STEPPING UP BASIS IN LIVING TAXPAYER ASSETS WITH UPSTREAM WEALTH TRANSFERS THROUGH INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

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I. INTRODUCTION: A NEW STRATEGY TO INCREASE BASIS IN APPRECIATED ASSETS

Estate planning attorneys focus most of their practice on passing their client's wealth down to a designated beneficiary at death.[1] The estate planner's typical client is a wealthy, high net-worth individual who holds a number of valuable assets. The ultimate goal of an estate planning attorney is to craft an estate plan that allows the client's assets to avoid probate upon death, minimize income and estate taxes (if applicable), and then distribute the client's assets to beneficiaries consistent with the client's intentions.[2]

A critical element of this planning is understanding the tax consequences of any transfers from client to beneficiary and how the federal estate tax might apply to the client's gross estate.[3] For instance: will the client's asset transfer to

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[1] *See* E. STEVEN LAUER, BASIC ESTATE PLANNING IN FLA, § 1.1 (The Florida Bar Legal Publications, 11th ed. 2022) ("Estate planning . . . is the process of ensuring a client's financial well-being by making certain that his or her estate is preserved and managed and that the client and client's beneficiaries are protected according to the client's intentions, both while alive and after death.").

[2] *See* I.R.C. § 2031(a) (defining a taxpayer's gross estate to include "the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated").

[3] *See* Melissa Street, *A Holistic Approach to Est. Plan.: Paramount in Protecting Your Fam., Your Wealth, and Your Legacy*, 7 PEPP. DISP. RESOL. L.J. 141, 141–42 (2006) ("Creating an estate plan involves much more than simply preparing a testator's will. *Estate planning encompasses a broad area of laws*, from wills and trusts, to property and *tax*, to insurance and employee benefits.") (emphasis added).

a beneficiary be subject to a federal gift tax?[4] What will the basis of inherited property be in the hands of the client's beneficiary?[5] And to what extent, if any, will the estate tax affect the client's gross estate?[6] All of these issues have historically been concerned with passing wealth and assets *down* from grantor to the future generations.[7]

But more recently, some estate planning attorneys have pioneered a new approach that has sparked debate among estate planning practitioners: the use of Intentionally Defective Grantor Trusts ("IDGTs") as a mechanism for passing wealth *up* to aging parents in order to dispose of appreciated assets while avoiding capital gains tax.[8] The strategy consists of shifting the benefit of an elderly parent's unused unified tax credit to their wealthy child in order to pass appreciated assets from child to parent and then back to child to get a stepped-up basis in the assets upon the elderly parent's death.[9] But its legality is still an open question.

This innovative strategy involves using IDGTs to pass assets pregnant with gain into the gross estate of a client's elderly parents.[10] Properly effectuated, the IDGT will transfer enough ownership of the client's appreciated assets to their elderly parents so as to cause gross estate inclusion, allowing the child-grantor a stepped-up basis when he re-inherits the assets at the parent's death.

The key is to convey appreciated assets to an elderly parent who has not used their entire unified tax credit.[11] The basic structure is as follows: a high net-worth individual creates an IDGT for the benefit of an elderly parent who also holds a general power of appointment. The child makes a partial gift of

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[4] *See* I.R.C. § 102(a) ("Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."). *But see* I.R.C. § 2503 (imposing a tax upon certain gratuitous transfers).

[5] *See* I.R.C. § 1011 (defining a taxpayer's adjusted basis for determining capital gain or loss upon sale or other disposition); *see also* I.R.C. § 1014 (allowing taxpayers to assign a "stepped-up" basis to property acquired from a decedent and where property is acquired from a decedent, a taxpayer's basis in such property is the fair market value of the property at the date of the decedent's death).

[6] *See* I.R.C. § 2001 (imposing an excise tax on the transfer of the gross estate of every decedent who is a citizen or resident of the United States, commonly referred to as the "estate tax").

[7] *See* Street, *supra* note 3, at 141 (defining estate planning as "[t]he method by which one generation passes wealth on to the next, usually their adult children").

[8] *See* Mark A. Schaum, *Mother's Little Helper*, L. OFF. OF MARK A. SCHAUM, P.A., (Feb. 11, 2020), https://markschaumlaw.com/2020/02/11/mothers-little-helper/ (discussing the strategy of "Using Your Elderly Parent's Unused Estate Tax Exemption to Obtain a New Step-Up in Basis").

[9] *See* Rev. Proc. 2022-38 (showing that every U.S. citizen is entitled to a Unified Credit applied against the estate tax upon their death. The credit is indexed for inflation yearly and in 2023 allows a credit of $12,920,000 for a single individual or $25,840,000 for married couples); *see also* I.R.C. § 2010(c)(3)(B).

[10] *See* Schaum, *supra* note 8 (laying out the basic structure of the upstream gift through an intentionally defective grantor trust); *see also* Julia Kagan, *Intentionally Defective Grantor Trusts (IDGT) in Estate Planning*, INVESTOPEDIA (Oct. 16, 2022), https://www.investopedia.com/terms/i/igdt.asp (providing basic background information on how IDGTs are used in estate planning).

[11] *See* § 2010; *see also* Treas. Reg. § 20.2010-1(d) ("The applicable credit amount allowed under . . . this section cannot exceed the amount of the estate tax imposed by section 2001.").

appreciated assets into the trust as seed money to fund the transaction. Due to the nature of the IDGT combined with a partial sale, the high net-worth individual retains some ownership of the assets even while the trust takes title.

So long as the elderly parents have a general power of appointment in the trust, the assets will be included in the parent's gross estate upon death.[12] As a result of the gross estate inclusion, the assets still in trust upon parents' death receive a stepped-up basis in the hands of the trust. In effect, the high net-worth individual's appreciated assets are moved from their own hands, into their parents, and finally back into their own hands upon their parent's death.[13]

Importantly, property acquired from a decedent receives a stepped-up basis in the hands of the recipient.[14] When properly executed, the structure described within this paper allows a high net-worth individual to take a stepped-up basis in their own appreciated assets by structuring an IDGT as a partial sale where an elderly parent is the beneficiary and possesses a limited general power of appointment because once the assets are transferred back to the child upon the parent's death, the basis is stepped-up to the asset's fair market value, effectively erasing capital gain in the child-grantor.[15]

The result is the grantor's assets grow within the trust tax-free do not count against the grantor's lifetime unified tax credit because the transfer is a sale and not a gift, and wealthy individuals are able to apply the § 1014 step-up mechanism to their own assets well before their own death.

