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Understanding Section 1014(e)

(Part of a Series of Articles on Tax Basis Planning)

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Author's Note: The author gratefully acknowledges the insights and help he received from Michael Burns, Dennis Calfee, Sheldon Kay, and Jonathan Blattmachr in completing this article. The article was generated by a comment Jonathan Blattmachr made to the author about Code section 1014(e).

Editor's Note**:** Jeff will be speaking on "Basis Planning" at the University of Florida Levin College of Law First Annual Tax Institute on February 21, 2014 in Tampa. For more information on the Tax Institute go to: www. http://floridataxinstitute.org/. We hope to see you there.

This article is part of a series of articles that will be written on tax basis planning issues over the coming year.

EXECUTIVE SUMMARY:

For decades, tax basis planning has been a secondary aspect of most estate planning. The high transfer tax exemptions permanently adopted in the American Taxpayer Relief Act of 2012 and the recent significant income tax increases are bringing income tax planning into the forefront of estate planning. As a result, tax basis planning is receiving increasing attention. Probably one of the least understood Code provisions dealing with tax basis is Code section 1014(e).

Code section 1014(e) is one of those "lingering" Code sections that quietly sit in the Code without much detailed discussion or comment by either the IRS or tax practitioners. But it's sitting there in the twilight, waiting to surprise us.

This article will provide insights to section 1014(e) and how it may apply. I've worked on this article for over a year and each time I put the article down and come back to it, I see new perspectives I missed before. Because of the ambiguity of the statute and the lack of IRS rulings, Treasury Regulations and court cases, the potential reach of section 1014(e) remains largely obscured.

The article will not deal with how section 1014(e) works in community property states.

COMMENT:

When someone dies, assets passing to heirs obtain a new tax basis equal to the assets' fair market value as of the date of death, subject to numerous exceptions and limitations. Code section 1014(a)(1) reads: *"(a) Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be (1) the fair market value of the property at the date of the decedent's death."* Even though tax practitioners normally talk about the "step-up" in basis, if the asset has lost value, it can be a "step-down."

Code section 1014(e) contains a significant exception to 1014(a)(1):
"(e) <u>Appreciated property acquired by decedent by gift within 1 year of death</u>.

(1) <u>In general</u>. In the case of a decedent dying after December 31, 1981, if—

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

*(B) such property is **<u>acquired from the decedent</u>** by (or **<u>passes from</u>** the decedent to) the **<u>donor</u>** 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.

(2) <u>Definitions</u>. For purposes of paragraph (1)

(A) <u>Appreciated property</u>. The term "appreciated property" means any property if the fair market value of such property on the day it was transferred <u>to the decedent</u> by gift exceeds its adjusted basis.

*(B) <u>Treatment of certain property sold by estate</u>. In the case of any appreciated property described in subparagraph (A) of paragraph (1) **<u>sold</u>** by the **<u>estate</u>** of the decedent or by a **<u>trust</u>** of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply **<u>to the extent</u>** the donor of such property (or the spouse of such donor) is **<u>entitled to the proceeds</u>** from such sale."* (emphasis added)

Section 1014(e) applies to transfers by donors and their spouses. For simplicity, when this article references to a transfer to a "donor," it will be deemed to include both the "donor and the donor's spouse."

The tax implications of section 1014(e) can be unexpectedly severe, even in unexpected situations in which there was no attempt to manipulate the rules. As a result, it seems appropriate for Congress to statutorily restrict the triggering of 1014(e) to those cases where there was a tax avoidance motive. But given how little attention section 1014(e) has garnered in the past that is probably not going to happen.

> ***Planning Example***: Assume a young Wife transfers a depreciable asset to her Husband. The asset is worth $5.0 million and has a tax basis of $1.0 million. The Husband unexpectedly dies within a year of the gift and under the terms of his Will the asset passes directly back to the Wife, who needs the asset to support her lifestyle. The Husband's Will does not contain a disclaimer trust in which the Wife has a beneficial interest. Instead, it provides that at the second death, the assets are held in trust for the benefit of the couple's minor children. Normally, at the Husband's passing, the depreciable asset would receive a step-up in basis to its fair market value of $5.0 million. The step-up in basis could reduce the heirs' future income taxes by depreciation deductions and reduce the recognized gain incurred upon a sale of the asset. However, in this case, upon the passage of the asset back to the Wife, section 1014(e)(1) eliminates the step up and $4.0 million of additional basis is lost.

BACKGROUND OF 1014(e)

<u>Creation</u>. Code section 1014(e) was adopted as a part of the Economic Recovery Tax Act of 1981 (Public Law 97-34). A copy of Congress's Explanation of the 1981 Act can be found at: https://www.jct.gov/publications.html?func=startdown&id=2397 (the "Explanation"). According to Congress's Explanation, section 1014(e) was adopted *"Because the Act provides an unlimited marital deduction and substantially increases the unified credit, the Congress believed that there would be an even greater incentive to plan such deathbed transfers of appreciated property to a donee-decedent. Because the Congress believed that allowing a stepped-up basis in this situation would provide unintended and inappropriate tax benefits, the Act provides that the stepped-up basis rules do not apply to appreciated property acquired by the decedent through gift within one year of death where such property passes from the decedent to the original donor or the donor's spouse."*

The Explanation goes on to provide*: "For decedents dying after December 31, 1981, the Act provides that the stepped-up basis rules for inherited property contained in section 1014 do not apply with respect to appreciated property acquired by the decedent through gift (including the gift element of a bargain sale) after August 13, 1981, and within one year of death, if such property passes, <u>directly or indirectly</u>, from the donee/decedent to the original donor or the donor's spouse."* (emphasis added)

Despite the language of the Explanation, section 1014(e) does not contain the phrase "*directly or indirectly*," which creates uncertainty as to the application of section 1014(e).

<u>IRS Guidance</u>. Since section 1014(e) was enacted, the IRS has provided little detailed information on how to apply section 1014(e).

- Even though 1014(e) was adopted 33 years ago by the Economic Recovery Tax Act of 1981, to date the IRS has not issued any Treasury Regulations with respect to section 1014(e). In IRS News Release 86-167, the IRS announced that it was closing its project to create regulations interpreting section 1014(e). Apparently, the project has never been restored.

- No Revenue Rulings or Revenue Procedures have ever referenced section 1014(e).
- Four IRS rulings have provided some limited guidance on the IRS's view of the application of section 1014(e)(1). See: PLRs 200210051, 200101021, 9026036 and TAM 9308002. The latest ruling was issued in 2002.
- PLR 9321050 also mentions section 1014(e), but the ruling was intended to reverse a part of the IRS ruling in PLR 9026036 that had nothing to do with section 1014(e).
- PLR9853005 mentions section 1014(e) without providing any discussion of the Code section.
- The author was unable to find any court decision interpreting section 1014(e), other than a concurring judge's opinion that did not provide any insight to section 1014(e).

