively for decedents dying after December 31, 2009.<sup>26</sup> Under the new law, the formerly repealed estate tax and § 1014 basis rules apply for decedents dying in 2010 and thereafter. There is a \$5 million exemption amount for estate, gift, and generation skipping taxes with a maximum tax rate of 35%.<sup>27</sup> However, the gift tax exemption amount remains set at \$1 million for 2010. Therefore, starting in 2011, the tax rates and exemption amounts will be unified for the three wealth transfer taxes. There is a new election provision applicable to the modified carryover basis rules of § 1022 for executors of estates of decedents who die in 2010. For these estates, the executor may elect to have § 1022 apply instead of the estate tax.<sup>28</sup> The election may be attractive for larger estates where the estate tax amount currently payable would exceed the projected income tax costs attributable to the modified carryover basis regime.

As a result of the most current tax legislation and its repeal of the prior repeal of the estate tax and enactment of the carryover basis provisions, the § 1014 basis rules that were to have been resurrected beginning in 2011, now are applicable in 2010. The renewed relevance of the § 1014 basis step up rules means that the scope of § 1014(e) remains to be delineated. Although enacted almost thirty years ago, regulations under § 1014(e) have not been promulgated. Moreover, the author of a noted treatise states “[i]t is unclear whether § 1014(e) would bar a step up in the basis of property that a donee-decedent leaves in trust for his or her surviving spouse.”<sup>29</sup> Another treatise author indicates it is unclear whether § 1014(e) applies if a husband leaves property received by gift from his wife to a QTIP marital deduction trust for her.<sup>30</sup> This article provides a proposal for the application of § 1014(e) to such trusts. Where appreciated property is left in trust, multiple interests are created for the beneficiaries. These interests must be separately evaluated to determine the extent, if any, to which the donor receives any economic benefit or value for purposes of applying § 1014(e).

## II. LIFE TENANTS AND BENEFICIARIES OF TRUSTS AND THE UNIFORM

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25. *Id.* § 301(a).

26. *Id.* § 301(e).

27. *Id.* § 302(a)(2).

28. *Id.* § 301(c).

29. JOHN R. PRICE & SAMUEL A. DONALDSON, PRICE ON CONTEMPORARY ESTATE PLANNING § 3.35.5 (CCH 2008 ed.) (2007).

30. KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS, ¶44.20[1] (Warren, Gorham & Lamont eds., 1997).

## BASIS CONCEPT

A decedent may decide that rather than leaving an outright devise or bequest of property to a named beneficiary, the property should be held in trust for the beneficiaries. The decision to dispose of property through the trust as the receptacle for the assets creates multiple interests in the property. Nevertheless, § 1014(a) applies to determine the adjusted basis of property acquired from a decedent when the property is left, for example, to one beneficiary for life with the remainder interest in such property left to another beneficiary. The fair market value at the date of decedent's death determines the adjusted basis of the underlying property. The proper percentages of the aggregate basis that are apportioned or allocated to each interest are determined according to the actuarial factors found in the valuation tables contained in the treasury regulations.<sup>31</sup> The factors contained in the valuation tables provide remainder factors based on assumed interest rates and either (i) the beneficiary's age for life interests or (ii) length of the term for term certain interests.<sup>32</sup> The income/life interest factor is derived from the remainder factor. The remainder factor is subtracted from the number one to produce the income/life interest factor.<sup>33</sup> The appropriate respective factor is multiplied by the adjusted basis of the underlying property to determine the allocable adjusted basis of each respective interest.

The treatment of the § 1014 adjusted basis when multiple interests are created in the underlying property is known as "uniform basis." As the foregoing demonstrates, the uniform basis in the underlying property is divided among the respective interests in the property according to the factors contained in the Treasury valuation tables.

As the regulations explain:

[t]he basis of property acquired from a decedent, as determined under section 1014(a), is uniform in the hands of every person having

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31. Treas. Reg. § 1.1014-5(a) (as amended in 1994). The rules apply to life interests as well as term certain interests. Treas. Reg. § 1.1014-5(a)(3) (as amended in 1994) provides:

The factors set forth in the tables contained in § 20.2031-7 or, for certain prior periods, § 20.2031-7A, of part 20 of this chapter (Estate Tax Regulations) shall be used in the manner provided therein in determining the basis of the life interest, the remainder interest, or the term certain interest in the property on the date such interest is sold.