This type of structure is relatively new and, as such, the IRS has not given any firm guidance as to how they will treat these types of transfers or if they are a legal avoidance of the capital gains tax.[16] This paper will argue that an IDGT

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[12] *See* I.R.C. § 2041(b)(1)(A) (defining the term "general power of appointment"); *see also* Treas. Reg. § 20.2041-1(a) ("A decedent's gross estate includes under section 2041 the value of property in respect of which the decedent possessed, exercised, or released certain powers of appointment."). According to this guidance from the regulations, a decedent's estate includes property on which the decedent retains a power of appointment at the time of death. *Id.*

[13] *See* Schaum, *supra* note 8 (suggesting that "[i]f son grants to mother a limited general power of appointment in the trust . . . this should cause the assets in the defective grantor trust to be included in mother's estate upon her death with a resulting step-up in basis equal to the value on date of death. Then, upon mother's death, the trust could provide a generation skipping trust for the lifetime benefit of the son.").

[14] *See* I.R.C. § 1014(a)(1); *see also* Treas. Reg. § 1.1014-1(a) ("[T]he general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death.").

[15] *See* Treas. Reg. § 1.1014-1(a); *see also* Schaum, *supra* note 8.

[16] The IRS issues a number of communications to the public detailing their opinion on the answer to a number of tax questions. *See* STEPHEN A. LIND ET AL., FUNDAMENTALS OF FED. INCOME TAXATION 24 (Foundation Press, 20th ed. 2022) ("The regulations are not the only income tax documents emanating from the Treasury Department. For example, there are Revenue Rulings that are issued under the same statutory authority as the regulations. They are generally the Treasury's answer to a specific question raised by a taxpayer concerning the taxpayer's liability . . . . While they do not have the force and effect of regulations, they do at least reflect the current policies of the Internal Revenue Service and they may be cited and relied on."). However, new tax theories and strategies, such as the one discussed in this paper, lack guidance because no questions on such

structured as an upstream gift is indeed a legal mechanism to increase basis in appreciated assets and allows high net-worth individuals to legally avoid capital gains taxes by stepping basis up in their own appreciated assets.

This paper will begin with a brief background discussion on the tax and estate planning principles underlying the legality of the wealth transfer including (A) the Taxable Gross Estate; (B) the Unified Tax Credit against the Estate and Gift Tax; (C) Basis and Adjustments; (D) Defective Grantor Trusts; and (E) Downstream Sale Combined with a Grantor Trust. The paper will then discuss the absence of guidance from the IRS on the legality of these trust structures and finally conclude that the IRS should allow wealth preservation through the transactions described herein because the current Code, properly construed, allows for it.

II. UNDERLYING TAX PRINCIPLES

A. THE TAXABLE GROSS STATE

Section 2031 of the Internal Revenue Code broadly defines a decedent taxpayer's taxable gross estate to include the value of all property to the extent of the decedent's interest at the time of death.[17] In using such broad language to define a taxpayer's gross estate, Congress clearly intended to capture all or substantially all of a decedent taxpayer's assets within the taxable gross estate.[18]

Simply put, § 2031 acts as a magnet upon an individual's death, anchoring all of the decedent's assets into a pool which comprises the gross estate. The plain text of § 2031 leaves no room for ambiguity in using the broad, all-encompassing terms "all property," and "wherever situated," signaling the federal government's intention to lay a claim on the entirety of a decedent taxpayer's wealth.[19] While some issues exist surrounding the determination of a decedent's gross estate, such as proper valuation of a taxpayer's assets and the proper time at which the assets should be valued, these issues assume the premise that Congress is interested in including as many assets within each taxpayer's gross estate. Accordingly, it is well understood that the starting point for any inquiry into the federal estate tax begins with identifying all property the decedent has an ownership interest in.

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issues have been asked.

[17] *See* I.R.C. § 2031(a); *see also* Treas. Reg. § 20.2031-1(b) (prescribing the fair market value at the time of the decedent's death as the method for valuation of the taxpayer's gross estate and defining fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts").

[18] *See* Flanders v. United States, 347 F. Supp. 95, 97 (N.D. Cal. 1972) ("The purpose of the federal estate tax is to tax the privilege of transmitting property at death based on its value.").

[19] *See* § 2031(a) ("The value of the gross estate of the decedent shall be determined by including to the extent provided in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.").

Once all assets are sealed within the § 2031 gross estate, the federal government imposes a tax on any transfer of the assets—i.e., wealth transfers at death—within the gross estate to the beneficiaries of the decedent's choosing.[20] The executor of the decedent taxpayer's estate is liable for complete accord and satisfaction of the taxable sum to the federal government.[21] However, most estates are not actually liable to even file an estate tax return because of the § 2010 unified credit against the estate tax.

B. UNIFIED TAX CREDIT AGAINST THE FEDERAL ESTATE TAX

Despite Congress's intention to tax as much property as possible at death, § 2010 of the Internal Revenue Code effectively allows every decedent to exclude a large number of assets from their gross estate and thereby avoid the federal estate tax to a very large extent.[22] The § 2010 unified credit is worth $10,000,000 and all is indexed yearly for inflation—but note, the credit is set to be reduced to $5,000,000 after January 1, 2026 barring any further action from Congress.[23] Even if the base value of the credit is reduced from $10,000,000 to $5,000,000, the unified tax credit is always adjusted for inflation.[24]

As of 2023, the inflation adjustment to the unified credit brings the total value of the credit against the estate tax to $12,920,000.[25] Better yet, married spouses may pool their credits together for a total exclusion worth $25,840,000 in 2023.[26] The unified tax credit has a long, interesting history which has seen several changes to its value. As mentioned above, the current law is planned to sunset in 2026, cutting the value of the credit in half barring further action from Congress. But whether the credit remains as is, is cut in half, or is even increased, the unified credit will remain as a vital tool in estate planning and wealth preservation.

For example, wealthy client Stanley dies in 2023. His only assets include a house worth $3,000,000, a stock portfolio worth $2,000,000, and bank accounts worth $5,000,000. Stanley's § 2031 gross estate is accordingly valued at $10,000,000 but his estate is not liable for any federal estate tax, nor must his estate even file an estate tax return. This is because Stanley's gross estate of

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[20] *See* I.R.C. § 2001(a)–(b) (imposing the estate tax); *see also* Treas. Reg. § 20.2002-1 ("The Federal estate tax imposed both with respect to the estates of citizens or residents and with respect to the estates of nonresidents not citizens is payable by the executor or administrator of the decedent's state. This duty applies to the entire tax.").

[21] *See* I.R.C. § 2002 (stating that the federal estate tax "shall be paid by the executor").

[22] *See* I.R.C. § 2010(a)-(b); *see also* Treas. Reg. § 20.2010-1(a) ("Section 2010(a) allows the estate of every decedent a credit against the estate tax imposed by section 2001. The allowable credit is the applicable credit amount.").

[23] *See* § 2010(c)(3)(C) ("In the case of estates of decedents dying or gifts made after December 31, 2017, and before January 1, 2026, subparagraph (A) shall be applied by substituting '$10,000,000' for '$5,000,000.'").

[24] *See* § 2010(c)(3)(B).

[25] *See* Rev. Proc. 2022-38.

[26] *See id.*

$10,000,000 is worth less than the § 2010 unified credit and applicable exclusion amount.