<u>Review of the IRS Rulings</u>. Although PLRs and TAM are not binding upon other taxpayers, they can provide insight to the IRS's position on how section 1014(e) should be applied. Unfortunately, these non-binding rulings represent the only material insight to how the IRS interprets the application of section 1014(e)(1).

- In PLR 9026036, a Wife proposed the creation of an inter-vivos trust for the benefit of her Husband, with the Husband receiving a lifetime income interest from the trust and a 30 day general power of appointment from the date of the trust's creation. If the Husband predeceased the Wife, the Husband's Trust paid an amount equal to his remaining GST exemption to a Family Trust and the balance of the Husband's Trust provided a lifetime income interest to the Wife. The Family Trust provided a lifetime income interest to the donor/Wife and at her death was passed to her descendants.
    - o **Decision**: The IRS ruled that at her Husband's death, a portion of the income interest from the trust she created for her Husband would revert back to her. As a result, section 1014(e) applied and *"the basis of a <u>portion of the assets</u> of the Husband's trust would be the same as the adjusted basis of the assets at the time of Husband's death*." With regard to the Trust's remainder interest, the ruling goes on to state: "*... on the death of Husband, the basis of the remainder interest presents a different question. Upon the death of Husband, section 2041 will be applicable to any remaining Husband's Trust assets and the <u>entire value of the Husband's Trust will be includible in Husband's gross estate</u>. Accordingly, section 1014(b) will apply, and the basis <u>of the remainder interest in Husband's Trust will be as described in section 1014(a)</u>*." (emphasis added)
    - o ***Comment***: The IRS focused on the fact that the asset that was given to the Husband was an income interest in the trust that would, at least partially, revert to the Wife upon the Husband's death. Note that the IRS recognized the concept of differing proportionate adjustments to the basis of appreciated property passing at death because of the different beneficial trust interests.

- In TAM 9308002, one month before the Wife died, a married couple placed joint assets in an inter vivos Joint Revocable Trust in a non-community property state. The trust required that all income be distributed annually to the grantors and provided an ascertainable standard for distributions of principal to the grantors. Either grantor could revoke the trust during their joint lives. The surviving Husband retained the ability to revoke the trust after the Wife's death subject and subordinate to the trustee's duty to pay taxes, expenses and debts of the deceased grantor/spouse. The Wife's estate included 100% of the trust property in the Wife's taxable estate and apparently the estate attempted to take a step-up in basis on all of the trust assets.

- **Decision**: The IRS ruled that the Husband's undivided 50% interest in the trust was subject to 1014(e). The ruling noted: "*In enacting section 1014(e) disallowing a step-up in basis for transfers made within one year of death, Congress clearly contemplated that a donor must relinquish actual dominion and control over the property for a full year prior to death.... In the instant case, the surviving spouse (i.e., donor) held dominion and control over the property throughout the year prior to the decedent's death, since he could revoke the trust at any time. It was only at the decedent's death that the power to revoke the trust became ineffective. Because the donor never relinquished dominion and control over the property (<u>and the property reverted back to the donor</u> at the spouse's death) the property was not acquired from the decedent under section 1014(a) and (e), <u>notwithstanding that it is includible in the decedent's gross estate.</u> Taxpayer's position in this case would produce the "unintended and inappropriate" tax benefit Congress expressly eliminated in enacting section1014(e).*" (emphasis added)
- ***Comment***: This ruling contains the weakest reasoning of the four IRS rulings. The ruling seems to confuse the retained power over a gifted interest to the trust (which triggered the one year rule of 1014(e)), with the "acquisition" by the surviving grantor/spouse. What reverted to the donor/grantor/spouse was a restricted trust interest, not direct ownership and control of the appreciated property that the donor had gifted.

- In PLR 200101021, a married couple created a Joint Trust. During their joint lives, either spouse could revoke the trust. At the death of the first grantor, the deceased grantor held a testamentary general power of appointment over the entire trust. If the general power of appointment was not exercised, assets first flowed to a Credit Shelter Trust with the balance passed outright to the surviving grantor/spouse. The Credit Shelter Trust provided that the trustee was to pay or apply for the benefit of the surviving grantor any part of the income and/or principal of the trust as was reasonably necessary for the survivor's support and maintenance. The Credit Shelter Trust also provided that income and/or principal could be paid to descendants subject to an ascertainable standard. The surviving grantor/spouse also retained a testamentary limited power of appointment over the Credit Shelter Trust solely for the benefit of descendants.
  - **Decision**: The IRS ruled that while the entire trust would be included in the taxable estate of the first to die grantor, the surviving grantor's portion of the trust was subject to 1014(e). The ruling noted: " .... *on the death of the first deceasing Grantor, the surviving Grantor is treated as relinquishing his or her dominion and control over the surviving Grantor's one-half interest in Trust. Accordingly, on the death of the first deceasing Grantor, the surviving Grantor will make a completed gift under section 2501 of the surviving Grantor's entire*

interest in Trust....... section 1014(e) will apply to any Trust property includible in the deceased Grantor's gross estate that is attributable to the surviving Grantor's contribution to Trust and that is acquired by the surviving Grantor, either <u>*directly or indirectly*</u>*, pursuant to the deceased Grantor's exercise, or failure to exercise, the general power of appointment."* (emphasis added)

  - ***Comment***: Given the prior rulings this is not an unexpected result. Like TAM 9308002 the central issue was the surviving grantor/spouse's continued dominion and control until the moment of death over assets the grantor/spouse contributed to the Joint Trust, followed by a retained beneficial interest in the trust.

- In PLR 200210051, a married couple created a Joint Trust. Each of the grantors retained the ability during their joint lives to revoke the trust. During their joint lives, all income was to be paid to the Donors and as much of the principal as the Donors or either of them should request. At the death of a grantor/spouse, a Marital Trust and an Exemption Trust were to be created. The Marital Trust provided that the surviving grantor/spouse would receive all of the income and as much of the principal as the surviving grantor/spouse may direct. The Exemption Trust provided that all income was paid to the surviving grantor/spouse, with principal distributions being made to the surviving grantor/spouse and the couple's issue as determined by an ascertainable standard. The surviving grantor/spouse retained a testamentary general power of appointment over the Marital Trust, but did not have any power of appointment over the Exemption Trust.
  - **Decision**: The IRS ruled that while the entire trust would be included in the taxable estate of the first to die grantor, the surviving donor/grantor's portion of the trust was subject to 1014(e). The ruling noted: *" ... each Donor holds a power to revoke the entire trust during their joint lifetime... Either Donor has the power to direct the trustee(s) to pay so much of the principal as the Donor may request to himself or in any other manner in accordance with the Donor's instructions. This power is not limited to specific individuals, and can be exercised in favor of Donor, Donor's creditors, Donor's estate, and the creditors of Donor's estate... section 1014(e) will apply to any Trust property includible in the deceased Donor's gross estate that is attributable to the surviving Donor's contribution to Trust and that is acquired by the surviving Donor,* <u>*either directly or indirectly*</u>*, pursuant to the deceased Donor's exercise, or failure to exercise, the general power of appointment over the Trust property."* (emphasis added)
  - ***Comment***: Given the prior rulings this is not an unexpected result. Like TAM 9308002 the central issue was the surviving grantor/spouse's continued dominion and control until the moment of death over assets the grantor/spouse contributed to the Joint Trust, followed by a retained beneficial interest in the trust.