32. Treas. Reg. § 20.2031-7(d)(6) (as amended in 2011), Table B, is the proper actuarial table for determining remainder factors relating to term certain interests. Treas. Reg. § 20.2031-7(d)(7) (as amended in 2011), Table S contains the single life remainder factors relating to life estates.

33. 1 minus the remainder factor equals the income factor. The sum of the income and remainder factors equals one.



possession or enjoyment of the property at any time under the will or other instrument or under the laws of descent and distribution. The principle of uniform basis means that the basis of the property (to which proper adjustments must, of course, be made) will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust.<sup>34</sup>

The uniform basis approach also means that the value of the property at the original decedent's date of death applies irrespective of when the holder's interest becomes possessory. The regulations state:

If the bequest is to trustees in trust to pay to A during his lifetime the income of the property bequeathed, and after his death to distribute such property to the survivors of a class, and upon A's death the property is distributed to the taxpayer as the sole survivor, the basis of such property, in the hands of the taxpayer, is its fair market value at the time when the decedent died.<sup>35</sup>

Under the uniform basis rule, where property is left by bequest or devise to a person for life or a fixed period of time and thereafter to another, the basis in the ultimate beneficiary's hands is the fair market value at the date of death rather than the fair market value at the subsequent time the remainder beneficiary's interest comes into possession of the property.<sup>36</sup> The creation of multiple interests through the trust form necessitates dividing the uniform basis if one of the interests is sold or otherwise disposed of. For example, if the remainder interest is sold by the beneficiary, the uniform basis is apportioned, as of the date the interest is sold or otherwise disposed of, to the remainder interest to determine the amount of gain or loss. Under I.R.C. § 1001(e), a different rule applies in the event the interest disposed of by the beneficiary is a "term interest."<sup>37</sup> Under this exception, the portion of the uniform basis that would have otherwise been allocated to the

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34. Treas. Reg. § 1.1014-4(a)(1) (as amended in 1960).

35. *Id.* § 1.1014-4(a)(2) (as amended in 1960). As the trust remainder beneficiary, the sole survivor's adjusted basis equals the fair market value of the property at the decedent/trust grantor's death rather than the fair market value of the trust property at the time of the life interest or term certain interest holder's death.

36. Of course, the beneficiary's basis would be adjusted for capital expenditures that constitute capital improvements or ACRS deductions under §§ 1016(a)(1) and (2). Treas. Reg. § 1.1014-4 (as amended in 1960).

37. A term interest is defined to include a life estate, term or years, or an income interest in a trust. I.R.C. § 1001(e)(2) (2006). The rules of § 1001(e) do not apply to transfers of remainder interests.

disposed of term interest is disregarded.<sup>38</sup> The effect of this rule treats the term interest disposed of as having a zero adjusted basis to offset against the funds the term interest holder receives for the interest.<sup>39</sup> The zero basis rule of § 1001(e) does not apply to sales of term interests that are part of a transaction transferring the entire interest in the property.<sup>40</sup> Therefore, if the holders of both the term and remainder interests transfer their interests upon sale, each of them will be able to offset their share of the sales price with the allocable portion of the uniform basis.

### III. ADJUSTMENTS TO BASIS FOR PROPERTY IN TRUST—CAPITAL IMPROVEMENTS AND ACRS DEDUCTIONS

The income tax basis of property a decedent leaves in trust for beneficiaries is subject to certain adjustments. These adjustments typically occur at a point in time well before the trust property may be sold or the beneficiaries transfer their respective trust interests. The cost of a capital improvement made to trust property acquired from a decedent increases the adjusted basis of the underlying property<sup>41</sup> under the uniform basis rules. As the overall adjusted basis is increased, for purposes of determining gain or loss in the event a trust beneficiary transfers his interest in a taxable transaction, each of the multiple interests in the trust will be increased by an amount determined in accordance with the product of the valuation table factors applicable to the respective life or term interest and remainder interests and the cost of the capital expenditure.<sup>42</sup> Therefore, the increase in the adjusted basis of the underlying property is fractionally divided between the multiple interests.

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38. I.R.C. § 1001(e)(1).

39. § 1001(a) requires comparing the adjusted basis and amount realized of property that has been sold or otherwise disposed of. The amount realized equals the sum of the amount of cash received and the fair market value of property received (other than cash). I.R.C. § 1001(b).

