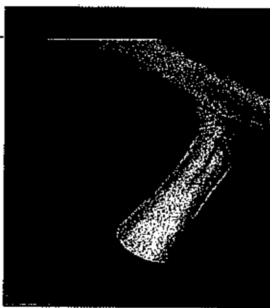

Searching for Basis in Estate Planning: Less Tax for Heirs

As the increased exemption amount reduces federal estate tax liabilities, the income tax implications of estate planning gain greater attention.

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Basis has always been important in estate planning, and the fundamental distinction between the carryover basis for gifts and the step up in basis for inherited property is a key factor in evaluating planning steps. As a result, for example, people will often postpone a sale of property if death is on the horizon in order to secure the step up in basis.

Until recently more attention usually was focused on estate tax than post-death income tax consequences. The main reason was the rate differential—for instance, in 2004 the top federal estate tax rate was 48% (with a $1.5 million exemption) while the top federal long-term capital gains tax rate was 15%.[1] In addition, capital gains tax will not be imposed until the gain in an asset is recognized (e.g., the asset is sold) so it is not clear when or even whether the donee will be subject to that tax. As a result, wealth transfer tax savings virtually always trumped income tax considerations.

In 2014, however, the federal estate tax exemption is $5.34 million, and the top federal estate and gift tax rate is 40%. Meanwhile the capital gains tax rate is 23.8% (including the ACA surtax under Section 1411) at the federal level, and 28.7% on average in total if state capital gains taxes are taken into consideration.[2] As a result, basis has stepped into the foreground.

Gifting depreciated assets

If assets have depreciated in value from the date of purchase, the gift basis for gain could actually be higher than an inherited basis. The basis amount used for figuring gain or loss in this situation depends on the property's sales price:

- Under Section 1015, even if the fair market value is lower than basis at the time of gift, if the property is later sold at a gain, the donee can use the donor's carryover basis.
- If, however, the property is later sold at loss, Section 1015 provides that the donee's basis is limited to the fair market value at the time of the gift.
- If the property is sold for less than the donor's basis but more than its fair market value when given away, the donee will experience neither gain nor loss.

The prospective donor of assets that have declined in value since being acquired might choose to sell the property and deduct the loss, assuming he or she can use it. This

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strategy may be impractical, however, for property (such as an interest in a closely held business) that is not readily marketable.

Also, the donor may wish to pass certain property on to family members regardless of its current value. In that situation, it is preferable to gift the property, even if immediately before death, to take advantage of the higher carryover basis for purposes of measuring gain. To be in a position to make such a "deathbed" gift, it is important to have a durable power of attorney in place that grants broad gifting authority, as the donor may lack capacity to make gifts shortly before death.

Gifting appreciated assets

In the case of appreciated assets, if the estate is assured of being under the remaining federal estate tax exemption equivalent (up to $5.34 million for those dying in 2014), it is better from a tax standpoint for the recipient to inherit the property than to receive it by gift—recognizing that there is no absolute certainty that the estate will remain low enough to be nontaxable. (After all, the a donor might win the lottery, discover a lost Rembrandt painting in the attic, or have a greater-than-expected return on investments.) This also ignores the impact of any state estate tax that might apply at a lower level, and potential changes in the tax regime.[3]

If wealth transfer tax is anticipated to be a concern, then the overall size of the estate, post gift appreciation, future exemptions and rates of tax, and the basis of the property will be among the relevant factors in evaluating whether a lifetime gift is more beneficial than holding the asset until death. Given that several of these factors are moving targets, alternative structures that preserve the ability to affect basis later on during lifetime may be especially valuable.

Gift and Inheritance Basis Basics

Under Section 1015, property acquired by gift generally takes a carryover basis. If, however, that basis amount is greater than the property's fair market value on the date of the gift, an exception applies for purposes of determining loss; the recipient's basis becomes the fair market value at the date of the gift. Basis will also be increased (but not above the fair market value on the date of the gift) by the gift tax paid with respect to the gift that is attributable to appreciation under Sections 1015(d)(1)(A) and 1015(d)(6).

By contrast, under Section 1014 the basis of property acquired from a decedent is generally the fair market value of the property at the date of the decedent's death (or on the "alternate valuation date" under Section 2032). This is usually referred to as the "step up" in basis, although of course it can also be a "step down" if the fair market value at death is less than the decedent's basis immediately prior to death.