The gist of the three most recent IRS rulings was an attempt by taxpayers to obtain a step-up in basis for appreciated property which remained under the donor's power or control until the death of their spouse. The IRS interpretation of section 1014(e) made those attempts unsuccessful. These rulings had two effective parts:

- First, the retained power (e.g., the power to revoke) of the surviving grantor/spouse over the Joint Trust created a situation in which the surviving spouse's gift to the trust was not deemed completed until the death of the other grantor/spouse. Effectively, under the terms of each of the Joint Trusts, every gift would always be within the one-year period because the donee/spouse's death triggers the completion of the gift.
- Second, the retained benefit of the surviving donor/grantor/spouse (after the passing of the donee/grantor/spouse) in the appreciated property activated 1014(e) and denied a step-up in basis for a least a portion of the appreciated property. Although the donor may not have acquired a direct interest in the appreciated property, the donor is deemed to have an "*indirect*" interest to the extent of the donor's beneficial trust interests. As noted below, this is the more questionable part of each of the rulings.

Each of the PLRs (but not the TAM) adds "indirectly" to how section 1014(e) should be applied:

- PLR 9026036 provides as follows: "*Section 1014(e) provides that, ... the stepped-up basis rules contained in section 1014(a) do not apply to appreciated property acquired by the decedent through gift within one year of the decedent's death, if such property passes, either <u>directly or indirectly</u>, from the donee-decedent to the original donor or the donor's spouse.*" (emphasis added)
- PLR 200101021 provides as follows: "*Section 1014(e) will apply to any Trust property includible in the deceased Grantor's gross estate that is attributable to the surviving Grantor's contribution to Trust and that is acquired by the surviving Grantor, <u>either directly or indirectly</u>, pursuant to the deceased Grantor's exercise, or failure to exercise, the general power of appointment*." (emphasis added)
- PLR 200210051 provides as follows: " ... *section 1014(e) will apply to any Trust property includible in the deceased Donor's gross estate that is attributable to the surviving Donor's contribution to Trust and that is acquired by the surviving Donor, <u>either directly or indirectly</u>, pursuant to the deceased Donor's exercise, or failure to exercise, the general power of appointment over the Trust property*." (emphasis added)

Each of the four rulings assumes that the gifted asset in question was "appreciated property."

<u>Joint Trusts</u>. There have been a number of recent articles about Joint Trusts designed to provide for a step-up in basis at the death of the first grantor/spouse. One purpose of such trusts is to obtain a basis step-up on all of the trust assets upon the first grantor/spouse's death.

There are a number of potential concerns with how Joint Trusts deal with section 1014(e), including:

- The articles do not generally offer new ways of creating trusts to obtain the basis step-up. Instead, they conclude that the IRS rulings referenced above are wrong. As noted in this article, the IRS may be wrong in the above rulings, but without any substantive interpretation (e.g., Treasury Regulations, Revenue Rulings or case law) on how section 1014(e) applies, such assertions are merely arguments, not substantive law. The supporters of such trusts do validly argue that even if the Joint Trust does not work, the client was no worse off from the failure.

Is the unstated (but underlying) argument of Joint Trusts that clients can ignore the IRS's non-binding positions, because of: (1) the IRS's apparent lack of attention to section 1014(e) and (2) the ability of the client to reasonably argue that "*indirect*" acquisitions by the donor are not subject to section 1014(e)?

- But the articles on Joint Trusts have ignored another threat to the basis step-up. Section 1014(e)(2)(B), which was ignored in each of the above PLRs and the TAM, creates a potential secondary standard for denying a step-up in basis. See the detailed discussion later in this article.

  Planning Example: A donor and the donor's spouse fund a Joint Trust using appreciated property. The donor/spouse retains the right to revoke the trust at any time until one of the two grantors dies. The donor's spouse retains a testamentary general power of appointment over the entire trust. The donor's spouse passes away three years later. At the donee/spouse's death, the assets flow into either an Exemption Trust with an independent trustee's discretionary spray powers over income and principal or to a QTIP Trust which permits an independent trustee's discretionary distributions of principal to the donor.

  - Consistent with the PLRs and TAM, the IRS could argue that the donor retained dominion and control over the appreciated property until the death of the donor's spouse. At the moment of the spouse's death, the gift of the appreciated property is deemed to have been made, because it is only at that moment that the donor loses the right to revoke the transfer. Therefore, the gift of appreciated property occurred within one year of the donee's passing and the requirements of section 1014(e)(1)(A) are met because: "*appreciated property was <u>acquired</u> by the decedent by gift during the 1-year period ending on the date of the decedent's death."*
  - Five years later, the trust sells the appreciated property. The specific language of section 1014(e)(2)(B) would appear to retroactively deny a step-up in basis "*to the extent*" the donor "*is entitled*" to the sales proceeds. Arguably, the donor is "*entitled*" to all of the sales proceeds if the trustee could exercise their discretionary authority to distribute such proceeds to the donor. See the discussion below.
  - This issue may be eliminated by having specific language in the trust instrument which denies the donor any direct benefit to the sales proceeds. For example, requiring such sales proceeds to be solely allocated to the principal of the trust and denying principal distributions to the original donor. However, many spouses will not accept such limitations on their potential access to the trust funds, creating potential basis step-up problems.

Research Sources:

- Gassman & Blattmachr, "*Stepping up Efforts to Step-Up Basis for Married Couples*," LISI Estate Planning Newsletter #2161 (November 12, 2013).
- Handler, *"The Estate Trust Revival: Maximizing the Full Basis Step Up,"* LISI Estate Planning Newsletter #2094 (April 30, 2013).
- Gassman, Ellwanger & Hohnadell: "*It's Just a JEST, the Joint Exempt Step-Up Trust*," LISI Estate Planning Newsletter #2086 (April 3, 2013).
- Zaritsky, Tax Planning for Family Wealth Transfers (WG&L), section 8.07[6].