Most individuals outside the estate planning community—and even most young law students—are shocked to learn that the lifetime exemption against the estate and gift taxes is worth so much. This paper intends to make clear that most taxpayers do not currently use their unified credit against the estate tax to its maximum utility and, under the current Code guidance, using another's unified credit is a legal means to get a step up in basis without triggering detrimental collateral tax consequences.

C. Basis, Adjustment, and Gain

Dispositions of property, through sale or other means, are only taxable to the extent of gain.[27] The type of property subject to special tax treatment upon disposition is called a "capital asset," hence the popular colloquial term "capital gain."[28] The amount of taxable gain on disposition of a capital asset is equal to the amount of money or other property received in exchange for the sale or other disposition (the "amount realized") *less* the cost of acquisition (the "adjusted basis").[29]

For instance, if Stanley purchased Blackacre for $10,000 and later sold it for $100,000, his taxable gain on the sale of Blackacre is $90,000. This is the result of Stanley's § 1001 gain is equaling the $100,000 amount realized *less* his $10,000 adjusted cost basis.[30] Being that Stanley has a capital gain of $90,000, he also has taxable income in the same amount.[31]

With that in mind, it follows that taxable gain is naturally reduced by increasing the adjusted basis because the difference between the amount realized and a property's adjusted basis is substantially dependent upon the property's adjusted basis; a higher adjusted basis will always close the gap towards the amount realized and thereby reduce any § 1001(a) gain.[32]

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[27] *See* I.R.C. § 61(a)(3) (including gains derived from dealings in property within taxable income); *see also* I.R.C. § 1001(a) (defining the capital gain upon disposition of property).

[28] *See* I.R.C. § 1221(a) (defining a capital asset); *see also* I.R.C. § 1221(a)(1)–(8) (defining capital assets negatively, listing all types of property which are *not* capital assets, and nothing that any type of property not listed within § 1221(a)(1)-(8) falls within the definition of a capital asset).

[29] *See* I.R.C. § 1001(a), (c).

[30] *See* I.R.C. §§ 1001(a), 1012 (a), 1011 (a); *see also* Treas. Reg. § 1.1001-1(a) ("[T]he gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received.").

[31] *See* I.R.C. § 61(a)(3) (taxing gains derived from dealings in property).

[32] *See* § 1001(a); *see also* Treas. Reg. § 1.1001-1(a) (stating that computation of taxable gain follows the basic formula of the amount realized minus the adjusted basis. It follows that the amount of gain will always be reduced where the subtrahend basis value is increased).

One statutorily sanctioned method to increase a property's basis is through the § 1014 "step-up" mechanism.[33] Section 1014 provides that a taxpayer's basis in any property received from a decedent is equal to the property's fair market value at the time of the decedent's death.[34] Section 1014 step-up in basis is one of the most important tools for tax avoidance because it allows property held within a family over a number of generations to be sold at an extraordinary gain without ever paying any capital gains tax.

In other words, if Stanley purchased Blackacre for $10,000 and held it until his death when it appreciated in value to $1,000,000, Stanley's heir would have a basis of $1,000,000 in Blackacre upon inheritance because § 1014 steps his heir's basis up to Blackacre's value at the time of Stanley's death. This means Stanley's basis is effectively erased and his heir may sell Blackacre for $1,000,000 without incurring any income tax liability.[35]

D. DEFECTIVE GRANTOR TRUSTS

One of the most popular ways to preserve and/or transfer wealth is by arranging a trust. In very general terms, a trust is a legal entity whereby a trustee is appointed to take legal title to property in order to protect and conserve it for the benefit of the grantor's beneficiary.[36] Most estate plans involve some type of trust because they simultaneously achieve the goals of preserving wealth and passing legal title to a desired beneficiary upon death.[37]

Trusts broadly fall within two categories: revocable trusts and irrevocable trusts.[38] As their names imply, revocable trusts allow the settlor to revoke the

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[33] *See* Jeremy T. Ware, *Section 1014(B)(6) and the Boundaries of Community Property*, 5 NEV. L.J. 704 (2005); *see also* I.R.C. § 1014.

[34] *See* Ware, *supra* note 33; *see also* I.R.C.§ 1014.

[35] *See* I.R.C. § 1014(b)(5); *see also* Treas. Reg. § 1.104-1(a) ("[T]he general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death."); *see also* Sharon Kovacs Gruer, *Basis in Inheritance After EGTRRA*, 5 MARQ. ELDER'S ADVISOR 74, 75 (2003) ("Under current law, if a mother purchased a home for $25,000 and then died years later when it was worth $200,000, leaving it to her children, the children would receive a stepped-up basis of $200,000. If the children sold the home for $200,000, there would be no capital gain.").

[36] *See* Treas. Reg. § 301.7701-4(a) ("In general, the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries . . . . Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit."); *see also* RESTATEMENT (THIRD) OF TRUSTS § 2 (2012) ("A trust . . . is fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee.").

[37] *See The role of trusts*, MERRILL LYNCH, https://www.ml.com/solutions/the-role-of-trusts.html, (last visited Nov. 21, 2023) ("Some of the ways trusts might benefit you include: [p]rotecting and preserving your assets[,][c]ustomizing and controlling how your wealth is distributed.").

[38] *See id.*; *see also* THOMAS A. THOMAS & DAVID T. SMITH, 2 FLORIDA ESTATES PRACTICE GUIDE

property conveyed to the trust while irrevocable trusts prohibit the settlor from reneging on their conveyance.[39] As a result, revocable trusts and irrevocable trusts have vastly different tax consequences for the grantor. Revocable trusts generally have less advantageous tax implications for the grantor because the fact that the grantor may revoke property from a revocable trust at any time means the property is still subject to their ownership and therefore remains their responsibility for tax purposes.[40]

An intentionally defective grantor trust involves an irrevocable transfer made during the settlor's life.[41] A defective grantor trust typically involves the settler conveying property to the trust through a sale. In exchange for the settler's assets, the trust conveys a promissory note as consideration to the settler. Due to the common structure of an IDGT as described below, the settler is still treated as the owner of the assets conveyed into the trusts for tax purposes despite the transfer and trust being irrevocable.[42] This is because the grantor retains certain administrative powers over the trust which, as a result, are taxable to the grantor rather than the trust or beneficiaries.[43] The outcome is that income taxes on any assets conveyed into an IDGT are paid by the grantor while the trust—and its beneficiaries—enjoy tax free growth.[44]

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(1) 169–172 (2023) (providing a general overview on the different types of trusts, specifically distinguishing between revocable and irrevocable trusts).

[39] *See* Thomas, *supra* note 38.

[40] *See id.*

[41] *See* Kagan, *supra* note 10 ("An intentionally defective grantor trust (IDGT) allows a person to isolate certain trust assets to segregate income tax from estate tax treatment.").