40. I.R.C. § 1001(e)(3).

41. I.R.C. § 1016(a)(1) (2006).

42. According to the treasury regulations:

gain or loss from a sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent is determined by comparing the amount of the proceeds with the amount of that part of the adjusted uniform basis which is assignable to the interest so transferred. The adjusted uniform basis is the uniform basis of the entire property adjusted to the date of sale or other disposition of any such interest as required by sections 1016 and 1017. Treas. Reg. § 1.1014-5(a)(1) (as amended in 1994).

In addition to capital improvements, the trust property may be used in a manner making it eligible for ACRS deductions.<sup>43</sup> ACRS deductions reduce the adjusted basis of property<sup>44</sup> and would, therefore, reduce the uniform basis of the trust property. Consequently, the adjusted basis of both interests in the trust, the life interest/term certain interest and the remainder interest, is reduced.<sup>45</sup> The apportionment of the ACRS deduction to the multiple trust interests results despite other tax code provisions granting or allocating the entire ACRS deduction to the holder of the life/term interest.<sup>46</sup> As § 167(d) views the life tenant or income beneficiary as the owner of the property, the holder of such lead trust interest enjoys the current income tax benefit attributable to the ACRS deduction while the holder of the remainder interest does not.

As a direct consequence of treating the holder of the lead interest as owning the property for depreciation purposes, the holder of the life interest or term interest depreciates the property over the property's ACRS applicable recovery period<sup>47</sup> rather than the expected term of the tenancy.<sup>48</sup> As a technical matter, when depreciable property is held in trust, the allowable deduction is apportioned between the income beneficiaries (as opposed to the remainder beneficiaries) and the trustee, in accordance with the trust agreement. If the trust agreement is silent, the deduction is in proportion to the income beneficiaries' shares of trust income.<sup>49</sup> This is in keeping with the philosophy underlying § 167(d) that the holder of the trust remainder does not have any interest in the property. As a result, the remainder interest does not receive the current income tax benefit of the ACRS deduction.

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43. ACRS deductions are a form of depreciation deduction. Property is eligible for ACRS deductions if, among other things, it is either used in connection with the taxpayer's trade or business or held for the production or collection of income. *See* I.R.C. § 167 (2006); I.R.C. § 168 (2006 & Supp. III 2010).

44. I.R.C. § 1016(a)(2) (2006). The amount of the reduction under § 1016(a)(2) equals the greater of the ACRS amount allowed or allowable.

45. This occurs in order to calculate the gain or loss from the sale or other disposition of a life interest, term certain interest or the remainder interest. *Treas. Reg.* § 1.1014-5(a)(1) (as amended in 1994); *see* I.R.C. § 1001(a).

46. This is the result because the life tenant or income beneficiary is treated as the absolute owner of the property. *See* I.R.C. § 167(d); *see also* I.R.C. § 62(c)(5) (2006) (life tenants and trust income beneficiaries granted "above the line deduction" treatment for depreciation). The result applies whether or not such beneficiary contributed to the cost of the depreciable property. Further, such beneficiary computes the amount of the ACRS deduction based on the uniform basis of the underlying property.

47. I.R.C. § 168(a)(2) (2006); I.R.C. § 168(c)(2) (2006).

48. I.R.C. § 167(d) (2006); *Treas. Reg.* § 1.167(h)-1(a) (as amended in 1964).

49. *Treas. Reg.* § 1.167(h)-1(b) (as amended in 1964).

#### IV. DRAFTING TRUST PROVISIONS—MARITAL AND BYPASS TRUSTS

The grantor of a trust may provide for the payment of trust income to the grantor's spouse for life.<sup>50</sup> Even where the trust provides for the mandatory payment of trust income, the problem with drafting the trust in this manner may very well be that the surviving spouse's financial needs may not be met from income only. Recognition of this distribution limitation to income only often causes trusts to include a provision that authorizes the trustee to also make discretionary payments of trust principal to the spouse to insure that the spouse's needs are addressed in the event the trust does not produce sufficient income.