THE APPLICATION OF 1014(e)

Planning Perspectives: Before getting into an analysis of the application of section 1014(e), a couple of interesting perspectives should be noted:

- Section 1014(e) pays no attention to the health of the donee at the time of the gift. Unexpected deaths will still trigger the Code section.
- The section applies only if the transferred property is "appreciated" as defined in section 1014(e)(2)(A). Appreciation is determined as of the date property was transferred to the decedent, not the date it was transferred by the decedent.
- The application of 1014(e) can be disproportionate. For example, the appreciated value could be $1.00 at the time of the gift, but under section 1014(e) all appreciation occurring from the date of the gift to the donee's date of death would also lose the benefit of its step-up in basis. While denying a step-up on the unrealized gain at the time of the gift may make sense, the denial of step up for any appreciation following the gift is not justified, given the stated purpose of section 1014(e).
- The total lack of case law on section 1014(e) raises the issue of whether the IRS is even paying attention to section 1014(e). For example, Jeff Pennell noted in "*Jeff Pennell on Estate of Kite: Will It Fly?*," LISI Estate Planning Newsletter #2062 (February 11, 2013), that the Tax Court commented that a step-up in basis was permitted when a gift was made a week before the donee's death and then returned to the donor as part of a marital trust.
- Despite its potentially broad impact, there is minimal analytical writing on the application of 1014(e).
- For section 1014(e) to apply the gifted appreciated property must still be in the donee's hands when the donee dies. If the asset had been sold or gifted to another party, then section 1014(e) can not apply.
- Section 1014(e)(1)(A) references "*such property*" being re-acquired by the donor. A literal reading of section 1014(e)(1)(A) means it would not apply if "*such property*" was not re-conveyed to the original donor. For example, what if the property interest has changed. Consider the following situations:
    - The gifted property was transferred as a part of a section 1031 like-kind exchange before the donee's death? Even though the basis may have carried over in the like-kind exchange, the property being bequeathed by the deceased donee is not technically the "*such property*" that was gifted by the donor.
    - The gifted property was contributed by the donee to a LLC, partnership or corporation? Particularly if the entity owns other assets besides the appreciated

property, it would appear that the "*such property*" has not been re-acquired by the donor.

- Interestingly, the "*such property*" issue does not appear to apply to sales by trusts or estates pursuant to section 1014(e)(2)(B). Code section 1014(e)(2)(B) provides that it is applicable: "*In the case of any appreciated property described in subparagraph (A) of paragraph (1)."* The "*such property*" provision is contained in section 1014(e)(1)(B) and is not referenced in section 1014(e)(1)(A). Nevertheless, it could be argued that "*appreciated property*" encompasses any exchange property or contributions of the appreciated property to a business entity when the underlying asset is retained in the new entity. Calculating the tax basis could be extremely tricky in such a situation.
- Section 1014(e) actually contains two possible triggers:
  (1) A re-acquisition by an original donor of appreciated property within one year of the original gift (section 1014(e)(1)), or
  (2) A donor makes a gift and the donee dies within one year of the gift, passing the appreciated property to an estate or trust and, at any time thereafter, the estate or trust sells the asset with the original donor being "*entitled*" to all or a part of the sales proceeds (section 1014(e)(2)(B)).

There are four primary and generally sequential determinations that practitioners should make in deciding if section1014(e) applies to their client.

Determination #1: Was there a Gift of an Appreciated Property? Before looking at any other aspect of section 1014(e), determine whether the gifted property was "*appreciated*" when it was gifted to the decedent - not when the decedent died. If there was no appreciation at the time of the gift, halt your analysis, because section 1014(e) cannot apply.

A pivotal starting point to this analysis is determining the fair market value of the asset as of the date of gift. For non-readily marketable assets, this probably necessitates obtaining an independent appraisal and creates the possibility of disagreements with the IRS over the value determined in the appraisal, with the IRS arguing for lower fair market value determinations.

> ***Planning Opportunity***. In 2014 a client has a $500,000 investment which the client believes will explode in value over the next few years, but it is currently worth the original investment, with no loss write-offs. The client has two elderly parents who have nominal assets. The combination of portability and the step-up in basis means the donor could receive up to $10.68 million in appreciated properties from his or her parents (e.g., perhaps in a Dynasty Trust), with a new step-up in basis as the investment grows - until the passing of the second parent. Even if both parents died within a year of the original gift, section 1014(e) would not apply because the original gift was not appreciated property.

If the original gift is of cash, then 1014(e) cannot apply, because by its nature cash cannot be appreciated. While some overly clever approaches may trigger the step transaction doctrine, in most cases, a gift of cash removes the transaction from the potential application of 1014(e).

> ***Planning Opportunity***: A child gives a dying father a cash gift of $1,000,000 and suggests that the parent invest in a particular investment. The parent, who has sufficient unused transfer tax exemption, makes the investment and dies within a year, when the investment is worth $3,000,000. When the investment passes back to the child, directly or in trust, section 1014(e) is not applicable. The gift given to the parent was cash and by nature cash (except perhaps collectible currencies) is not appreciated property.

> ***Planning Opportunity***: Here is an idea from Jonathan Blattmachr. A donor gifts $1.0 million in cash into an income defective grantor trust in which the donor is the deemed grantor and the donor's dying spouse is the sole lifetime beneficiary. The donee/spouse holds a testamentary general power of appointment over the entire trust and exercises the power of appointment in favor of the donor or a trust for the donor's benefit. Property owned by the grantor is sold into the trust during the spouse's lifetime. As a result:
>
> - The sale by the grantor to the grantor trust is not recognized for income tax purposes. See Revenue Ruling 85-13.
> - 1014(e) would not apply because the gifted cash was not "appreciated."
> - The entire trust fund would be included in the donee/spouse's estate pursuant to Code section 2041(a)(2).
> - Pursuant to Code section 1014(b)(9) step-up in basis would be allowed because the trust assets were included in the donee/spouse's estate.
> - Because the donor did not retain any powers over the trust which would cause the gift to be incomplete for transfer tax purposes, that portion of the PLRs and TAM discussed above would not apply.

It would appear that "appreciated property" refers to a single asset that was gifted. A property by property determination of the "appreciation" was not dealt with in any of the above IRS rulings. Each of the rulings assumes the gifted assets were appreciated property. Given that Code section 1015(a) adopts an asset by asset determination of whether gifted assets are appreciated or depreciated, it would seem reasonable that a similar determination would be appropriate under section 1014(e). This could create some interesting complexities, particularly when a group of assets are transferred as a whole. For example, assume a Husband moves an entire brokerage account to his Wife. If the Wife passed away within one year of the gift and transferred the brokerage account pack to the donor/Husband, the determination of "*appreciated property*" would have to be made for each security in the portfolio at the time o the gift.

If the gifted asset is an ownership interest in an entity that owns underlying assets, then the determination of being "appreciated" should be made at the ownership level of the entity.

> ***Planning Opportunity***: If the above assumption is correct, then clients who are facing the potential application of section 1014(e) have the ability to eliminate the potential application in at least two ways:
>
> - The donor can place an appreciated asset in an entity with assets having unrealized losses to offset any unrealized gain that exists in the entity.
> - The donor could consider adopting planning techniques designed to discount the value of the gifted property interest, with the goal of eliminating any appreciation in the value of the gifted asset (e.g., gifting a minority interest in a family limited partnership that owns appreciated property).
>
> ***Potential Tax Trap***: The donor should not use entities that are disregarded for tax purposes to hold the appreciated property. For example, do not use a single member LLC.

