CHAPTER 29

TAX BASIS IRREVOCABLE TRUST

INTRODUCTION

Basically, the tax basis irrevocable trust is a living trust structured to achieve a step-up of the income tax basis of appreciated property (to date of death fair market value) owned by either spouse on the death of either spouse. This is accomplished by using a general power of appointment in tandem with a marital deduction and/or credit shelter trust so that all of the property owned by the spouses will qualify for the basis step-up by virtue of passing through the taxable estate of the first spouse to die. Ideally, the end result will be a stepped-up basis that would reduce or eliminate capital gain with little or no estate consequences.

The tax basis trust is a fairly recent development and was previously thought to require establishing a trust that would be revocable until the death of the first spouse to die. Unfortunately, pertinent IRS rulings on this subject indicate that in a non-community property state, only the basis of assets of the deceased spouse would be stepped-up to date of death fair market value.[[1]](#endnote-1) This chapter explores how the goal may perhaps be achieved by creating an irrevocable trust.

WHEN IS USE OF SUCH A DEVICE INDICATED?

This device may be considered in a variety of scenarios where one or both spouses own appreciated property. By virtue of the inclusion of all the spouses’ assets in the estate of the first spouse to die, the ultimate goal of a basis step-up of all appreciated assets of both spouses to the date of death (of the first spouse to die) fair market can be achieved. Thus, as a consequence of a basis step-up on all assets, potential capital gain on the sale of any of the marital assets (including those of the surviving spouse) would be reduced and possibly eliminated. Obviously, it is most advantageous when this basis step-up is accomplished with no estate tax consequences when the combined assets included in the estate of the first spouse to die is less than the available exemption equivalent provided by the unified credit (generally, a combined total of $10,860,000 in 2015). It will also be most advantageous when the surviving spouse owns considerably more appreciated property than the decedent spouse. Upon the death of the first spouse, his or her applicable exclusion can be used to the fullest extent possible, even if his or her individually owned assets are significantly less than the exclusion amount. The importance of this may be somewhat mitigated by the availability of “portability” with regard to the addition of the unused exemption amount of the first spouse to die to the exemption amount of the surviving spouse.

WHAT ARE THE REQUIREMENTS?

This technique starts with the transfer of appreciated property to either a single irrevocable trust created by both spouses, or two separate irrevocable trusts created by each spouse. Assuming a separate trust, to avoid making a completed gift of the property transferred to the trust, the grantor spouse(s) would retain a limited right to appoint the property. Because the appreciated property transferred to the trust is an incomplete gift, if the grantor spouse is first to die, the appreciated property will be included in his or her estate. As a result, pursuant to IRC Section 1014(a), the basis of the appreciated property included in a decedent’s estate will step-up to its date of death fair market value. (But see CCA 201208026 indicating that retaining a mere testamentary limited power of appointment may not be sufficient to avoid a completed gift).

Additionally, the trust would provide the nongrantor spouse with a general power of appointment with respect to the appreciated property. So if the nongrantor spouse dies first, the property in trust would be included in such spouse’s gross estate with a resulting basis step-up to its date of death fair market value.[[2]](#endnote-2) This is because granting the nongrantor spouse a general power of appointment is the equivalent of making a completed gift of the underlying property. However, to receive a basis step-up, the gift, i.e., transfer of the property to the trust with the general power of appointment must have occurred at least one year prior to the nongrantor spouse’s death. Pursuant to IRC Section 1014(e), there is no step-up in basis with respect to property acquired by the decedent from the donor (in this case the grantor spouse) within one year of the decedent grantor spouse’s death. By inference, proponents of this technique argue that, as long as the nongrantor spouse was granted the general power of appointment at least one year prior to his or her death, IRC Section 1014(e) would not apply so the basis of the appreciated property in the trust should be stepped-up to its date of death fair market value.[[3]](#endnote-3)

In drafting a trust into which the assets of the irrevocable trust are to be transferred following the death of the first spouse, the provisions relating to the surviving spouse should permit the property transferred to the trust to qualify for the marital deduction with respect to the estate of the decedent spouse[[4]](#endnote-4) or to fund a credit shelter trust. To do so, the trust should be drafted in a way that would qualify it as qualified terminable interest property (QTIP) trust if elected to be treated as such by the executor, or employed as a credit shelter trust if no election (or a partial QTIP election) is made.

An obvious drawback to this arrangement, in addition to the possibility that the IRS may deny the basis step-up, is the potential exercise of the power of appointment by the nongrantor spouse in a way that is detrimental to the ultimate goal of the grantor spouse. For this reason, this technique should be limited to spouses in very stable marriages. Some proponents of the technique attempt to minimize this drawback by limiting the nongrantor spouse’s general power of appointment to his or her creditors (rather than the broader power to appoint to anyone). Further, the general power of appointment may be limited to a testamentary power, i.e., a power only exercisable by a will or other document at death. Finally, the impact of the power may be further limited by restricting it to only those assets that would benefit most from a basis step-up, generally those assets that either have or are most likely to appreciate in value.