[42] *See* Bradley M. Beaman, *Estate Tax Consequences of Revenue Ruling 2004-64: Silence in Grantor Trusts is Anything but Golden*, 54 DRAKE L. REV. 929, 931 (2006) ("An intentionally defective grantor trust (IDGT) is a trust in which the grantor is treated as the owner for income tax purposes. That is, the grantor retains sufficient strings in the trust property to be treated as the owner for income tax, yet not enough to include the trust property in the grantor's gross estate under § 2036 or § 2038 of the Internal Revenue Code.").

[43] *See* Treas. Reg. § 1.671-1(a)(3) ("Sections 673 through 677 define the circumstances under which income of a trust is taxed to a grantor. These circumstances are in general as follows: . . . [i]f certain administrative powers over the trust exist under which the grantor can or does benefit (section 675)."); *see also* I.RC. § 675(4) ("The grantor shall be treated as the owner of any portion of a trust in respect of 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 . . . the term 'power of administration' means any one or more of the following powers: (A) a power to vote or direct the voting of stock to other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substitution other property of an equivalent value.").

[44] *See* Beaman, *supra* note 42, at 932 ("A grantor potentially benefits the trust beneficiaries twofold, by not only shifting income on the trust to a lower tax bracket but also vita the quasi-forced, tax-free gift from the grantor to the beneficiaries when the grantor pays the income taxes for the trust . . . . Additionally, transactions between the grantor and the IDGT are treated as 'non-events' for income tax purposes because the grantor, for income tax purposes, is considered the owner.").

IDGTs are increasingly popular estate planning tools because they offer a number of advantageous features for wealthy individuals intending to preserve and protect wealth. In addition to IDGTs allowing for assets within a trust to grow tax free as mentioned above, the IDGT also allows the grantor to reduce their taxable estate because, despite retaining enough ownership interest to pay income taxes, the grantor releases enough of an ownership interest in the assets sold to the trust so that the assets are removed from the grantor's gross estate.

Since the IDGT removes assets sold from the gross estate, a decedent taxpayer's estate tax liability is likewise extinguished as the assets, now under the ownership of the IDGT, are not included within the grantor's the § 2031 gross estate.[45]

For example, Stanley conveys Blackacre to a trust in exchange for a promissory note bearing adequate interest. Stanley's basis in Blackacre is $10,000, but Blackacre has since appreciated to have a fair market value worth $100,000. Stanley structures the trust so that he does not retain the power to revoke,[46] but he does retain a general power of administration in that he allows himself to reacquire Blackacre by repurchasing it for the fair market value.[47] Stanley names his son as the beneficiary of the trust and Blackacre is held in trust for as long as Stanley specifies (in practice, the property is commonly held in trust until death).

The beauty of an Intentionally Defective Grantor Trust is that, because Stanley is still taxable on the income generated by Blackacre due to his retained administrative rights, his beneficiaries do not pay any income tax until the trust is terminated and title to Blackacre vests within Stanley's beneficiary.[48] This means if the trust rented Blackacre to tenants for $5,000 each month, the income tax on those rents are paid by Stanley—not Stanley's beneficiary.[49] This allows Blackacre to continue its tax-free appreciation and for Stanley to make tax-free gifts in the form of income tax paid.[50] This is an example of an Intentionally Defective Grantor Trust.

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[45] *See* I.R.C. § 2031.

[46] *See* I.R.C. § 676; *see also* Treas. Reg. § 1.676(a)-1 (defining a grantor's power to revest title to portion of trust property and explaining that a grantor who retains such power over trust property is treated as owner of the property for tax purposes).

[47] *See* § 675(4).

[48] *See id.*; *see also* Treas. Reg. § 1.671-1(a)(3) (defining the circumstances under which income of a trust is taxed to the grantor).

[49] *See* I.R.C. § 61(a)(5) (including rents within the scope of taxable income); *see also* Treas. Reg. § 1.61-8(a) ("Gross income includes rentals received or accrued for the occupancy of real estate or the use of personal property.").

[50] *See* Old Colony Trust Co. v. Comm'r., 279 U.S. 716 (1929) (noting payment of another's income tax liability typically constitutes a gift by the payor and taxable income to the payee). *But see* I.R.C. § 671 (noting that grantors who retain certain rights remain liable for payment of the income tax on income generated by the trust property. However, Intentionally Defective Grantor trusts allow taxpayers to escape tax liability in connection with payment of income tax for the benefit of others because of the way Section 671 assigns tax liability).

E. PARTIAL SALE TO A DEFECTIVE GRANTOR TRUST

As mentioned above, taxes on capital gains are assessed at the time of sale or other disposition of capital asset property.[51] This means that capital assets are allowed to appreciate tax-free and are only taxed once the property is sold or disposed of by other means.[52] This might imply that a grantor who sells appreciated assets to a Defective Grantor Trust in exchange for a promissory note has taxable gain equal to the difference in the grantor's basis and the value of the promissory note.[53]

But a sale of assets by the grantor to a defective trust does not require computation of gain when the sale of assets is to a trust in which he retains general administrative powers.[54] This is because the IRS views the grantor and the trust as the same taxable entity and therefore does not require a § 1001 calculation on the computation of gain. While this transaction is technically an avoidance of the capital gains tax, it is important that the sale is bona fide otherwise it might be subject to scrutiny by the IRS.[55]

The conventional wisdom is for the grantor to make a gift of some seed money to partially fund the trust. If Stanley wanted to use the defective grantor trust to get a stepped-up basis in Blackacre, which had a fair market value of $100,000, Stanley might make a gift of $10,000 cash to the trust, which the trust will then use to make installment payments toward the promissory note it conveyed to Stanley in consideration for Blackacre. Stanley is not required to make a § 1001 calculation on the exchange of Blackacre for the promissory note because they are the same taxable entity. Further, any interest payments made by the trust to Stanley are also tax free for the same reason.

Being that the transaction is susceptible to attack by the IRS on account of legitimacy, a taxpayer can assess their own personal risk tolerance when deciding how much seed money they want to gift to the trust to begin the partial payments. Of course, the gift of seed money is taxable to the grantor and uses a small chunk of the grantor's lifetime unified tax credit against the estate tax, assuming no gift tax exclusions apply.[56]

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[51] *See* I.R.C. § 1001(a).
[52] *See* I.R.C. § 1221 (defining capital assets); *see also* Treas. Reg. § 1.1001-1(a) (stating "the gain or loss realized from conversion of property into cash, or from the exchange of property for other property differing materially either in kind or extent, is treated as income or as loss sustained.").
[53] *See* I.R.C. § 1001(a); *see also* § I.R.C. 61(a)(3).
[54] *See* I.R.C. § 1(10)(E) (listing an estate or trust as a pass-thru entity).
[55] *See Bona Fide*, BLACK'S LAW DICTIONARY (11th ed. 2019) (stating a bona fide transaction is one made "in or with good faith; honestly, openly, and sincerely; without deceit or fraud. Truly; actually; without simulation or pretense. Innocently in the attitude of trust and confidence; without notice of fraud."); *see also* Treas. Reg. § 20.2043-1(a) ("To constitute a bona fide sale for an adequate and full consideration in money or money's worth, the transfer must have been made in good faith, and the price must have been an adequate and full equivalent reducible to a money value.").
[56] *See* I.R.C. § 2010 (showing that gifts made during the decedent's (here the grantor's, lifetime) count towards the grantor's Section 2010 Unified Credit against the estate tax. So, if the grantor makes a gift of $10,000 in seed money to fund the payments toward the promissory note, that