Several special rules modify the basic step up rule under Section 1014. One of the most important is Section 1014(c), which provides that the step up does not apply to "property which constitutes a right to receive an item of income in respect of a decedent under section 691." A common type of income in respect of a decedent (IRD) is retirement benefits, including individual retirement accounts (IRAs) described in Section 408 and retirement plans described in Section 401.

Making gifts to others in trust

Making gifts to others in trust is advantageous for many reasons, including the flexibility trusts offer in terms of tax planning. It is difficult to predict today what the best tax treatment will be even a few years from now, and certainly more so in the distant future. When considering the issue of basis, there are several available options if the gift is made in trust.

Grantor trust

A "grantor trust" is a trust that may not be part of the grantor's gross estate and transfers to which may be complete for gift tax purposes, but as to which all income (including recognized capital gain) is taxed directly to the grantor.[4] A common method by which a trust is made a grantor trust is for it to either contain a substitution power under Section 675(4)(C) or a power to add to the class of beneficiaries under Section 674(c), and is otherwise structured to avoid inclusion under Section 2036 or 2038. Like the wheeled suitcase, once used only by an elite few, the grantor trust has become much

[1] Certain types of gain were then and are now taxed at a rate higher than that "standard" long-term capital gains tax rate. For example, the federal tax then was and is now up to 28% on the sale or exchange of collectibles such as works of art. Section 1(h)(4). Note also, that the profit may be ordinary income when sold or short-term capital gain, both of which may be taxed at the highest ordinary tax rate. Whether the nature of the gain will be the same in the hands of a donee (i.e., the recipient of the gifted property) as it was in the hands of the donor depends, it seems, on the nature of the asset in the hands of the donee. That result is different for an item of IRD. See, e.g., Rev. Rul. 53-196, 1953-2 CB 178, where the nature of the income or gain will be the same when taxed to the "inheritor" of the right to the IRD as it would have been in the hands of the decedent from whom it was acquired. Note also that proceeds paid at death on a policy of insurance on the donor's life will not, under Section 101(a)(1), be subject to income tax even if the policy is not included in the donor's gross estate.

[2] See Tax Foundation Combined State and Federal Top Marginal Tax Rate on Capital Gain, 2/20/2014, for a useful map. http://taxfoundation.org/sites/taxfoundation.org/files/docs/Capital-Gains-States-2014-(large)2.png.

[3] Some states (including New York and New Jersey) impose estate tax on estates at a much lower level of wealth than does the federal government, although the trend seems to be to raise those state exemptions to match the federal level. The most recent New York State legislation phases in a higher exemption over time, starting with an increase to $2,062,500 for decedents dying from now until 3/31/2015. Even under that new law, however, there are some differences between the way the New York estate tax will operate and the federal system does.

[4] See generally Akers, Blattmachr, and Boyle, "Creating Intentional Grantor Trusts," 44 RPTELJ 207 (Summer 2009).

more common over the last ten years.

Advantages. The core benefit of a grantor trust is that the grantor continues to bear the tax on the trust income and gain, which constitutes an additional wealth transfer to the trust despite the fact that the grantor is not treated as making a gift by doing so. That results from the primary planning attribute of a grantor trust, which is that for income tax purposes the grantor remains the owner of the trust assets.[5] When assets are transferred to a grantor trust effecting a completed gift and removing the assets from the federal gross estate, the gifted assets should have the same basis in the trust as they did in the hands of the grantor because the transfer is ignored for income tax purposes.[6]

It is less clear what happens to the basis of those assets when the grantor dies. One position is that even though the assets are not included in the value of the federal gross estate, they nevertheless should receive a step up in basis under Section 1014(b)(1).[7] The answer is not certain, however, and the IRS at least has indicated in a Chief Counsel Advice that it does not follow that analysis, but instead takes the view that such assets do not receive a step up in basis.

It is, however, clear that as a consequence of grantor trust status any transaction between the grantor and the grantor trust is ignored for income tax purposes, including any transaction by which the grantor acquires assets from the trust in exchange for other assets.[8] A grantor trust thereby offers the possibility of gifting low-basis assets to the trust, and then later reacquiring those assets from the trust in exchange for high-basis assets and/or cash. In that way, the low-basis assets can be given away earlier in life to reap the benefit of post-gift appreciation, but can then be reacquired by the grantor and pass through his or her estate with a resultant step up in basis.