In an estate-planning context for wealthier individuals whose estates are potentially subject to the payment of estate taxes, the drafting of testamentary trust provisions must take into account various tax concerns. In order to qualify for an estate tax marital deduction for the estate of the first spouse to die, if property is left in trust for the surviving spouse, two of the most commonly drafted marital trust forms are known as the qualified terminal interest property (QTIP) trust and the marital deduction power of appointment trust.<sup>51</sup> Both of these marital deduction trust forms require that the surviving spouse be entitled to payment of the trust income at least as often as annually for life.<sup>52</sup> By requiring the qualifying income interest for marital deduction purposes, the spouse becomes entitled to that income portion of the trust. As addressed later in this article, the nature of the qualifying income interest becomes significant in determining the scope of § 1014(e). For these trusts, the value of the income portion can be actuarially determined for purposes of barring the step up in basis under § 1014(e)

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50. In this example, the trust may be viewed as providing for the mandatory payment of income to the beneficiary. The trust may be drafted in an alternative manner authorizing the trustee to distribute so much or all of the trust income to the beneficiary. If the trust income beneficiaries include spouse and children, the provision may be drafted to authorize the trustee to distribute so much or all of the income to one or more of the spouse and children. Trusts of this type are often referred to as spray or sprinkle trusts as the income may be distributed among the beneficiaries as the trustee determines and permits the accumulation of income within the trust.

51. I.R.C. §§ 2056(b)(7), (b)(5) (2006).

52. These provisions mandate that the surviving spouse, have, among other things, a qualifying income interest. *See* I.R.C. § 2056 (b)(5), (b)(7)(B)(i)(II), (B)(ii)(I) (2006). The marital deduction rules applicable to the estate trust, used far less frequently than trusts qualifying under (b)(5) or (b)(7), does not require that the beneficiary have a qualifying income interest. *Treas. Reg. § 20.2056(c)-2(b)(1)* (as amended in 1994). Therefore, the estate trust, unlike the other trusts forms eligible for the marital deduction under § 2056, may accumulate income as long as the trust remainder passes to the surviving spouse's estate at death.

to the extent of that portion only rather than extending the bar to the entire trust.<sup>53</sup>

The marital trust is not the only trust with tax sensitive planning provisions. In this context, the estate plan often includes two trusts, one of which is the marital trust in the form of either the QTIP trust under § 2056(b)(7) or the marital deduction power of appointment trust under § 2056(b)(5), and the other of which, known as the bypass or credit shelter trust, is created to take advantage of the available estate tax exemption amount.<sup>54</sup> The bypass trust must be properly drafted so as not to cause estate tax inclusion of the principal in the surviving spouse's estate. A number of bypass trust provisions relating to the payment of trust income and principal to the beneficiary spouse could be included without triggering unwanted estate tax results. Regarding the payment of trust income, the trust could provide that the trustee shall pay all trust income to the beneficiary spouse for life.<sup>55</sup> Moreover, the trust could include a trust principal invasion power limited by an ascertainable standard.<sup>56</sup> For example, the trustee would be authorized to distribute as much trust principal as is needed for the beneficiary's health, education, maintenance, and support. The trust could give the beneficiary the noncumulative right to annually withdraw from trust principal the greater of \$5,000 or 5% of trust principal.<sup>57</sup> These provisions could be included with the spouse appointed as trustee.<sup>58</sup>

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53. See general thesis discussion at text accompanying notes 72 et. seq. *infra*.

54. The trust is known as a bypass trust because it is designed to bypass estate tax inclusion of the trust corpus in the beneficiary's estate. It is also known as the credit shelter trust because the amount to be placed in the trust in a tax planned estate is tied to the marital deduction amount and the available applicable credit amount at the death of the predeceasing spouse.

55. The bypass trust, unlike the marital deduction trusts discussed above, does not have to provide for the mandatory payment of trust income. As an alternative to the mandatory payment, the trust agreement could authorize the trustee, in its discretion, to either distribute the income or accumulate any income not distributed currently.

56. By limiting the power to access trust corpus with the ascertainable standard relating to health, education, support, and maintenance, the beneficiary does not have any general power of appointment requiring estate tax inclusion. I.R.C. § 2041(b)(1)(A) (2006).

57. This type of power is commonly called a "5 x 5" power. The ability of the beneficiary to access trust principal through an exercise of the withdrawal power can be accomplished without having to establish to the trustee the presence of a need under the ascertainable standard invasion power language. Although inclusion of such a power will not cause estate tax inclusion of the entire bypass trust, there will be estate tax inclusion to the limited extent of the 5 x 5 power itself. See I.R.C. § 2041(a)(2) (2006).

