Meltzer, Lippe, Goldstein & Breitstone, LLP

April 14, 2023

TRUSTS & ESTATES AND PRIVATE WEALTH & TAXATION PRACTICE GROUPS

Meltzer Lippe is home to a large and experienced Trusts & Estates and Private Wealth & Taxation Practice Group.

Nationally ranked by Chambers and Partners USA and U.S. News & World Report, Meltzer Lippe's Trusts & Estates and Private Wealth & Taxation Practice Groups are widely recognized as a leader and innovator in the trusts & estates, wealth preservation and private client space, with 25-plus attorneys in the group.

Our attorneys work with our clients to develop tailored plans that meet each client's wealth preservation and business succession goals.

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IRS Issues Guidance on Basis for Assets in a Grantor Trust

On March 29, 2023, the Internal Revenue Service ("IRS") issued Revenue Ruling 2023-2 (the "Revenue Ruling"), which impacts important estate planning techniques involving lifetime trusts. The Revenue Ruling holds that upon the death of the grantor of a so-called "grantor trust," there is no basis step up for assets that were gifted to the trust during the grantor's life when the trust is outside of the grantor's taxable estate. Although some tax practitioners had taken an aggressive approach and advocated that such assets would be entitled to a basis step up, the Revenue Ruling has confirmed what has been Meltzer Lippe's understanding of the law all along—that unencumbered assets gifted to a trust that is outside of the grantor's taxable estate do not receive a basis step up at death even if the trust is a grantor trust.

The rationale for denying the basis step up under Section 1014 appears to be that the assets in the grantor trust are outside the grantor's taxable estate. Although grantor trusts are disregarded for income tax purposes so that the grantor continues to be treated as the owner of the trust property, they can be treated as owned by the trust for estate and gift tax purposes. In such a case, this disparate tax treatment creates estate planning opportunities and is central to many estate planning techniques.

Although the Revenue Ruling provides clear guidance that unencumbered assets gifted to a trust outside the taxable estate will not receive a basis step up, it is limited to the straightforward facts of the Revenue Ruling. We note, however, the Revenue Ruling does not address whether there is a basis step up for assets held in a grantor trust outside the taxable estate that were not received by gift. For example, a common way to fund a grantor trust that is outside the taxable estate is for the grantor to "sell" assets to the trust in exchange for an installment note. Because grantor trusts are deemed owned by the grantor for income tax purposes (even when they are not owned by the grantor for estate and gift tax purposes), this sale is ignored for income tax purposes and no gain is triggered. The Revenue Ruling does not address whether those assets would be entitled to any basis step up, including for payments made on the installment note, nor the income tax consequences of those payments after the grantor's death.

Additionally, the Revenue Ruling does not address what happens if the property in the trust has liabilities in excess of basis or a negative capital account. We believe there are good policy arguments for an increase in basis to apply for these assets. However, there is a material risk that the IRS will deny the basis increase like they did under the Revenue Ruling. There are techniques we recommend to avoid that risk – such as the freeze partnership.

As such, we anticipate that future guidance will be issued by the IRS to address the other aspects of grantor trust planning that remain unanswered. In the meantime, we encourage you to reach out to your Meltzer Lippe advisor to discuss your particular plan to see if there is any additional planning you should consider in light of the Revenue Ruling and the questions that remain open.