Caveat. Under the Obama Administration Budget Proposal, if a grantor engages in a sale, exchange, or similar transaction without income tax effect with a grantor trust that is not includable in the grantor's estate, "then the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction) will be subject to estate tax as part of the gross estate of the deemed owner, will be subject to gift tax at any time during the deemed owner's life when his or her treatment as a deemed owner of the trust is terminated, and will be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to the distributee) during the life of the deemed owner." The proposal would reduce the amount subject to transfer tax by any portion of that amount that was treated as a prior taxable gift by the deemed owner, would have an exception for life insurance trusts, and would be effective only for transactions after the date of enactment.[9]

Planning considerations. Under current law, however, in order to accomplish the strategy of giving low-basis assets to a trust and later reacquiring them to achieve a basis step up at death, the grantor must have sufficient high-basis assets or cash on hand to exchange for the appreciated trust assets. It is not advisable for the grantor to exchange a note for the trust assets because it is not clear what the income tax consequences may be if the assets are acquired in exchange

[5] See Rev. Rul. 85-13, 1985-1 CB 184.

[6] *Id.* Because the existence of the trust is ignored, the basis of the property remains the same. It is uncertain if the increase for gift tax under Section 1015 applies when property is given to a grantor trust. See Ltr. Rul. 9109027 (if transfer of stock to grantor trust was a gift to children, then basis would be increased by gift tax attributable to appreciation under Section 1015(d)(6)). Under Section 6110(k)(3), a private letter ruling cannot be cited or used as precedent.

[7] See Blattmachr, Gans, and Jacobsen, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 J. Tax'n 149 (September 2002). The article concludes that, even if the trust is not included in the grantor's gross estate, the trust assets experience a change in basis under Section 1014 upon the grantor's death if loss of grantor trust status occurs by reason of that death. The article is itself discussed in Spratt, "Recent Developments," ABA Real Property, Trust and Estate Law Leadership Meeting, Laguna Beach, California (11/20/2009), in connection with issuance of CCA 200937028 (property transferred prior to death, even to a grantor trust, would not be subject to Section 1014, unless the property is included in the gross estate for federal estate tax purposes as per Section 1014(b)(9)). http://www.americanbar.org/content/dam/aba/publications/rpte_ereport/2010/february/te_spratt.authcheckdam.pdf. Cf. Ltr. Rul. 201245006 (indicating in a situation involving a foreign grantor trust that assets can receive a step up in basis under Section 1014 even without estate tax inclusion upon the death of the grantor). If the trust in that ruling had been a U.S. trust, the assets would have been included in the federal gross estate of the grantor because the grantor had retained powers over the trust assets. The ruling seems on its face somewhat inconsistent with the CCA because it relies on 1014(b)(1) where 1014(b)(9) does not apply, a rationale which has also been argued to justify a step up for a U.S. grantor trust in a case where the assets are not includable in the gross estate. See Lee, "Venn Diagrams: Meet Me at the Intersection of Estate and Income Tax," 48th Annual Heckerling Institute on Estate Planning (2014), at page 50, discussing this ruling and noting that according to the lawyer who submitted it the reference to 1014(b)(1) in the ruling is an error and should have referred to 1014(b)(3) on account of the grantor's retained interest. http://cdn.trustedpartner.com/docs/library/CommunityFoundation2013/Lee%20Venn%20Diagrams%20Outline%20with%20cover(1).pdf.

[8] Rev. Rul. 85-13, *supra* note 5.

[9] See *General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals*, Department of the Treasury, April 2013, 145-14, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.

for the grantor's note which remains outstanding at death.[10] Thus, it may be necessary to arrange a bank line of credit well ahead of time to ensure that cash will be available immediately when needed.

If assets are depreciated in value from the date of purchase, the gift basis for gain could actually be higher than an inherited basis.

The purchase of assets can be made shortly before death, and the trust can hold the cash in an account at the bank that issued the line of credit. The day after death the trust can buy the assets back from the estate using the cash, and the estate can repay the bank.

When timing the steps of the strategy, bear in mind that it is not certain whether a sale of estate assets on the owner's date of death will be treated as having received a "new" basis pursuant to Section 1014(a). The reason is that it is not certain when the individual's life as a taxpayer ends and the tax life of his or her estate begins. Arguably, his or her tax life ends as of the moment of his or her death, and the tax life of his or her estate then begins. This is not entirely clear, however, so a prudent idea is for the sale of assets included in the gross estate not to occur until the day after death.