What happens if the "appreciated property" depreciates in value from the date of the gift to the date of the donee's death? Read section 1014(e)(1) closely. The value as of the date of the donee's death appears to be irrelevant and the donor's basis at the time of the gift would appear to apply, rather then creating a step-down in basis: "*the <u>basis of such property in the hands of such donor</u> (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent."* (emphasis added)

What if the initial transaction was an installment sale and not a gift? While section 1014(e) would not apply, any deferred gain will eventually be taxable. The disposition of an installment sale at the time of death does not cause acceleration of the installment note's unreported gain. Pursuant to Code section 691(a), the unreported gain is income in respect of a decedent. There is no step-up in basis for the installment sale note. Any remaining unreported gain is recognized as the installment payments are made. However, section 691(a)(5) provides that if the installment sale note is transferred to the obligor, the installment note's unreported gain is immediately subject to income taxation.

<u>Determination #2: Was a gift of Appreciated Property made with One Year of the Date of Death</u>?

If there has not been a gift of appreciated property to the deceased donee within one year of the donee's death, then section 1014(e) does not apply. For clients who have inadvertently placed themselves in the path of section 1014(e), this raises the morbid concept of keeping the donee alive long enough to get past the one year mark - not dissimilar to rumors of terminally ill millionaires "surviving" into 2010.

Under the above PLRs and TAM, the date of the gift is the date a donor/grantor of the trust finally relinquished dominion and control over the assets of the trust. If the date of the gift is always triggered by the date of death of the other trust grantor, it would appear that the one year rule automatically applies.

Planning Opportunity: A client's Wife is terminally ill, but owns no assets. In 2013, the donor transfers $1,500,000 in low-basis assets to the spouse, who revises her Will to provide that those specific assets pass to her Husband if he survives her and if not to a family trust for the descendants. If the Wife dies within one year, the donor/spouse can disclaim his interest and the assets will receive a step-up in basis to their fair market value when they pass to the family trust, saving taxes for the descendants. If the Wife survives the gift by one year, the step-up occurs and the disclaimer is unnecessary.

Planning Opportunity: In the alternative, the Husband could create a trust over which the Wife has a general power of appointment. Arguably, the general power of appointment is not a gift and therefore section 1014(e) may not apply, but see the contrary rulings in PLRs 200101021 and 200210051. See also PLR 200403094 which does not deal with the basis issue, but does provide insights into how the IRS would view the transfer tax consequences of a testamentary power of appointment given to a trust beneficiary.

<u>Determination #3: Is there a Re-acquisition of the Appreciated Property by the Donor</u>? Once you have determined that there is an "appreciated property" that was gifted within a year of the donee's death, the next pivotal determination is determining whether there was transfer of the appreciated property of the decedent/donee to the original donor.

<u>Direct Bequest to the Donor</u>. Clearly a gift of appreciated property to a donee who dies within one year of the gift and bequeaths the asset directly back to the donor is not entitled to a step-up in basis.

Tax Trap: Because of portability of the estate tax exemption, married clients are increasingly foregoing Exemption Trusts and bequeathing assets outright to a surviving spouse. Clients who did not expect a spouse to pass or who did not consult with their tax advisors may inadvertently run afoul of section 1014(e) and lose the step-up in basis.

Drafting Opportunity: Consider drafting Wills with provisions allowing the surviving spouse to disclaim direct bequests into a discretionary spray trust in which the spouse is not a Trustee and which require that sales proceeds from section 1014(e) assets must be allocated to principal. However, the income tax cost and beneficiary expectations may make this a hard choice. See the discussion below.

Planning Opportunit*y*: A gift was made of appreciated property but the donee is now terminally ill and is not expected to survive the one year mark. The donee's Will passes all of her assets back to the donor. In addition to the other ideas discussed in this article, consider the idea of having the donee gift or specifically bequeath the appreciated property to someone other than the donor, such as a GST trust for the donor's descendants.

Direct Bequest to a Third Party. At the other extreme of section 1014(e) is a gift to a donee who dies within one year and directly or indirectly transfers the gifted asset to someone other than the donor.

> ***Planning Opportunity***: Dad gives unimproved real estate to granddad when the fair market value is $1.0 million and the basis is $200,000. Granddad passes away 9 months later and has a specific bequest in his Will passing the asset to his grandson. The value of the land would step-up to its date of death fair market value.

> ***Planning Opportunity***. Section 1014(e) applies if the appreciated property is transferred back to the donor or the donor's spouse upon the death of the donee. But a bequest to the donor's long-term live-in partner would not trigger the Code section.

Indirect Benefits. When you move out of direct bequests and deal with bequests that are more indirect (e.g., beneficial interests in trusts), the answers get more elusive. The starting point in this analysis must be to determine how broadly the term "*acquired*" should be interpreted. Specifically, does the section 1014(e)(1) reference to "*acquired*" include only direct acquisitions by the donor, or should it be broadened to include indirect acquisitions? And if "*indirect*" acquisitions are permitted, what are the limits of that "*indirect*" determination?

As noted above, the Explanation of Economic Recovery Tax Act of 1981 provides that section 1014(e) was intended to apply to "*property [that] passes, directly or indirectly, from the donee/decedent to the original donor or the donor's spouse."* Three of the four IRS rulings referenced transfers "*directly or indirectly*" to the donor or their spouse. See: PLRs 200210051, 200101021, and 9026036. However, TAM 9308002 does not use this phrase.

There are a number of reasons to believe that section 1014(e)(1) was not intended to apply to trusts created by the donee/decedent and other indirect bequests that may at least partially benefit the original donor.

- Section 1014(e)(1) makes no reference to any indirect acquisition. Given that the Explanation references both direct and indirect passing, the absence of any reference to an indirect transfer in section 1014(e)(1) would seem to be purposeful.
- A beneficiary does not "*acquire*" an interest in the property held in trust any more than a limited partner of a family limited partnership has a direct legal ownership interest in the assets of the FLP. In each case, the trust or FLP holds title to the asset and the interest of the beneficiary or limited partner is subject to the terms and limits of the governing instrument
- It can be argued that avoiding section 1014(e)(1) by placing the donated appreciated property in a trust that provides benefits to the donor makes it too easy to get around the intent of the section 1014(e). That was a central argument of TAM 9308002 which stated: "*Taxpayer's position in this case would produce the "unintended and inappropriate" tax benefit Congress expressly eliminated in enacting section1014(e).*" But this argument ignores that Congress had the ability to limit the basis step-up in such indirect situations, but the statute did not address the

issue. Moreover, how would this structuring of an estate plan be any different from a client who creates an ILIT to avoid having life insurance taxable in their estate? The simplicity of the tax avoidance technique does not render it ineffective. Once you make the argument that "intent" overrides the express terms of a statute, where do you stop and how would any taxpayer have certainty in the tax impact of how they structured their personal affairs?

- It can be argued that "*indirectly*" in the Explanation was handled by the language in section 1014(e)(2)(B). See the discussion of section 1014(e)(2)(B) below.

Interests in Trust. So how are interests in trust for the donor to be treated under section 1014(e)(1)? There are a number of possibilities:

- A literal reading of the language of section 1014(e)(1) seems to permit a step-up in basis for transfers in trust where the donor retains a beneficial trust interest, but is not a Trustee. In such a situation, the donor has not "*acquired from the decedent"* any right to the assets held by the trust (particularly if trust distributions are discretionary or otherwise limited). The Trustee is the legal title holder to the asset, not the donor/beneficiary.