HOW IT IS DONE – AN EXAMPLE

James and Martha Edwards, husband and wife, who live in a common law state, create a joint irrevocable trust. To avoid making a completed gift upon the transfer of assets into the trust, each spouse retains a limited power to appoint the assets he or she contributes to the property. Upon the death of a spouse, the deceased spouse has a testamentary general power to direct the payment of any of his or her debts and taxes from the assets contributed to the trust by the surviving spouse.

Assume the only transfers to the trust are separate assets of James worth $500,000, with an income tax basis of $100,000. Martha dies more than one year after the transfer. Since she has a general power of appointment over the trust, i.e., a power to appoint to her creditors, the property in the trust will be included in her taxable estate and presumably its income tax basis will be adjusted to its fair market value, $500,000.

Will the property also be included in James’ taxable estate upon his subsequent death? That depends on the terms of the trust. For example, if the remaining assets (those assets not used to pay Martha’s creditors) were to be transferred to a trust that would qualify as a QTIP trust for the benefit of James (see Chapter 24) if so elected by Martha’s executor, the property would be included in James’ taxable estate. In the alternative, if those assets were used to fund a credit shelter trust for James, they would not be included in his taxable estate.

Assuming, in this case, upon James’ subsequent death, if he has no other substantial assets, there may be little or no estate tax owing whether or not the property is included in his gross estate. If there is, assuming James can disclaim (see below), he could make a qualified disclaimer to prevent those assets from being included in his estate. In the alternative, in the case of a transfer of property from the original trust to a trust what would qualify as a QTIP trust, by the executor of Martha’s estate making no QTIP election or a partial QTIP election upon Martha’s death.

TAX IMPLICATIONS

As discussed above, this device is entirely tax motivated and requires that the trust or trusts grant the nongrantor spouse a general power of appointment over the property that will result in its inclusion in the estate of the nongrantor spouse if he or she is the first spouse to die. What if the grantor spouse is the first to die? Because the granting of a general power of appointment to the nongrantor spouse would be a completed gift, none of the property would be included in the estate of the grantor spouse. To solve this problem, the trust could provide for the payment of income to the grantor spouse during his or her life. By doing so, pursuant to IRC Section 2036(a), as a transfer of property subject to a retained interest, the property would be included in his or her estate. As a result of that inclusion in the grantor spouse’s estate, upon his or her death, first, the basis of the trust property would step-up to the date of death fair market value.

As to the surviving nongrantor spouse, the terms of the trust for the surviving nongrantor spouse can provide him or her with a general power of appointment over the property, or allow a QTIP election to qualify it for the marital deduction if necessary to eliminate estate tax at the first death.[[5]](#endnote-5) However, in that case, the property will be included in the estate of the surviving nongrantor spouse possibly subject to estate tax.

As a way to avoid inclusion in the surviving spouse’s estate potentially subject to estate tax, the trust could be drafted to qualify as QTIP trust so that a partial QTIP election could be made, or the surviving spouse could make a qualified disclaimer, discussed in Chapter 11.

The disclaimer should be considered as an option to be exercised upon the death of either spouse. For example, assume the nongrantor spouse dies first, and does not exercise his or her general power of appointment so that the property would return to the grantor spouse. By disclaiming, the grantor spouse may be able to disclaim enough of the property to be absorbed estate tax-free by the nongrantor spouse’s available estate tax exemption equivalent (as much as $ $5,340,000 in 2015). As a consequence of a disclaimer, all of the property of the estate could pass either directly to children or other family members or to a trust (e.g., a credit shelter trust) for the benefit of the family without being subject to estate taxation.

To the author’s knowledge, the IRS has not ruled on whether or not the disclaimer would be effective in the foregoing situation. In effect, it could be argued that the grantor spouse is disclaiming an interest in property he or she already owns, not generally permitted under the disclaimer rules. However, since the IRS has conceded, in a number of private letter rulings that the property passes first through the taxable estate of the nongrantor spouse, the surviving owner spouse should have a disclaimer power.

The other use of the disclaimer here is in the event the owner spouse is the first to die. If the surviving nonowner spouse has a general power of appointment over the trust, it would all pass through his or her taxable estate. The surviving nonowner spouse may disclaim a sufficient part of the property to take advantage of the available unified credit of the predeceased spouse, avoiding estate taxation to that extent. Again, the disclaimed property could pass to children, other family members, or in trust.