If the assets do not change in value prior to death, then the inclusion of the value of the assets in the estate should be fully offset for estate tax purposes by the debt deduction for the borrowing pursuant to the credit line under Section 2053. If the assets increase in value pre-death there could potentially be some additional value in the estate that is not fully offset, which suggests the interval should ideally be as short as reasonably practicable. The repurchase by the selling trust should also occur quickly after death in order to avoid any significant post-death increase in value of the assets that could result in gain to the estate. A decrease in value of the assets after the date of the initial purchase from the trust might also complicate the situation if the estate does not have other suitable assets to resell to the trust to compensate for that decrease.[11]

It is also important that the transaction be authorized both from the grantor's standpoint and from the standpoint of the trust. The sale of the trust assets to the grantor may be an exercise of the substitution power, or may be a sale by the trustee(s) to the grantor. Therefore, the grantor should have in place a durable power of attorney expressly authorizing the attorney in fact to borrow and also to exercise a substitution power on the grantor's behalf and to purchase assets from the trust, in case the grantor is incapacitated. On the trust side, it is helpful if the trust expressly permits an attorney-in-fact to exercise the substitution power or authorizes transactions between the trust and the grantor (or the grantor's attorney-in-fact).[12]

In addition, the exchange must be for fair market value or else there may be adverse gift and estate tax consequences (and a potential breach of duty by the trustees if the assets were undervalued for sale). As a consequence, an appraisal will be needed if the assets are other than marketable securities or similar property that has an easy-to-determine fair market value.[13]

[10] See Blattmachr, Gans, and Jacobsen, *supra* note 7. That article considered the issue, if a note from the trust to the grantor remains outstanding at death, whether the trust experienced gain to the extent that the grantor's note exceeds the pre-death basis of the assets on the theory that there is a deemed sale when grantor trust status terminates by reason of death. The article concludes there is no gain. Here presumably the issue would similarly be whether the trust experienced gain to the extent the grantor's note exceeds the pre-death basis of the assets on the theory that there is a deemed sale when grantor trust status terminates by reason of death. Based on the same analysis, there should not be any gain.

[11] A deduction for the loss experienced on a sale by the estate back to the trust might not be allowed on account of Section 267.

[12] Under Section 1014(e)(2)(B) if appreciated assets are transferred to a decedent within a year of death and then sold by the decedent's estate or by a trust of which the decedent was the grantor, the step up in basis is denied "to the extent the donor of such property ... is entitled to the proceeds from such sale." As discussed further below, this may be a concern in structuring a joint exempt step-up trust (JEST) to achieve a full basis step up in a common law jurisdiction. However, it may be that this should not be a concern in the case of a transfer of assets to the grantor from a grantor trust prior to death, because that transfer is simply non-existent for income tax purposes under Rev. Rul. 85-13, *supra* note 5. For income tax purposes, the grantor has always owned the assets, whether in the trust or in his or her hands. Thus, it should not be a "transfer" within the meaning of Section 1014(e)(2)(B). Moreover, any sale back to the trust post-death will be for full fair market value.

[13] In order to protect against valuation error, it may be appropriate to consider a clause to define the assets being transferred with reference to the dollar amount of the consideration being received, similar to the type of clause used to define the gift in Wandry, TCM 2012-88 (formula gift of LLC units equal to a specific dollar amount). However, such a clause cannot be relied upon absolutely to protect against an IRS valuation challenge given that the IRS has indicated its non-acquiescence in Wandry, and Wandry is only a Tax Court Memorandum decision and appears to go beyond prior case law in some respects. 2012-46 IRB. See Angkatavanich, Crane, and Putnoki-Higgins, "Gift Planning with Formula Clauses, from Procter's Progeny to Wandry World (Part 2)," 28 Probate & Property 2 (March/April 2014).

[14] See McCaffrey, "Maximizing the Gift Tax Exclusion, Using a Powerful Estate Planning Tool to its Greatest Advantage," NYLJ, page 9 (4/6/1998).

[15] Reg. 20.2038-1(b).

[16] See Reg. 20.2041-3(b) (about powers of appointment, referring to condition of having or not having descendants). See also Rev. Rul. 80-255, 1980-2 CB 272.

[17] McCaffrey, *supra* note 14.