III. DISCUSSION

A. How Intentionally Defective Grantor Trusts as Upstream Gifts Are Being Used to Get Stepped-up Basis in Appreciated Assets

Consider the following hypothetical: Stanley purchased 100,000 shares of Amazon stock in 1998 at a uniform price of $0.78 per share.[57] Stanley holds the stock for several years, and by 2023, the average price for one share of Amazon is approximately $105.41.[58] Stanley's investment has appreciated handsomely, having grown by nearly 13,000% since his purchase in 1998 and his shares are pregnant with $10,541,000 in gain. Stanley decides he wants to cash out on his investment and reap the benefit of his two-decade-long investment. But unfortunately for Stanley, his sale of stock will be subject to capital gains tax.[59]

Since Stanley intends to sell his Amazon stock, he must perform a § 1001 calculation which then must be recognized as taxable gain.[60] Assume Stanley held all 100,000 shares since the time of purchase, and further assume he is selling the same 100,000 all at the same time, for the same uniform price. The calculation is as follows: Stanley's basis in the stock is $78,000 because that is what he paid to acquire it in 1998.[61] Assuming Stanley sells all 100,000 shares for the fair market value of $105.41, his amount realized is $10,541,000 because that is the amount of money he will receive in exchange for his 2023 sale.[62] According to § 1001(a), Stanley has taxable gain of $10,463,000 because that is the difference between his adjusted basis in the Amazon stock and his amount

amount will count towards the grantor's lifetime exclusion. Still, this cost pales in comparison to potential savings in capital gains taxes once the step-up in basis is achieved).

[57] *See Amazon – 26 Year Stock price History | AMZN*, MACROTRENDS, https://www.macrotrends.net/stocks/charts/AMZN/amazon/stock-price-history (last visited Nov. 21, 2023) (showing that the average price per share of Amazon stock was $.07814 in 1998 and $105.4054 in 2023).

[58] *See id.*

[59] *See* I.R.C. § 61(a)(3) (stating that gains derived from dealings in property are taxable gross income); *see also* Treas. Reg. § 1.61-1(a) ("Gross income includes income realized in any form, whether in money, property, or services. Income may be realized therefore, in the form of . . . stock.").

[60] *See* I.R.C. § 1001(a) (explaining computation of gain or loss); *see also* § 1001(c) (stating that "the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.").

[61] *See* I.R.C. § 1012(a) ("The basis of property shall be the cost of such property."); *see also* I.R.C. § 1011(a) (stating general rule of the adjusted basis for determining gain or loss); *see also* Treas. Reg. § 1.1012-1(a) ("In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property."). Here, the § 1012 cost basis applies and Stanley's $78,000 purchase price in 1998 becomes his basis for determining any § 1001 gain or loss.

[62] *See* § 1001(b) ("The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."); *see also* Treas. Reg. § 1.1001-1(a) (defining the amount realized).

realized upon sale ($10,541,000 *minus* $78,000 equals $10,463,000).[63] Stanley will have to pay a sizeable amount in taxes if he chooses to recognize this gain.

As a result of the Amazon stock qualifying for treatment as a capital asset, Stanley's income upon sale is, at least, taxed at a preferential rate in contrast to the income tax rate for ordinary income.[64] Additionally, Stanley's gain is characterized as a long-term capital gain, and therefore taxed at a further preferential rate because Stanley held the stock for nearly twenty-five years.[65]

The applicable long-term capital gains tax rate depends upon the taxpayer's income bracket.[66] If we assume Stanley files as the head of household and has § 63 taxable income greater than $523,050, then Stanley falls in the top tax bracket, and his capital gains are taxed at 20%.[67] At Stanley's capital gains tax bracket, he will be liable for $2,092,600 in capital gains taxes when he sells his Amazon stock to collect his gain ($10,463,000 of gain *times* 20% equals $2,092,600).[68] Very quickly, Stanley's return on investment is cut from $10,463,000 down to $8,370,400 due to capital gains taxes.

Fortunately for Stanley, "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the treasury; there is not even a patriotic duty to increase one's taxes."[69] Stanley looks to his elderly parents whom he has a wonderful personal relationship with, but who have not been as fortunate financially. Stanley is very well-off and owns many valuable assets, but his elderly parents are very average by comparison: their entire net worth consists of their primary residence, valued at $400,000, and a single bank account worth $100,000. Additionally, due to their financial circumstances, Stanley's parents have not made any taxable gifts during their lifetimes.[70]

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[63] *See* § 1001(a) ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain.").

[64] *See* I.R.C. § 1221(a)(1)–(8) (defining capital assets as all property held by the taxpayer, except for eight explicitly defined categories of property which are not entitled to capital asset treatment).

[65] *See* I.R.C. § 1223 (defining the holding period for capital assets); *see also* Treas. Reg. § 1.1223-1(a) ("The holding period of property received in an exchange by a taxpayer includes the period for which the property he exchanged was held by him, if the property received has the same basis in whole or in part for determining gain or loss in the hands of the taxpayer as the property exchanged."); *see also* I.R.C. § 1222(3) (defining long-term capital gain as "gain from the sale or exchange of a capital asset held for more than [one] year, if and to the extent such gain is taken into account in computing gross income."); *cf.* § 1222(1) (defining short-term capital gain as "gain from the sale or exchange of a capital asset held for not more than [one] year, if and to the extent such gain is taken into account in computing gross income.").

[66] *See* I.R.C. § 1(h)(1) (defining the maximum capital gains rate).

[67] *See id.*

[68] *See id.*

[69] *See* Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) (Hand, J., majority opinion), *aff'd*, 293 U.S. 465 (1935).

[70] *See* I.R.C. § 2010 (explaining that if Stanley's parents have not made any taxable gifts during their lifetimes, then they also have not spent any of their § 2010 unified credit against the estate tax).

Stanley consults with his estate planning attorney who creates an irrevocable grantor trust for the benefit of Stanley's elderly parents. Instead of selling his Amazon stock on the public market, Stanley conveys all 100,000 Amazon shares to the trust in exchange for a promissory note equal to the fair market value of the Amazon stock ($10,541,000). The promissory note bears an adequate interest rate.[71] Stanley does not have to perform a § 1001 calculation when he conveys his stock to the trust in exchange for the promissory note because the trust is a disregarded entity.[72] Weary of this transaction being audited by the IRS, but still tolerant enough to pursue tax avoidance, Stanley makes a gift of $1,054,100 of his Amazon stock (10% of the purchase price) to the trust. The trust proves to be a bona fide purchaser by making installment payments to Stanley on balance of the note by conveying the gifted stock back to Stanley.