- However, the above three PLRs and the Explanation provide that acquisition may be direct or indirect. Ignoring the fact that such language does not appear in the Code section and that PLRs are not binding authority to other taxpayers and legislative comments have no statutory power, how should this "indirect" acquisition be treated? If the IRS is going to treat a beneficial interest in a trust as an indirect "*acquisition*," then it would also appear appropriate to actuarially determine the donor's proportionate beneficial interest in the trust (e.g., if the donor has a vested life interest in a QTIP or Exemption Trust, then determine the proportionate actuarial value of that interest pursuant to the Treasury Regulations) and apply that proportionate interest in determining the basis of the section 1014(e) assets in the trust. An example in the Explanation uses a proportionate approach to the step-up in basis. PLR 9026036 also recognizes the proportionate approach.

- Assuming the "indirect" argument is sustained, the IRS may argue that if the donor acquired a trust interest from the donee and the value of the trust interest cannot be actuarially determined, then a proportionate basis step-up cannot be determined and the entire bequeathed appreciated property should lose the step-up in basis. For example, assume a donee's Will created a trust that provided the donor with a right to all income for life and a right to principal distributions subject to an ascertainable standard. The trust requires the trustee to take into account the other assets and income of the donor/beneficiary or which are otherwise available to the donor/beneficiary in making discretionary principal distributions. It is virtually impossible to actuarially calculate the value of the donor's beneficial interest in the principal of the trust.

- However, even the "indirect" argument would appear to fall apart if the donor/beneficiary is not a Trustee and the independent Trustee has absolute discretionary power over the distributions of income and principal to the donor/beneficiary and all of his or her descendants. The donor/ beneficiary has "*acquired*" nothing more than being on a list of potential distributees subject to the discretion of an independent Trustee. Trying to treat such highly nebulous rights as an "*acquisition*" seems absurd. Moreover it is unjustly punitive to any other beneficiaries who actually received the asset or its benefits. The better recourse for the IRS might be to wait and see if section 1014(e)(2)(B) is applicable upon a later sale of the appreciated property.

  Drafting Opportunity: In preparing the client's estate planning documents, consider having a special allocation of all appreciated property that might otherwise be governed by section1014(e) to a discretionary Exemption trust (not to a marital trust) in which the original donor is not a Trustee and has no rights to the trust principal or remainder interest. However, the income tax cost and beneficiary expectations may create problems with this approach.

If the indirect argument works for transfers in trust, the loss of a step-up in basis could carry over to other beneficiaries.

> ***Planning Example***: Assume a donee creates an Exemption Trust which provides an income only beneficial right to the donor and the donor does not survive for donor's actuarial life. At the donor's death the appreciated property passed from the trust to someone other than the donor's spouse. Pursuant to Code section 643(e)(1) the recipient's basis is the basis of the asset in the hands of the estate or trust, adjusted for gain or loss recognized by the trust or estate upon distribution.

What happens if the decedent/donee's appreciated property is placed in a trust over which the Donor is the trustee, but has no beneficial interests in the trust? Technically, the trustee "*acquired*" the property because legal title is held by the trustee and the appreciated property did pass from the decedent to the trustee. While such a situation would technically appear to trigger section 1014(e), it would be an absurd conclusion, given the stated purposes of the Code section.

As noted in the section on Joint Trusts, it is important to determine what was the gifted asset. Was the "*appreciated property*" a particular asset, such as a real estate tract? Or was the gift an interest in a trust which owned underlying appreciated assets? Defining what "*appreciated property*" the donor gifted is central to determining if the asset was subsequently "*directly*" or "*indirectly*" re-acquired by the donor.

What asset passed from the Donor to the Donee in the PLRs? Was it a beneficial interest in the trust the donor created or an interest in the property contributed to the trust? Unfortunately, the PLRs do not offer much help.

- PLR 9026036 provides: *"However, Wife reserved an <u>interest for her life</u> in the Husband's Trust if she survives Husband and Husband does not exhaust the assets of* *the Husband's Trust during the 30 day period described above. Because <u>Husband is the donee of an income interest in the Husband's Trust</u> received from Wife, and she could receive back, upon Husband's prior death, a similar income interest in the Husband's Trust within one year of the creation of Husband's Trust, section 1014(e) could be applicable to this case."* (emphasis added)

- *PLR* 200101021 appear to focus on the property held in the trust: *"... section 1014(e) will apply to <u>any Trust property</u> includible in the deceased Grantor's gross estate that is attributable to the surviving Grantor's contribution to Trust and that is acquired by the surviving Grantor, either directly or indirectly, pursuant to the deceased Grantor's exercise, or failure to exercise, the general power of appointment."* PLR 200210051 takes a similar approach. (emphasis added)

Why is this distinction important? Because if the "*appreciated property*" transferred by the donor to the donee is a beneficial interest in the trust created by the donor and that trust interest returns to the donor (in whole or part), it would appear that the donor directly re-acquired at least part of what was gifted and the step-up in basis is suitability reduced. If instead, the donor transferred a real estate tract to the donee who bequeathed to the donor benefits to the property through a lifetime interest in a trust, then the "*indirect*" issue would seem apply.

<u>Determination #4: Is there a "Sale" of the Asset that the Donor was "Entitled" to</u>? Was there a bequest in which the appreciated property passed to an estate or trust and was sold by the estate or trust with the donor being "entitled" all or a portion of the sales proceeds?

This second application of section 1014(e) deals with sales of appreciated property by estates and trusts created by decedents. Code section 1014(e)(2)(B) provides that the section 1014(e) rules apply if: "*any appreciated property... <u>[is] sold by the estate of the decedent or by a trust of which the decedent was the grantor</u>, rules similar to the rules of paragraph (1) shall apply <u>to the extent the donor of such property</u> (or the spouse of such donor) <u>is entitled to the proceeds</u> from such sale."* (emphasis added)

<u>Perspectives on section 1014(e)(2)(B)</u>:

- Except for the one year period that triggers section 1014(e), there is no time limit to when section 1014(e)(2)(B) applies. Section 1014(e)(2)(B) is, in many ways, more dangerous for taxpayers than 1014(e)(1). Why? Because its application is not triggered until a sale of the appreciated property occurs and a determination is then made of whether the original donor was entitled to any of the sales proceeds. As long as the appreciated property remains in the donee's trust or estate, the donor/beneficiary remains alive and the donor beneficiary has not renounced or otherwise lost an interest in the trust, section 1014(e)(2)(B) remains in the shadows, patiently waiting to be applied.
- There is not a single PLR, TAM, Revenue Ruling, case or Treasury Regulation that even mentions section 1014(e)(2)(B). That makes it a bit hard to know how it applies to detailed fact patterns.

- Section 1014(e)(2)(B) is applicable to trusts in which "*the decedent was* <u>*the*</u> *grantor*." Does that mean that the decedent/donee must be the sole grantor of the applicable trust in order for section 1014(e)(2)(B) to apply? Nobody knows.
- When the Explanation refers to "*indirect*" transfers back to the donor, was section 1014(e)(2)(B) intended to be the Code section that covered "*indirect*" transfers?