[18] *Id.*

[19] Some practitioners have suggested that a power is a general power only to the extent it could be exercised. For example, if the power holder can only appoint to creditors of his or her estate and there are none, they contend there is no general power of appointment.

[20] Sections 2041(b)(1)(A) and (C).

Formula 2038 power

It has been posited that a formula clause might be used to create a reversion to the grantor at death if and to the extent that such reversion would result in overall lower taxation taking into account both estate tax and capital gains tax.[14] Such a formula could be complex. The mere presence of a carefully crafted formula reversion should itself not trigger the application of Section 2036 because it would not take effect until the death of the donor, and so does not permit the donor to have or control the possession, enjoyment, or income from the property at any point during the donor's lifetime. Similarly, Section 2037 should not by its terms apply.

Under Section 2038, however, the suggested analysis is that the reversion causes inclusion only if and to the extent that it actually takes effect, because it is based on a contingency (or contingencies) beyond the donor's control, namely the amount of appreciation of the property (and applicable tax rates). Unlike Section 2036, Section 2038 does not apply to "a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death...."[15] This suggests that the donor should not in that event be a trustee of the trust or have any direct or indirect control over the trust investments. It is possible that changing the donor's domicile might indirectly affect tax rates and, therefore, the actual application of the formula, but it is generally understood that such actions of "real world" consequence are not considered to be donor controlled—for example, a decision to marry or have a child, although it may affect a disposition, it is not treated as a control held by the donor.[16]

For similar reasons, the gift is arguably also complete.[17] One disadvantage of a formula is that it would be inflexible because it would apply by its terms, rather than permitting a choice of action in the future. For example, it would apply by its terms to an asset that will likely not be sold until long after death. In order to address that concern, it has been suggested that the trustee could be given the power to terminate the reversion should it become appropriate to do so, especially if changes in the law render the formula flawed in some manner.[18] To that extent such a reversion would seem to operate in a manner similar to the grant of a general power as discussed in the next section.

Authorize granting of GPA by trustee

A power of appointment is a power held by a trust beneficiary to direct the disposition of the trust property in some respect, either for his or her own benefit or for the benefit of others. Under federal tax law, the value of property subject to a general power of appointment (GPA) is included in the gross estate of the power holder. Under Section 2041(b)(1), a general power is a power to appoint to oneself, one's estate, one's creditors, or the creditors of one's estate. This test is disjunctive, so the power to appoint to any one of those will cause inclusion.[19] There are also some exceptions to this definition, including a power that is subject to an ascertainable standard relating to health, education, support, or maintenance, and a power that is exercisable jointly with the creator or with a person having a substantial adverse interest.[20]

If a trust beneficiary has a general power of appointment, it is

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apparent that the value of trust property that is subject to that power will be included in the gross estate and as a result will receive a step up in basis at death.[21] However, that inclusion and associated step up may or may not be beneficial at the time of the beneficiary's death. In order to afford flexibility to determine the best approach at the time of death, the trust may instead provide that a "disinterested" trustee has the authority to confer a general power of appointment on the beneficiary. In that case the general power should not exist unless and until it is conferred by the trustee.[22]

This general power may also be made subject to exercise only with the consent of a non-adverse trustee, meaning that as a practical matter there is a constraint on the beneficiary's ability to divert the trust property away from where the donor of the power intended, such as to his or her descendants. Under Section 2041, the consent of a person without an adverse interest does not affect the characterization of a power of appointment as general. In particular, a trustee who has no beneficial interest in the trust does not have an adverse interest.[23] As a result, as a practical matter, conferring a general power offers an opportunity to cause inclusion and associated basis step up with no change in the dispositive scheme. One significant issue that arises with this approach, however, is potential fiduciary liability if the trustee makes a mistake in the granting of the general power (e.g., it increases taxes or shifts tax liability from one person to another in an unanticipated way), or does not grant the power but it is later determined the trustee should have done so.[24]

Delaware tax trap

Generally, if a person holds a limited (non-general/special) power of appointment over a trust, no wealth transfer tax consequence will arise from the release or exercise of that power.[25] However, under Section 2041(a)(3) there is an exception if a limited power is exercised to create another power, and if that second power can in turn be exercised to postpone vesting for a period determined without regard to the time of creation of the initial power. In that case, such exercise of the initial power will trigger estate tax inclusion in the initial power-holder's estate and, as a consequence, the change of basis under Section 1014(a).