58. Despite the inclusion of more than one of the discussed provisions, the predeceasing spouse may be concerned that the survivor may have unmet economic needs beyond that provided in the trust. In such a case, the beneficiary should not be named as trustee if the invasion power over trust corpus is more broadly drafted without the ascertainable standard limitation. If the

## V. LIMITING THE BAR TO BASIS STEP UP WHERE GIFTED PROPERTY RETURNS OUTRIGHT TO DONOR

For married clients where one spouse has an estate in excess of the estate tax exemption amount while the other spouse is substantially below the threshold amount, estate planners and other tax advisors often suggest a lifetime gifting strategy to make sure that each spouse has sufficient assets to take full advantage of the amount each may exempt from the imposition of estate taxes. The question remains whether this wealth transfer tax strategy is also effective for income tax purposes. Consistent with the statutory language contained in § 1014(e)(1), the legislative history to § 1014(e) clearly indicates congressional concern about the situation where the donee-spouse dies within a year of the transfer and leaves the donor-spouse the property outright. The statutory language found in § 1014(e)(1) lends support to the argument that the step up in basis is not barred where, rather than returning the property directly to the donor, the donee-spouse instead provides that the property passes in trust for the surviving donor-spouse. By leaving the gifted property in trust, there is an argument that no direct transfer has been made to the donor. Legal title to the property vests in the trustee, not the trust beneficiary. Further, the trust may not be solely for the benefit of the donor. There is the potential that the donor may be one of several permissible income beneficiaries along with the fact that the trust remainder may be payable to a beneficiary other than the donor. However, ultimately prevailing with such an argument may require the government or courts to ignore the legislative history, as well as other parts of the statute.

The potential inapplicability of § 1014(e) to the property in trust for the donor spouse requires limiting the scope of the provision to transfers directly from the donee-decedent to the donor. Several problems arise for taxpayers seeking to so limit the scope of § 1014(e). Congress appears to have anticipated situations beyond the retransfer of appreciated property directly to the donor. Significantly, § 1014(e)(2)(B) states:

In the case of any appreciated property . . . sold by the estate of the decedent or by a trust of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply to the extent the donor

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beneficiary is a co-trustee with these more broadly drafted invasion powers, most planners suggest that these powers be restricted to co-trustees other than the beneficiary/co-trustee.

of such property (or the spouse of such donor) is entitled to the proceeds from such sale.<sup>59</sup>

The statute contemplates that appreciated property in trust is not automatically immune from the reach of § 1014(e). Under this part of the statute, the question then is whether the donor is entitled to the proceeds from the sale of the appreciated property. The language may be limited only to situations where the appreciated property is sold and the fiduciary is directed to distribute the proceeds to the donor. For example, in the context of the sale of appreciated property by a trust, the language may be intended to cover the limited situation where the donee created a trust and the trustee of that trust sells the appreciated property and distributes the proceeds to the donor according to the trust agreement. In contrast, the statute may not expressly cover the donee-decedent's testamentary trust funded with the appreciated property with the donor as beneficiary of a life interest or term certain interest. To this point, there has been no appreciated property sold that would create proceeds the donor is entitled to receive. Where trust property is sold, the proceeds are generally allocable to trust corpus or principal rather than income.<sup>60</sup> As an item of trust principal, the proceeds would belong to the beneficiary of the trust remainder. If the trustee had in fact sold the property, the donor, as income beneficiary, would not be entitled to the proceeds from the sale. Thus, it appears that § 1014(e)(2)(B), standing alone, is insufficient to bar the step up in basis where the gifted property is left to a trust with the original donor as an income beneficiary even though there clearly is a form of transfer back to the donor.

The statutory language in § 1014(e)(2)(B) is not the only concern to be addressed. The limited statutory language argument may prove problematic in that the legislative history evidences congressional concern for transfers directly or indirectly from donee-decedent back to the donor. For the application of § 1014(e), the statute seems to require that either the donor receive the appreciated property back or is entitled to the proceeds from the sale of the property by the executor or trustee. The statute contemplates the appreciated property being held in trust, but does not clearly address the situation where the property passes into a

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59. I.R.C. § 1014(e)(2)(B) (2006).

60. In general, cash or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including realized profit, is allocated to principal. See Uniform Principal and Income Act of 1997, § 410(2).

testamentary trust with the donor as a beneficiary of a term interest or life interest.