<u>"Appreciated Property is Sold."</u> Section 1014(e)(2)(B) makes a <u>retroactive</u> basis determination that is dictated by a future event - the sale of the previously gifted appreciated property. However, the section does not apply if:

- A sale of the asset by the donee's estate or trust does not occur.
- The sale occurs after the donor/beneficiary no longer had any beneficial interest in the trust (e.g., the donor had a life interest in the trust and passed away).

> ***Planning Opportunity***: Assume a donor is entitled to all or some of the proceeds of the sale of appreciated property by an estate or trust. Before the sale, the donor could specifically renounce any right to the sales proceeds, thus rendering section 1014(e)(2)(B) moot. Even if the nine month disclaimer period of Code section 2518 has run and the renouncement created a taxable gift, the large estate exemption of the donor may eliminate any adverse transfer tax concerns.

The retroactive nature of the determination raises some interesting issues, including:

- How are tax actions which reduce the basis of the asset (e.g., depreciation) handled in the period between the donee/decedent's death and the sale of the asset - and even more so, what happens if the retroactive application of section 1014(e)(2)(B) eliminates tax benefits which have been applied on returns that have already been filed?
- How are subsequent changes in the nature of the trust's asset accounted for (e.g., contributions to other business entities and like-kind exchanges)?
- When does the potential application of section 1014(e)(2)(B) stop? Apparently, only after the donor dies or any entitlement of the donor to the sales proceeds has been terminated or renounced by the donor.

"<u>To the Extent</u>." If the donor's interest in the trust or an estate is limited, then the "*to the extent*" language of section 1014(e)(2)(B) applies. For example:

- To the extent the original donor is entitled to the proceeds of a sale of the gifted property, a step-up in basis is not permitted. The Explanation reads as follows: "*For example, assume that A gives appreciated property with a basis of $10 and a fair market value of $100 to D within one year of D's death, that D's date of death basis was $20, and that the date of death fair market value of the property was $200..... If A subsequently sells the property for its fair market value of $200, A will recognize gain of $180. If, instead, the executor sells of the property, distributing the proceeds to A, similar rules will apply and the estate will recognize a gain of $180.*"

- To the extent that the sales proceeds are needed to pay estate or trust debts and expenses, then the step-up in basis would appear to still be available. The Explanation provides as follows: *"Thus, in the above example, if the decedent's estate consisted only of the appreciated property and total estate liabilities were $50, the heir would only be entitled to three-fourths of the appreciated property. Accordingly, the portion of the property to which the donor-heir was not entitled (one-fourth in the example) will receive a stepped-up basis. In such a case, the basis of the appreciated property in the hands of the executor or the heir will be $65 (i.e., one-fourth of $200 (or $50) plus three-fourths of $20 (or $15))*."

Drafting Opportunity: Consider specifically allocating any section 1014(e) appreciated property (and sale proceeds) to the residue of the estate or trust where the potential impact of a section 1014(e) loss in step-up in basis may be mitigated by the proportionate step-up permitted to appreciated property that is used to pay the expenses and debts of the estate.

<u>"Donor is Entitled</u>." Section 1014(e)(2) is triggered only if the donor or the donor's spouse is "*entitled*" to the sales proceeds.

- If the Trust Instrument or Will mandates a distribution to the donor of the proceeds from the sale of appreciated property, it is clear that a step-up in basis should be denied. However, few trusts will contain such provisions. Once again practitioners are forced to properly discern what Congress intended by "*donor of such property ...... is <u>entitled to the proceeds</u> from such sale."* (emphasis added).

- If a discretionary spray trust holds the asset, at first blush, the donor/beneficiary would not appear to be "*entitled to the proceeds*" because any distributions remain in the discretion of the Trustee(s). This would appear to be true even if distributions were actually made to the donor/beneficiary under the Trustee's discretionary distribution authority.

    Planning Example: Assume a donor transfers the asset to a donee who bequeaths the asset to a discretionary spray trust for the benefit of the donor and the donor's descendants. Because the benefits are payable to the donor or the donor's descendants at the discretion of the trustee, how do you determine the extent that the donor is entitled to the proceeds? The cautious planning approach would be to segregate this asset in a separate discretionary trust in which the donor's beneficial rights are limited to discretionary distributions of income, not principal. Sales proceeds for section 1014(e) appreciated property should be specifically allocated to trust principal of this segregated trust.

    However, a contrary argument can be made, that by holding a beneficial interest in the trust, even an interest that is subject to the absolute discretion of an independent trustee, the donor/beneficiary is "*entitled*" to the proceeds of the sale. While "*acquired*" gives a sense of ownership of the asset, "*entitled*" carries a connation of a lesser sense of power over the asset - as is often reflected in beneficial interests in a trust. If the donor/beneficiary is not "*entitled*" to the proceeds, then how could they be distributed to the donor/beneficiary?

Moreover, if the intent of section 1014(e)(2)(B) was that it apply only where there is a required distribution of sales proceeds to the donor, why didn't the drafters replace "*entitled*" with the words "*distributed*" or the phrase "*required to be distributed*"? By not using words indicating a required distribution, it seems that the drafters had a different intent.

But, what if the donor/beneficiary's "*entitlement*" is shared with others and subject to an independent trustee's discretion? Arguably, the donor could receive 100% of the sales proceeds. Does this mean that because the donor is "*entitled*" to 100% of the sales proceeds that section 1014(e)(2)(B) would deny any step-up in basis? If an independent Trustee decides how much of the sales proceeds the donor/beneficiary is "*entitled to,*" but does not actually pass any of the proceeds to the donor/beneficiary, then denying a basis step-up would seem punitive to the other beneficiaries who did receive the appreciated property or sales proceeds.

This raises another interesting issue: who pays the income tax from the reduced basis on the sale of the appreciated assets? With differing tax rates among beneficiaries and between the beneficiaries and the estate or trust, skillful allocations and distributions could reduce the overall tax impact of the denial of the step-up in basis.

> ***Drafting Opportunity***: Consider drafting documents that specifically deny a donor/beneficiary any entitlement to any portion of the sale proceeds (but not the income from the sales proceeds) of section 1014(e) appreciated property. This drafting approach should eliminate the foregoing concern.

- If the donor's beneficial trust right is limited by time (e.g., a life interest), then the "*to the extent*" language might require an actuarial determination of the proportionate interest in the trust.

> ***Planning Example:*** Assume a donor transfers an asset with a basis of $300,000 and a fair market value of $3,000,000 to a terminally-ill spouse. The donee spouse's Will bequeaths the asset to an income only trust for the benefit of the donor and the trust sells the property. While the IRS could argue that value of the donor's life interest in the trust might not receive the basis step-up, the proportionate value of the remainder interest should be entitled to a step-up because the donor would not be entitled to the remainder.