Another trust that can be created for a spouse without including the transferred property in the transferor spouse’s estate is a SLAT – a spousal lifetime access trust. A SLAT is essentially a lifetime funded credit shelter trust which one spouse establishes for the benefit of the other spouse. However, one concern with a SLAT is that the recipient spouse can use the funds for his or her support. Reg. 20.2036-1(b)(2) is problematic because it requires the inclusion of the trust assets in the grantor spouse’s estate if those assets are used to discharge grantor spouse’s support obligation towards the recipient spouse. To avoid this result, language can be included that prohibit the use of trust funds to satisfy support obligations. See *Upjohn v. U.S*.,[[6]](#endnote-6) which suggests that the trust should include a “savings” clause preventing the trustee from distributing funds in a way that would discharge the grantor’s obligation of support. Also, the trust can include language that requires the trustee to look to a beneficiary’s other resources prior to making a trust distribution. Finally, it is important to consider the prudence of using an independent trustee.[[7]](#endnote-7)

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

Pursuant to IRC Section 1014(b)(6), upon the death of either spouse, the basis of all of the community property owned by the spouses is stepped-up to the first to die date of death fair market value. Therefore, for community property, the tax basis trust is not necessary. In fact, purpose of the tax basis trust is to achieve the same tax basis with respect to separate property that would result if the property were community property. In a community property scenario, such a trust could, however, be used to fully fund the credit shelter trust at the first spouse’s death if the decedent spouse’s one-half interest in the community estate is less than the applicable exclusion amount. This can be particularly useful if the community property estate held by the surviving spouse is expected to increase.

Where either spouse owns separate property in a community property state, the tax basis trust may be created to achieve the same income tax basis step-up to the separate property as applies to community property upon the death of either spouse. Depending on state law, the same result could be achieved by converting the separate property to community property conferring equal ownership of all property to both spouses.

FREQUENTLY ASKED QUESTIONS

**Question** – Why did the IRS deny the basis step-up of both grantors’ assets (including the grantor spouse’s assets) upon the death of a grantor spouse with respect to tax basis joint revocable trusts?

*Answer* – Because it can be reclaimed by the grantor at any time, property transferred to a revocable trust is not a completed gift. So, if a nongrantor spouse held a general power of appointment executable upon his or her death, the gift became complete (meaning at that time the grantor spouse could no longer reclaim the property) at the time of his or her death. In several private letter rulings, relying on IRC Section 1014(e), the IRS denied the stepped up basis in the grantor spouse’s trust assets upon the death of the nongrantor spouse holding a general power of appointment with respect to those assets. Pursuant to IRC Section 1014(e), the basis of appreciated property acquired by gift by a decedent during the 1 year period prior to the date of death that passes from the decedent back to the donor of such property does not step-up to date of death fair market value. In PLR 200101021, the IRS applied IRC Section 1014(e) very broadly to include “any Trust property includible in the deceased Donor’s gross estate that is attributable to the surviving donor’s contribution . . . and that is acquired by the surviving Donor . . . pursuant to the deceased Donor’s exercise, or failure to exercise, the general power of appointment over the Trust property.” So because the completed gift occurred simultaneously to death, the gift occurred within 1 year of death; and, thus, there is no basis step-up with respect to the grantor spouse’s property. Because that assertion appears only in a private letter ruling, however, it merely reflects the IRS’ position subject to challenge in potential litigation.

**Question** – Based upon the answer to the question above, is the IRS likely deny the basis step-up of a grantor spouse’s assets with respect to a tax basis irrevocable trust?

*Answer* – To date, although the IRS has not taken a position, IRC Section 1014(e) should not apply. In the case of an irrevocable trust, the granting of a general power of appointment to the nongrantor spouse is a complete gift. This is because, unlike a revocable trust, the grantor spouse has no right to reclaim the property. For that reason, assuming the nongrantor spouse survives for more than 1 year following the grant of the general power of appointment, the basis of the nongrantor spouse’s property includible in his or her estate should step-up to fair market value would and have no control over the trust.

**Question** – Will the disclaimer by a grantor spouse with respect to his or her property that passes through the nongrantor spouse’s estate be honored by the IRS?

*Answer* – As noted above, there may be some question as to the availability of a disclaimer by the grantor spouse following the death of the nongrantor spouse, on the theory that one cannot disclaim property he or she already owns. However, since that property passes first through the estate of another person, the disclaimer should be honored. By analogy, it should be noted that the IRS concedes that where an individual places property in joint tenancy with another person, either joint tenant could have partitioned the property at will while both tenants were alive, and the other person is the first to die, the transferor can disclaim the survivorship interest in the transferee’s half of the joint tenancy.

CHAPTER ENDNOTES

1. PLR 200210051, PLR 2002101021 [↑](#endnote-ref-1)
2. . IRC Sec. 2041(a)(2). [↑](#endnote-ref-2)
3. . IRC Sec. 1014(a). [↑](#endnote-ref-3)
4. . IRC Sec. 2056. [↑](#endnote-ref-4)
5. . IRC Sec. 2056(b). [↑](#endnote-ref-5)
6. . 1972 WL 3200 (W.D. Mich 1972) 30 AFTR 2d 72-5918. [↑](#endnote-ref-6)
7. . See LISI (Leimberg Information Services, Inc.) Estate Planning Newsletter No. 1379 (12/2/2008). [↑](#endnote-ref-7)