Section 1014(e) precludes an upward basis adjustment at a decedent's death if the property passes to "the donor of such property (or the spouse of such donor)." There is an argument then that where the gifted property returns to the donor in trust such a transfer does not come within the literal language of the statute requiring that property "passes to the donor." Thus, for purposes of applying § 1014(e) to deny a basis step up, there would be a difference whether the property were left outright to, as opposed to in trust for, the original donor. As to this argument, that the form in which the return of the property takes place matters, there may be a very real problem with this argument because the legislative history provides that the section applies to property given to a decedent and passing back to the original donor (or spouse) "directly or indirectly."<sup>61</sup> However, is a transfer of the appreciated property to a trust with the donor as beneficiary to be treated as passing back to the donor indirectly?

The legislative history to § 1014(e) includes language covering the return of the transferred property from the decedent to the donor (or spouse of the donor) "directly or indirectly." In the context of the federal gift tax, § 2511(a) provides that the gift tax shall apply "whether the transfer is in trust or otherwise" and "whether the gift is direct or indirect."<sup>62</sup> A gift in trust is treated as a gift of separate interests to the beneficiaries rather than a gift to the trust.<sup>63</sup> A gratuitous transfer in trust is an example of an indirect gift.<sup>64</sup> The characterization of the lifetime gift in trust as an indirect gift should likewise extend to the testamentary transfer in trust as an indirect gratuitous transfer.

The legislative history suggests that the scope of § 1014(e) should not be limited to outright transfers and would seem to contemplate that a transfer in trust for the original donor or spouse would likewise be covered as an indirect transfer. Several examples in the legislative history support expanding the reach of the section beyond gifts to a donee who, upon death, returns the original gift outright to the donor. The step up in basis rule of § 1014(a) will not apply to appreciated property acquired by the decedent through gift within one year of death

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61. H.R. REP. NO. 97-201, at 188 (1981).

62. I.R.C. § 2511(a) (2006).

63. RICHARD B. STEPHENS, GUY B. MAXFIELD, STEPHEN A. LIND, DENNIS A. CALFEE & ROBERT B. SMITH, FEDERAL ESTATE AND GIFT TAXATION ¶10.01[2][a] (Warren, Gorham & Lamont eds., 2002).

64. *Id.* ¶10.01[2][a].



if “such property passes, directly or indirectly, from the donee-decedent to the original donor or the donor’s spouse.”<sup>65</sup> Further, the language covers the situation 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.<sup>66</sup> This added language extends § 1014(e) without regard to the form of testamentary disposition utilized by the decedent. Taken together, these two passages from the legislative history may indicate that gifted property returned to the donor through decedent’s disposition in trust just as surely triggers § 1014(e) as if it had been bequeathed outright to the donor. Although the transfer may be within the scope of § 1014, the language contained in the legislative history invites an inquiry into examining whether the donor receives the benefit of the appreciated property to the same extent as if it had been bequeathed outright.

With the added provisions contained in the legislative history, property that passes in trust for the donor can be viewed as passing indirectly from the donee-decedent in much the same manner as property passing directly to the donor. However, as to the returned property, there is a fundamental difference between the donor as trust beneficiary and donor as outright owner that should not be overlooked. Where the interest passes in trust rather than outright, the donor does not have the entire interest in the property because the remainder beneficiary has an interest that must be recognized. The trust creates multiple, but separate, interests that must be examined. The legislative history contains some instructive language and potential guidance indicating that § 1014(e) “applies only to the extent that the donor-heir is entitled to receive the value of the appreciated property.”<sup>67</sup> The legislative history goes on to state that the rules apply on a pro-rata basis if the donor-heir is only entitled to a portion of the property.<sup>68</sup> The portion of the property that the donor-heir is not entitled to receives a stepped up basis and § 1014(e) would apply to the portion the donor-heir is entitled to.<sup>69</sup> The pro-rata

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65. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

66. *Id.*

67. *Id.*

68. *Id.* The legislative history includes an example where the beneficiary is only entitled to a portion of the transferred property because the property must be used to satisfy debts or administrative expenses. *Id.*

69. *Id.* at 188-89. The example contained in the legislative history applying the pro-rata rule is helpful. A owns property with a basis of \$10 and \$100 fair market value and gives it to D within 1 year of D’s death. At D’s death the property has a basis of \$20 and \$200 fair market value. Estate liabilities equal \$50. The heir is only entitled to three-fourths of the appreciated property. The one-

example used in the legislative history covering property used to satisfy estate liabilities is but one example where the donor may only be entitled to a portion of the property but the reasoning should be extended by analogy to the case where the property passes back in trust for the donor. As trust beneficiary, the donor may only be entitled to a portion of property so that the rules should be applied on a pro-rata basis instead of denying the entire step up.