Stanley's trust is irrevocable but he retains administrative powers in the ability to retake title to the trust corpus at any time in exchange for property of equal value.[73] Although the trust is irrevocable, it is also defective because Stanley's retained administrative rights render him liable for the trust's income taxes. As a result, the Amazon stock is technically trust property, but Stanley continues to pay the income taxes on the dividends Amazon pays to his parents as beneficiaries of the trust. Now, Stanley's parents can afford to retire and live off the Amazon dividends without incurring any income tax liability.[74]

Several years pass and Stanley's parents pass away. As mentioned above, their only assets at the time of death were their house worth $400,000, a single bank account worth $100,000, but now also their $10,541,000 interest within the trust. Their entire gross estate accordingly is valued at $11,041,000.

With a total value of approximately $11,041,000, Stanley's parents need not file an estate tax return because their entire gross estate is valued less than the § 2010 Unified Credit against the Estate Tax.[75] In fact, Stanley's parents are still entitled to avoid estate tax on more than $10,000,000 worth of property because the Unified Credit for married couples allows for a total exemption of $25,840,000.[76] Indeed, Stanley could have purchased as many as 200,000 shares of Amazon in 1998 and happily avoided close to $20,000,000 of capital gains taxes in 2023.

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[71] *See* I.R.C. § 1274 (mandating that certain debt instruments bear an adequate interest rate, sometimes referred to as the "applicable federal rate").
[72] *See* I.R.C. § 1(10)(E); *see also* § I.R.C. 1001(a) (requiring a calculation of gain or loss upon sale or disposition of property).
[73] *See* I.R.C. § 675(4).
[74] *See generally* Helvering v. Horst, 311 U.S. 112 (1940) (stipulating that income is generally taxable to the party who controls how the property is used). Although Amazon does not pay any dividends to stockholders as of 2023, this example uses Amazon merely to illustrate an example of an asset with potential for extraordinary gain.
[75] *See* I.R.C. § 2010.
[76] *See id*; *see also* Rev. Proc. 2022-38, I.R.B. 2022-45.

Upon their death, the gross estate of Stanley's parents includes all of the appreciated Amazon stock because they have a large enough ownership interest and a general power of appointment. Accordingly, the trust property now receives a stepped-up basis because § 1014 grants a step-up to all property acquired from a decedent.[77]

The trust is now free to repay the balance of the promissory note to Stanley with a stepped-up basis. Whether the trust chooses to repay the balance in the form of stock, or sell the stock and pay cash to Stanley, a stepped-up basis applies.[78] Because Stanley and the trust are the same taxable entity, Stanley's basis in the Amazon stock is effectively stepped-up from $78,000 to $10,541,000. Stanley realizes millions on his appreciated investment without any income tax liability on his capital gain.

B. LACK OF IRS AND TREASURY GUIDANCE

Paraphrasing tax law professor Mark J. Wolff,[79] participation within the income tax system is mandatory but also voluntary. The IRS does not sit down with each taxpayer as he files his return at the end of the year, glaring over his shoulder to make sure each penny is properly recorded at the time of filing. Instead, the initial responsibility of filing a return is left to the taxpayer. If the IRS subsequently decides some error exists within a taxpayer's return, the IRS may assert a deficiency which the taxpayer is then responsible for paying or disputing.[80]

Of course, litigation is expensive and burdensome, even for the IRS. Contrary to what many might believe, the IRS would prefer to *not* audit taxpayers or litigate disputes on tax returns. As a government agency with a limited budget, the IRS has a vested interest in reducing litigation as much as possible while still collecting all tax owed to the Treasury.[81] In order to achieve the

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[77] *See* I.R.C. § 1014.

[78] *See* § 1014(a) (reflecting that a step-up applies here because the property is deemed to have been received from a decedent pursuant to I.R.C. § 1014(b)(9) which provides that property acquired from the decedent by reason of death, including property acquired through the exercise of a power of appointment, is property received from a decedent and therefore entitled to a step-up in basis); *see also* § 1014(b)(9).

[79] *See Mark J. Wolff*, ST. THOMAS UNIV., https://www.stu.edu/law/faculty-staff/faculty/mark-wolff/ (last visited Nov.5, 2023) ("Professor Wolff received . . . his LL.M. (in Taxation) from New York University Graduate School of Law . . . and over the past [thirty-nine] academic years has specialized in teaching courses in various areas of [taxation] . . . .").

[80] *See Taxpayer Bill of Rights 5: The Right to Appeal an IRS Decision in an Independent Forum*, IRS, https://www.irs.gov/newsroom/taxpayer-bill-of-rights-5 (last visited Nov. 5, 2023) (stating how the IRS may assert a deficiency within a taxpayer's return when they believe a taxpayer's tax liability exceeds the amount of income tax actually paid. A taxpayer facing a notice of deficiency has several options: they may (1) pay the tax and move on; (2) pay the tax and sue for a refund in Federal District Court or the Court of Federal Claims; or (3) file a petition in the Tax Court disputing the deficiency. Filing in the Tax Court is the only way to litigate the deficiency before paying the asserted sum to the IRS).

[81] *See* I.R.S. Pub. 5530 (Rev. 3-2022) (stating the "IRS FY 2023 budget request is $14.1 billion.");

conflicting goals, the IRS publishes a number of guidance materials answering complex tax questions which taxpayers may rely on when calculating their tax liability.[82]

However, the IRS has been largely silent on the issue of Intentionally Defective Grantor Trusts to get a stepped-up basis in a *living* (emphasis added) taxpayer's appreciated assets.[83] Perhaps the closest guidance available on the issue comes from the recent Revenue Ruling 2023-2, which broadly held that the § 1014 step-up mechanism does not apply to irrevocable grantor trust assets not included in the grantor's gross estate at his death.[84]

According to the ruling, only seven types of property are eligible for the § 1014 step-up in basis: (1) property acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent;[85] (2) property transferred by the decedent during their life in trust to pay income for life to or on the order or direction of the decedent where the decedent reserves the right to revoke before death;[86] (3) property transferred by the decedent during life in trust to pay income for life or on the order or direction of the decedent with the right reserved by the decedent to make any change in its enjoyment through the exercise to alter, amend, or terminate the trust;[87] (4) property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;[88] (5) property representing the surviving spouse's one-half share of community property held by the decedent under community property laws if at least one-half interest in the property was includible in determining the decedent's gross estate;[89] (6) property acquired from the decedent by reason of death, form of ownership, or other conditions if the property must be included in valuing the decedent's gross estate under Chapter 11 or the 1939 Code;[90] and (7)

see also Returns Filed, Taxes Collected & Refunds Issued, IRS, https://www.irs.gov/statistics/returns-filed-taxes-collected-and-refunds-issued (last visited Nov. 21, 2023) ("Nearly 213.4 million returns and other forms were filed electronically." If the IRS faced a dispute on every single return filed, they would only have about $66 available to dedicate towards each controversy (assuming the entire budget was allocated towards litigation—which it is not). It is therefore in the IRS's interest to have as few tax controversies as possible).