It is helpful if the trust expressly permits an attorney-in-fact to exercise the substitution power or authorizes transactions between the trust and the grantor (or the grantor's attorney-in-fact).

Under the law of most states, such exercise would trigger estate tax inclusion only if the second power was a presently exercisable general (PEG) power. However, under Delaware law such exercise would trigger estate tax inclusion even if the second power was a limited power, hence the term "Delaware Tax Trap."[26]

When to use. Despite the name, the Delaware Tax Trap is no longer an adverse trap but rather offers an

[21] Sections 1014(b)(4) and (9).

[22] See Blattmachr and Pennell, "Using 'Delaware Tax Trap' to Avoid Generation Skipping Taxes," 68 J. Tax'n 242 (April 1988); Reg. 20.2041-3(b) ("a power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death").

[23] Reg. 20.2041-3(c)(2).

[24] The extent to which a trust can by its terms exculpate a trustee varies depending on applicable state law. In general an exculpatory clause cannot protect a trustee for actions taken in bad faith or with intentional or reckless disregard for the interests of the beneficiaries or the purposes of the trust. See Restatement (2d) of Trusts § 222(2); Restatement (3d) of Trusts § 96(1)(a); Bogert, *Trusts and Trustees* § 542; Cooper and Harper, "Incomplete Protection: Exoneration Clauses in NY Trusts and Powers of Attorney," 28 Touro L.Rev. 2 (2012). Cf. Ltr. Rul. 200537044 (switch from conduit to accumulation trust status at discretion of trust protector effective ab initio for IRA purposes).

[25] Sections 2041(a)(2) and 2514(b).

[26] See Blattmachr and Pennell, *supra* note 22. As discussed further below, there are other states that have laws like that of Delaware where the second power does not have to be a PEG power in order to trigger estate tax inclusion.

[27] See Raatz, "'Delaware Tax Trap' Opens Door to Higher Basis for Trust Assets," 41 ETPL 3 (February 2014), for a detailed discussion.

[28] See Blattmachr and Pennell, *supra* note 22. An unresolved issue is whether, if the trap is sprung, it can be unsprung (that is, undone) by a disclaimer by the person granted the presently exercisable power. As discussed in detail in the cited article, because the second power was created by exercise of a limited power, the time period for disclaimer may relate back to the original creation of the trust, which would obviously preclude an effective disclaimer of the second power in virtually all cases. Note that if the beneficiary does not hold a non-general power of appointment, needed to trigger the trap, the trustee may be able to grant such a power pursuant to a trust "decanting." See generally, Blattmachr, Horn, and Zeydel, "An Analysis of the Tax Effects of Decanting," 47 RPTELJ 141 (Spring 2012).

[29] Raatz, *supra* note 27. The article references the utility of Zaritsky, "The Rule Against Perpetuities: A Survey of State (and D.C.) Law" (2012), http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf.

[30] *Id.*

[31] It seems that an otherwise general power should be classified as a PEG power for state law perpetuities purposes even if the exercise is subject to the consent of a non-adverse party. See Restatement (Third) of Property: Wills and Other Donative Transfers, § 17.3, comment e. See generally Blattmachr, Kamin, and Bergman, "Estate Planning's Most Powerful Tool: Powers of Appointment Refreshed, Redesigned and Re-examined," 47 RPTELJ 529 (2013); Matter of Accounting under Indenture f/b/o/ Margaret H. Moore, 129 Misc. 2d 639 (1985) (beneficiary could validly create special power in appointees where beneficiary had unfettered PEG power during lifetime).

[32] See Raatz, *supra* note 27. For a discussion of potential income tax consequences of decanting, see Blattmachr, Kamin, and Bergman, *supra* note 31.

opportunity for the beneficiary power-holder to control whether or not to expose trust assets to estate tax in his or her estate. In deciding whether the beneficiary should trigger the trap, one important consideration is whether the beneficiary has sufficient assets of his or her own to completely use his or her estate tax exemption amount. Another factor is the basis of the trust assets. If the trap is triggered, the resultant estate tax inclusion yields a step up in basis under Section1014(b)(9).