As applied to dispositions in trust, the pro-rata rule should recognize the split interests between income beneficiary and remainder beneficiary. The trust agreement may direct the trustee to pay all the income to the donor. If that is the case, the donor possesses the right to the income and would be entitled to receive only the value of that portion of the property. Actuarial principles would be used to determine the value of the income interest<sup>70</sup> and § 1014(e) would apply to that portion to prevent a step up in basis. However, the income beneficiary is not entitled to receive the value of the trust remainder so that the remainder portion should receive a step up in basis under § 1014(a). The portion attributable to the remainder interest should be valued according to actuarial principles.<sup>71</sup> The terms of the trust income interest must be examined to ascertain whether the donor-income beneficiary is entitled only to a portion of the property. For example, if the trustee were authorized to pay the income or accumulate it, the discretionary nature of the income interest would prevent the donor from having the right to the income and being entitled to receive the value of that portion of the property. Therefore, the valuation tables would not apply to value the discretionary income interest. As a result, there is no portion of the trust property the donor is entitled to and section 1014(e) would not apply. Consequently, the entire property would receive a section 1014(a) step up.

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fourth of the property to which the heir is not entitled to receives a step up in basis. The total basis of the appreciated property in the hands of the executor or the heir equals \$65 ((1/4 x \$200) + (3/4 x \$20)).

70. The proper income factor to utilize would be a function of the § 7520 rate in effect at death and either the age of the donor if income were payable for life or the number of years if income were payable over a fixed term. The income factor produces the percentage to apply to the property that will receive the § 1014(e) basis.

71. The remainder factor produces the percentage to apply to the property that receives a § 1014(a) stepped up basis.

## VI. SUGGESTED APPROACH

For purposes of the application of § 1014(e), property the donee-decedent reconveys to the donor in trust is distinguishable from property transferred by devise or bequest outright to such beneficiary. The outright conveyance makes the beneficiary the absolute owner of the property. In contrast to being the sole beneficiary of the property, the transfer in trust creates multiple interests in the form of either (i) the life interest or (ii) the term certain interest, followed by the succeeding remainder interest. These various interests and the economic benefit conferred on the respective trust interest holders must be recognized for proper application of § 1014(e).<sup>72</sup> Therefore, it becomes necessary to determine what portions of the trust, if any, the donor is entitled. This approach finds support from the legislative history denying a basis step up “where the donor receives the benefit of the appreciated property” and extending the bar “to the extent that the donor . . . is entitled to receive the value of the appreciated property.”<sup>73</sup>

While the property the decedent retransfers in trust may give the donor a life interest or term certain interest, in either case, the remainder interest is given to another person. The existence of the remainder interest has economic significance and should properly serve to limit the scope of § 1014(e) even in the presence of the donor who receives a life or term interest in the trust. As a beneficiary of a trust with multiple interest holders, the donor does not bear the same economic relationship to the property that the donor would have as outright owner. The economic interest given to the holder of the remainder interest must be taken into account when deciding whether to apply § 1014(e). By recognizing the value inherent in the trust remainder given to a beneficiary other than the donor, the § 1014(e) exception barring a basis step up should not apply to that portion of the trust because the donor is not entitled to receive its economic value. Therefore, that portion would be entitled to receive a basis calculated upon the fair market value of the property at the date of death of the donee-decedent. § 1014(e) would apply to that portion of the trust that the donor is entitled to receive the value from the appreciated property. However, merely because the donor possesses a life or term certain interest in the trust does not

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72. In two private letter rulings, the government seems to suggest that § 1014(e) would only apply to the portion of the trust assets in which the donor reacquired an income interest, leaving the trust remainder interest beyond its reach. See I.R.S. Priv. Ltr. Rul. 90-26-036 (June 29, 1990) and 93-21-050 (May 28, 1993).