[82] *See* LIND, *supra* note 16; *see also Understanding IRS Guidance - A Brief Primer*, IRS, https://www.irs.gov/newsroom/understanding-irs-guidance-a-brief-primer (last visited Nov. 21, 2023) (providing a primer on "seven of the most common forms of guidance," including Revenue Rulings, Revenue Procedures, Private Letter Rulings, Technical Advice Memorandums, Notices, and Announcements). While taxpayers are entitled to rely on these communications, they are merely persuasive and do not carry the authoritative weight of the Internal Revenue Code, Treasury Regulations, or court decisions. However, these communications are helpful insights into what the IRS allows taxpayers to get away with and what might trigger an audit or deficiency.

[83] *See* § 1014.

[84] *See* Rev. Rul. 2023-2, 2023-16 I.R.B. 658.

[85] *See* § 1014(b)(1).

[86] *See* § 1014(b)(2).

[87] *See* § 1014(b)(3).

[88] *See* § 1014(b)(4).

[89] *See* § 1014(b)(6).

[90] *See* § 1014(b)(9).

property includible in the gross estate of the decedent which was previously deductible under § 2044.[91]

The key point of law uniting all property entitled to a step-up in basis is that the property must have been acquired or passed from a decedent.[92] In the ruling, the facts include an individual, G,[93] who established an irrevocable trust, T, funded with an asset that was a completed gift for federal gift tax purposes. G retained certain administrative power over T which caused G to be liable for the income tax for income generated by the trust. In other words, the trust was intentionally defective.

But while G held administrative rights causing him to be liable for income taxes, G did not hold enough power over T that would cause the trust's assets to be included in G's § 2031 gross estate. The trust's assets appreciated for seven years until G's death. The ruling concludes that the appreciated trust assets do not receive a step-up in basis at the time of G's even despite G retaining enough interest in T to be liable for federal income tax purposes.[94]

The trust property was not entitled to a step-up in basis at G's death because the trust assets did not fall within any of the seven above-mentioned types of properties entitled to a step-up in basis.[95] Particularly, the trust property did not qualify for a step-up because the assets were not bequeathed, devised, or inherited as required by § 1014(b)(1).[96] The ruling cites a Sixth Circuit case from 1961 where the court held that property transferred in trust prior to the decedent's death is not bequeathed or inherited within the meaning of § 1014(b)(1) because mere existence of the trust and its ownership interest in the trust assets prevented the property from passing by either will or intestacy.[97]

In the revenue ruling's fact scenario, the trust assets are held by T—not by G—so the property is never technically bequeathed or inherited after's G's death, and is therefore not the type of property described by § 1014(b)(1).[98] Accordingly, because G does not actually own the property at death, and holds no power of appointment that would cause gross estate inclusion, the ruling properly concludes that the property is not entitled to a stepped-up basis.[99]

The ruling references the congressional committee report discussing the step-up basis in property acquired from a decedent which a California district court interpreted to mean that § 1014 "applies basically to property in the

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[91] *See* § 1014(b)(10).
[92] *See* Rev. Rul. 2023-2, 2023-16 I.R.B. 658.
[93] *See id*. The revenue ruling actually refers to the owner of the trust as "A," but I will refer to the trust owner as "G" for an easier reading.
[94] *See id*.
[95] *See id*; *see also* I.R.C. § 1014(b)(1)–(10) (stating the seven scenarios in which a trust asset is entitled to a step-up in basis).
[96] *See* § 1014(b)(1); *see also* Treas. Reg. § 1.1014-2(a)(1)–(5) (detailing the scenarios in which property is deemed to have been acquired from a decedent so that its basis is stepped up by § 1014).
[97] *See* Bacciocco v. United States, 286 F.2d 551, 554–55 (6th Cir. 1961).
[98] *See* Rev. Rul. 2023-2, 2023-16 I.R.B. 658.
[99] *See id.*

decedent's probate estate and includible in his gross estate under [§ 2031(a)]," and to property "acquired by certain specifically described methods of disposition which are treated as though the acquisition was by bequest, devise, or inheritance."[100]

Importantly, the congressional committee report implies that a § 1014 step-up in basis will always apply to property that is included within a decedent's gross estate under § 2031.[101] It makes sense that no step-up is allowed in situations like the example within the revenue ruling where the grantor conveys the appreciated assets in whole to the trust such because the assets are not included within the grantor's gross estate at death. But what about assets conveyed to a defective grantor trust by a *living* taxpayer?

In our example discussed in part A above, the grantor conveyed his appreciated stocks to a defective grantor trust, similar to the scenario in Rev. Rul. 2023-2. In both scenarios, the assets in trust were pregnant with gain and were held in trust where the grantor was liable for the income taxes for the income generated by the trust. But the key difference is that our example involves a grantor conveying assets to a trust where the beneficiary takes ownership and includes the assets in their gross estate. By contrast, the revenue ruling only discusses a completed gift by a grantor to the trust, meaning that the assets are not included within the grantor's gross estate.

The dispositive fact distinguishing our example is that the assets are included in the gross estate of the beneficiary at the time of the beneficiary's death while the revenue ruling's scenario locks the assets into the trust for years to come while the trust beneficiaries are still living.[102] The beneficiary in our scenario is the decedent while the beneficiary of the revenue ruling is still living. As a result, our example properly includes the trust assets in the beneficiary's gross estate, and Revenue Ruling 2023-2 does not control whether a step-up in basis is appropriate.

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[100] Collins v. United States, 318 F. Supp. 382, 386 (C.D. Cal. 1970); *see* Rev. Rul. 2023-2, 2023-16 I.R.B. 658; *see also* H.R. REP. NO. 83-1337 at 4407–08 (1954).

[101] *See* I.R.C. § 2031(a); *see also* Rev. Rul. 2023-2, 2023-16 I.R.B. 658.

[102] This is a key distinction which is a dispositive factor in whether the revenue ruling controls the type of structure described in this paper. The revenue ruling held that assets transferred by a grantor to a trust do not receive a step-up in basis at the time of the grantor's death. *See* Rev. Rul. 2023-2, 2023-16 I.R.B. 658. This is because property must generally pass through a decedent's § 2031 gross estate in order to qualify for a § 1014. When the assets are conveyed to a defective grantor trust in a manner that does not include the assets in the grantor's gross estate, it properly follows that no § 1014 step-up is available for the assets' basis.

IV. ARGUMENT AND CONCLUSION

A. TAXPAYERS MAY USE INTENTIONALLY DEFECTIVE GRANTOR TRUSTS TO GET A STEPPED-UP BASIS IN THEIR OWN APPRECIATED ASSETS BECAUSE THE CURRENT CODE, REGULATIONS, AND TREASURY GUIDANCE DO NOT PROHIBIT SUCH A STRUCTURE

As discussed at length, a step-up in basis is proper where property is received from a decedent.[103] The Code and Regulations are clear that the general rule is that all types of property received from a decedent are subject to § 1014 and accordingly have a stepped-up basis in the hands of the recipient.[104] Because the current Code and Regulations do not explicitly prohibit taxpayers from using intentionally defective grantor trusts as partial upstream transfers to get a stepped-up basis in appreciated assets while also avoiding the estate tax via the unified credit, its legality must be assumed absent further guidance.