But given that section 1014(e)(2)(B) delays its application until the sale of the appreciated property, how would any actuarial computation be handled? Is it effective the date of the trust's creation or the date the property was sold? Oddly enough, it would seem that the actuarial value as of the date of the sale would appear to make the most sense, because that was when the donor had a right to the sales proceeds. As the donor ages and the appreciated property is not sold, the step-up in the basis of the appreciated property may increase because the donor's actuarial life expectancy decreases.

- However, it can be argued that the actuarial approach to sales proceeds makes no sense if the donor has no direct entitlement to the sales proceeds. For example, if the donor's beneficial trust right is limited to an income interest and state law or the governing instrument require that sales proceeds be totally apportioned to the principal of the trust, the entire step-up in basis would appear to be allowed because the donor is not entitled to any sales proceeds. The donor's indirect benefit of the income rights would seem to be too much of an indirect participation in the sales proceeds.

SECTION 1014(e) & TAX ADVISORS

There are a many ways in which tax advisors and estate planners need to react to the potentially broad reach of section 1014(e), including:

- Code section 1014(e) opens another CYA caveat for estate planning advisors to make when a gift of appreciated property is made. You may want to add to your advisory letter(s) to donors a sentence similar to the following: *"If [the donee] passes away within one year of the date of the gift and the asset at the time of the gifted asset had an unrealized gain, then the Tax Code may deny a step-up in basis if the appreciated property you gifted is bequeathed to you or your spouse, or potentially a trust that benefits either you or your spouse."*
- Is there a statute of limitations on basis determinations made pursuant to 1014(e)? I defer to greater minds than mine, but I do not see how the statute closes - at least until after heirs and beneficiaries start dying or the appreciated property is sold.
- Particularly when pre-mortem planning is focusing on the possible triggering of section 1014(e), the documents should probably be drafted with these considerations in mind:
  - Either eliminate the donor as a Trustee (my preference) or significantly limit the donor's powers as Trustee.
  - I would strongly suggest that having the donor as sole Trustee of an ascertainable standard trust is a particularly poor idea.
  - Provide that all sales proceeds from section 1014(e) assets be allocated to the principal of the trust and restrict the right of the donor to receive any of those proceeds (e.g., provide for a life interest to the donor and allocate all sales proceeds for section 1014(e) appreciated property to the trust principal).
- Joint Revocable Trusts should be entered into only with a thorough knowledge of the potential reach and risks of section 1014(e) and while simultaneously understanding that the lack of substantive authority on section 1014(e) makes it virtually impossible to determine the reach of the section.

What advice should practitioners give to fiduciaries? Here are a few perspectives:

- Despite the fact that the Congressional Budget Office has estimated that 99.8% of all decedent estates in 2014 will not have an estate tax liability or a requirement to file an estate tax return (except to elect portability of a deceased spouse's transfer tax exemption), the executor and/or trustee probably have a fiduciary responsibility to provide beneficiaries with proper basis information on the assets they are inheriting.

- If the fiduciary or probate counsel ignored or were unaware of the application of section 1014(e), could they be subject to claims by heirs who miscalculated their taxes as a result of a fiduciary's mistakes? Perhaps not, particularly if the donor knew that the appreciated property was bequeathed within one year of the original gift by the donor. This is information which the fiduciary may not have. Would the heirs argue that the fiduciary had an affirmative obligation to investigate the history of bequeathed assets?
- Does the fiduciary have a duty to independently appraise non-readily marketable property that a donee passes back directly or indirectly to the donor within one year of the gift? Two appraisals may be necessary for non-readily marketable property. One appraisal will determine the fair market value at the time of the gift to determine if the asset is "*appreciated property*" and the second appraisal would determine the date of death value. Can the fiduciary charge the cost of the appraisal to the donor's beneficial interest in the trust?
- Practitioners should encourage fiduciaries holding section 1014(e) appreciated property to consider placing the property and any sales proceeds into sub-trusts in order to segregate the property and provide a better financial trail. Such funds should not be comingled with other estate and trust investments.

<u>Maintaining Basis Records</u>. When should clients destroy records dealing with the basis of assets, including related appraisals, tax returns (e.g., a parent's estate tax return), etc? Remember that the burden of proving basis facts rests on the taxpayer, not the IRS. My personal recommendation is **<u>never destroy basis records</u>**!

Treasury Regulation section 1.1015-1(g) provides as follows: *"To insure a fair and adequate determination of the proper basis under section 1015, <u>persons making or receiving gifts</u> of property should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value as of March 1, 1913, or its fair market value as of the date of the gift."* (emphasis added)

Treasury Regulation section 1.1014-4(c) provides as follows: *"The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this section is applicable, shall maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by sections 1016 and 1017, and shall furnish to the district director such information with respect to those adjustments as he may require."*

CONCLUSIONS:

As noted above section 1014(e) is replete with unanswered questions. For most practitioners, the central issue in applying section 1014(e) will be how applicable bequests in trust and indirect transfers are to be treated.

Code section 1014(e) is a classic example of appropriate legislative intent coupled with horribly ill conceived legislative drafting - creating a mess of uncertain terms and unknowable limits for taxpayers and their advisors.

The lack of substantive authority on section 1014(e) and its imprecise language makes it virtually impossible to determine the reach of section1014(e). How far do the 1014(e) phrases "*acquired from the decedent*" and "*entitled to the proceeds*" reach? How are "*indirect*" transfers to the donor to be treated? While we can logically speculate, no one really knows.

Could it be that the lack of rulings, cases and other comments from the IRS and its 1986 abandonment of regulations for section 1014(e) is because the IRS analyzed section 1014(e) and concluded that the Code section's bark was substantially more frightening (and complex) then its actual bite? Wouldn't there be more case law, TAMs or other rulings if the IRS was actually focused on broader applications of section 1014(e)?

But the IRS's past hands-off treatment of section 1014(e) is no predictor of its future treatment. The revenues generated by transfer taxes have diminished, just as income taxes are rising. It should be expected that much of the focus of the Estate and Gift Tax Division of the IRS will naturally shift from estate tax examinations to fiduciary income tax issues. Does section 1014(e) become one of the here-to-fore underutilized tools that the IRS releases from the shadows to increase its tax collections? An early warning of this change in policy may occur if the IRS issues one or more "clarifications" of section 1014(e) - new TAMs, Revenue Rulings, Treasury Regulations and/or proposed legislative modifications designed to eliminate many of the problems discussed in this article.

Research Sources: It is amazing how few analytical materials there are on the interpretation of section 1014(e), but here are a few helpful research sources.

- Siegel, "*IRC Section 1014(e) and Gifted Property Reconveyed to the Trust,*" 27 Akron Tax Journal 33 (2012).
- Zaritsky, Tax Planning for Family Wealth Transfers (WG&L), section 8.07[5]
- Casner & Pennell, Estate Planning §10.7 (8th ed. 2012).
- Mulligan, "*Is It Safe to Use a Power of Appointment in Predeceasing Spouse to Avoid Wasting Applicable Exclusion Amount?*" Estates, Gifts and Trusts Journal, July 12, 2007.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jeff Scroggin