73. H.R. REP. NO. 97-201, at 188-89 (1981).

automatically mean that the donor is entitled to that portion of the trust. The governing instrument terms regarding the distribution of income would control. For these purposes, the donor would be entitled to the value of the term interest or life interest portion only if the trustee were required to distribute trust income. Income payable in the discretion of the trustee would not provide the necessary economic benefit to the donor sufficient to conclude entitlement to receive the value of that portion of the trust.

Under the suggested approach where the trust remainder constitutes the portion of the appreciated property held in trust to which the donor is not entitled, the actuarial tables would be used to quantify that portion of the trust eligible for a stepped up basis. Suppose the donor gave property that at the time of the gift had an adjusted basis of \$100,000 and fair market value of \$1 million<sup>74</sup> to her spouse who thereafter dies within one year of the gift. Decedent spouse's will is drafted in a manner that results in the \$1 million passing into a QTIP trust for donor for her life and with trust remainder to their children. As a QTIP trust beneficiary, the donor would be entitled to the value of the income portion as a result of the qualifying income interest requirement.<sup>75</sup> Assuming at the date of decedent's death donor is fifty years old and a § 7520 rate of 2.4%, the income and remainder factors are .47745 and .52255, respectively.<sup>76</sup> § 1014(a) would apply to 52.25%, or \$522,500 of the total \$1 million trust value. § 1014(e) would likewise apply but only with respect to approximately 47.75% of the trust. The .47745 income factor is multiplied by donor's original \$100,000 basis that carried over to the donee-decedent. The total adjusted basis is the sum of \$47,745 plus \$522,500, or \$570,245. Rather than the full basis step up to the \$1 million value, there is a proportionate step up.

If the property in the preceding example were left by decedent's will to a bypass trust that authorized the trustee to distribute such amounts of trust income to the donor or to donor and children in the discretion of the trustee, with the remainder thereafter payable to the decedent's descendants upon the donor's death, the donor, though a beneficiary of the trust, would not be entitled to receive the value of any portion of the trust given the discretionary power over income vested in the trustee. As a result, § 1014(e) would be inapplicable, and there

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74. For purposes of this example, assume there is no post-gift appreciation upon the \$1 million fair market value from the time of the gift to the date of death of the donee.

75. See I.R.C. §§ 2056(b)(5), (b)(7)(B)(i)(II), (B)(ii)(I) (2006).

76. Treas. Reg. § 20.2031-7, Table S (as amended in 2011).

would be a full basis step up rather than the proportionate step up of the preceding example.<sup>77</sup>

## VII. CONCLUSION

The suggested approach this article advances for the application of § 1014(e) incorporates the economic benefit analysis contained in the legislative history to the section and is more in keeping with the uniform basis regulations that apportion or divide the tax adjustments among the trust interests. The analysis contained in the suggested approach distinguishes between those trusts whose income payment provisions are mandatory versus those that are discretionary. Recognizing and examining the multiple interests that are created through trusts stands in sharp contrast to the § 167(d) approach that grants the depreciation deduction solely to the holder of the life interest or term interest. Because § 167(d) treats the life tenant as the absolute owner, adoption of the approach contained in § 167(d) would ignore the remainder beneficiary's interest in the trust, thereby equating the retransfer in trust to the outright transfer to the donor. Rather than applying § 1014(e) to the extent of the value of the appreciated property as suggested, any step up would be entirely denied. Moreover, equating the situation to § 167(d) fails to distinguish between trust income payment provisions that were mandatory versus discretionary pay.

There is statutory language and legislative history that suggests the scope of § 1014(e) should not be limited to outright transfers of the gifted property back to the donor and, borrowing from the federal wealth transfer tax regime, would seem to contemplate that a transfer in trust for the original donor or spouse would likewise be covered as an indirect transfer. As a result, although the appreciated property does not literally pass directly to the donor, the legislative history does not support extending § 1014(a) to them by exempting all trusts from the scope of § 1014(e). However, treating all trusts as covered in the same manner as property left outright is overly broad. The multiple interests that are created by the trust agreement must be considered to properly determine the extent to which the basis step up is to be denied. By implementing an economic benefit analysis, the bar of § 1014(e) should extend to those

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77. The suggested approach does not necessarily exempt all bypass trusts from § 1014(e). A bypass trust that provided for the mandatory payment of trust income to the donor would entitle the donor to that portion of the trust and therefore be subject to the proportionate basis step up analysis as illustrated in the context of the QTIP trust.

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trusts where the donor's trust interest can be valued using the actuarial factors contained in the valuation tables found in the regulations.