The Internal Revenue Code has historically been construed through a binary lens. For example, an item of income is either (a) included or (b) excluded from a taxpayer's gross income.[105] Because § 61 uses the words "all income from whatever source derived," it properly follows that, unless otherwise specified, § 61 gross income includes *all* accessions to wealth that are clearly realized and subject to the taxpayer's complete dominion.[106] This broad and literal reading of the Code is what allows for absurd results such as illegal income being taxable despite also criminal.[107]

It makes sense then to also read § 1014 as it is plainly written: *all* property received from a decedent receives a step-up in basis unless otherwise provided.[108] Property is either (a) received from a decedent or (b) not received from a decedent. Where it is, "the general rule is that [its basis] is the fair market value of such property at the date of the decedent's death."[109] As long as the

[103] *See* I.R.C. § 1014(a); *see also* Treas. Reg. § 1.1014-1(a) (affirming that the general rule governing basis of property acquired from a descendent shall have no application if the property is disposed before the decedent's death by the person who acquired the property from the descendant); *see also* H.R. Rep. No 83-1337 at 4407–08 (1954) (discussing the legislative intent of the § 1014 step-up mechanism).
[104] *See* § 1014(b)(1)–(10) (listing nearly all situations in which property passes from decedent to taxpayer).
[105] *See* I.R.C. § 61(a) ("Except as otherwise provided in this subtitle, gross income meals all income from whatever source derived."); *see also* Treas. Reg. § 1.61-1(a) ("Gross income means all income from whatever source derived, unless excluded by law.").
[106] *See* § 61(a); *see also* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (expanding the definition of gross income to include any "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").
[107] *See* Treas. Reg. § 1.61-14(a) ("In addition to the items enumerated in section 61(a), there are many other kinds of gross income. For example, . . . [i]llegal gains constitute gross income."); *see also* Cesarini v. United States, 296 F. Supp 3 (N.D. Ohio 1969) (affirming principle that any item not specifically excluded from income is included in gross income due to the broad statutory language of § 61).
[108] *See* § 1014(a).
[109] *See* Treas. Reg. § 1.1014-1(a).

property passes from the decedent in one of the manners prescribed by § 1014(b)(1)-(10), its basis in the hands of the person or entity acquiring the property is stepped-up to the property's fair market value.[110]

When a grantor constructs a trust as described in this paper and reacquires appreciated assets following their elderly parents' death, the grantor is deemed to have acquired property from a decedent pursuant to § 1014(b)(9).[111] Section 1014(b)(9) plainly states that "property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise . . . of a power of appointment)" (emphasis added) is the type of property described by § 1014(a) and therefore receives a stepped-up basis.[112]

When the elderly parent dies holding a power of appointment within the defective trust, the trust assets must be included within the decedent-parents' § 2031 gross estate.[113] Because the trust assets are included in the parents' gross estate, the asset's basis must therefore be stepped to the fair market value at the time of parents' death pursuant to § 1014(a).[114] This means the trust has a stepped-up basis in the appreciated assets because it acquires the assets in the manner described by § 1014(b)(9). As a result of the trust and the grantor-son being the same taxable entity, the son also has a stepped-up basis in the appreciated assets at the time of his parents' death.

To the same point, there is no reason why the § 2010 unified credit against the estate tax cannot be used in a manner described in this paper. Section 2010 states that "[a] credit of the applicable credit amount shall be allowed to the estate of every decedent against the [estate tax]."[115] Nothing within the plain text of the Code or Treasury Regulations denies the credit's use toward a decedent's beneficial interest in a defective grantor trust.

Indeed, § 2031(c)(10) provides that the gross estate of a decedent shall include the decedent's interest in a trust.[116] Being that trusts are the type of

[110] *See* § 1014(b)(1)–(10) (listing the methods by which property is deemed to be acquired from a decedent).

[111] *See* § 1014(b)(1) (defining property acquired from a decedent to include "[p]roperty acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.").

[112] § 1014(b)(9).

[113] When a decedent dies owning an interest in a trust, the entire interest must be included within the decedent's gross estate. *See* I.R.C. § 2031(a) ("The value of the gross estate of the decedent shall be determined by including . . . the value at the time of his death of all property, real or persona, tangible or intangible, wherever situated."); *see also* Treas. Reg. § 20.2036-1(a) ("A decedent's gross estate includes under section 2036 the value of any interest in property transferred by the decedent after March 3, 1931, whether in trust or otherwise.").

[114] *See* Rev. Rul. 2023-2, 2023-16 I.R.B. 658 (holding that § 1014 does not apply to irrevocable grantor trust assets not included in the grantor's gross estate at his death, but remaining silent on the issue of whether § 1014 applies to trust assets first included in the gross estate of beneficiaries which are then transferred back to the grantor).

[115] I.R.C. § 2010(a).

[116] *See* § 2031(c)(10) ("[§ 2031] shall apply to an interest in a partnership, corporation, or trust if at least [30%] of the entity is owned (directly or indirectly) by the decedent.").

property included within the § 2031 gross estate, it follows that the § 2010 unified credit, which is applied against the entirety of a decedent's gross estate, may be used to avoid tax liability on the privilege of passing trust ownership to the next generation.[117] Nowhere does § 2010 prohibit assets acquired by an upstream asset transfer through a grantor trust from enjoying the unified credit.

In conclusion, the current Code, Regulations, and IRS guidance allow taxpayers to increase basis in their own appreciated assets through § 1014 by constructing a defective grantor trust for the benefit of a parent who has not used their § 2010 unified credit against the estate. The current rules and guidance available to taxpayers do not specifically prohibit this type of transaction, and therefore, its legality must be assumed absent further guidance on the subject.

If the IRS intends to prohibit taxpayers from acquiring a § 1014 step-up using the strategy described within this paper, they must first issue guidance on the topic. As discussed, the purpose of IRS and Treasury guidance is to provide taxpayers with adequate information as to the tax consequences of their transactions. Because upstream transfers to defective grantor trusts are not explicitly prohibited from § 1014 step-up treatment, taxpayers are entitled to assume that assets held in trust for the benefit of their parents entitled to a basis step-up at the time of their parents' death and capital gains taxes may be avoided upon reacquisition of the appreciated assets due to the property's increased basis.

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[117] *See* Flanders v. United States, 347 F. Supp. 95, 97 (N.D. Cal. 1972) ("The purpose of the federal estate tax is to tax the privilege of transmitting property at death based on its value."). Therefore, it follows that the purpose of the § 2010 credit against the estate tax is to enhance the privilege of transmitting property at death to the extent that the property is includable within a decedent's gross estate.