Because the grant of the limited power does not cause estate taxation unless and until there is a triggering exercise, the decision can be made based on the then current tax and economic situation. Thus, drafting a trust to confer a limited power which can potentially be exercised to trigger the Delaware Tax Trap offers a significant tax planning opportunity.[27]

Advantages. One of the benefits of the Delaware Tax Trap is that it is less rigid than a formula inclusion clause. Another advantage is that it puts the choice between estate taxation (with step up) and continuing out of the estate with carryover basis in the hands of the beneficiary as opposed to a third-party fiduciary. That means the fiduciary is not at risk of liability for failing to make the correct decision, and the decision is being made by the person (the beneficiary) who presumably is best qualified to evaluate it and whose family is directly affected by it.[28]

Caveats. On the downside, triggering the trap requires the creation of a second power of appointment which, depending on the law governing the trust, may have to be a PEG power. In his recent article, "'Delaware Tax Trap' Opens Door to Higher Basis for Trust Assets," Les Raatz has an extensive discussion of the impact of state law. He observes that "under the common law and in all states, the date of creation of the new [PEG power] is the date of exercise of the initial power crating the new [PEG power]."[29] However, he also observes that some states have different rules, notably Arizona which starts a new vesting period with the grant of even a special power. "Other states that have abolished their [rule against perpetuities] might (or might not) permit the springing of the Trap (e.g., Delaware, Pennsylvania and Rhode Island). Virginia's statute might also so permit."[30]

There may well be concern about granting a PEG power including degree of control, creditor exposure, and future tax issues.[31] If it is not certain whether state law permits effective exercise of the trap or permits exercise by grant of a special power, decanting offers the ability to change the trust situs to a more favorable jurisdiction.[32]

GST implications. When considering the Delaware Tax Trap, it is important to keep in mind that exposing property to estate tax will also change the transferor of the trust for GST tax purposes. In fact, that was the original focus of the trap and associated analysis.[33] In most cases, it is likely that the exposure to estate tax and resultant change of transferor will result in moving down a generation for GST tax purposes. If the trust is not exempt from GST tax, that change in transferor may also prevent the imposition of GST tax that would otherwise have been imposed at death, and could theoretically also permit a new allocation of GST exemption. That is one of the rea-

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sons it is preferable to trigger the trap by the grant of a special power rather than a PEG.

Drafting a trust to confer a limited power which can potentially be exercised to trigger the Delaware Tax Trap offers a significant tax planning opportunity.

If the person triggering the trap has unused GST exemption, it cannot be effectually allocated if the power granted is a general one, because when the person holding the PEG dies, the trust assets will be in his or her gross estate, thereby undoing as a practical matter the allocation of the GST exemption. By contrast if the power granted is a special one, the allocation continues to be effective even after the new powerholder dies. If the trust is GST exempt, that status may effectively be continued if the power granted is a special one and the person triggering the trap has sufficient exemption to fully protect the trust to the extent of the exercise. However, it would seem to be a high barrier to overcome to sacrifice the GST exempt status of a trust from the original transferor in the long run.

Effect of estate tax inclusion on "IRD type" items

In the case of an irrevocable discretionary trust created, say, for the grantor's descendants, and where no beneficiary has a general power of appointment, the death of a beneficiary should not result in estate tax inclusion with respect to any portion of the value of the trust assets. As a result, there is no step-up in basis of the trust assets by reason of the beneficiary's death. But as discussed, if the Delaware Tax Trap is triggered, then the death of the beneficiary will cause estate tax inclusion to the extent of the value of the trust subject to that exercise.

Trusts, of course, may receive many different types of income, some of which may be of the type that would constitute IRD if received by an individual decedent ("IRD type" items). For example, the trust may receive a dividend that was declared prior to the death of the beneficiary.[34] In such a case, will such an "IRD type" item receive a step up in basis to date of death value as a result of inclusion in the beneficiary's estate?[35]

It seems the answer should be that any "IRD type" items do not actually constitute IRD in the estate of the beneficiary and, hence, should receive a full step up in basis under Section 1014.

The general rule under Section 1014 is a step up in basis for the value of assets included in the gross estate. Only if an asset falls under one of the specific statutory exceptions, such as IRD under Section 1014(c), should the step up be denied.[36] Therefore, unless the "IRD type" item actually constitutes IRD there is no apparent justification for denying a step up. The Code does not define IRD, but does refer to "items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death," and further provides that "the amount includable in gross income ... shall be considered ... to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount."[37] This language ties

[33] See Blattamchr and Pennell, *supra* note 22.

[34] See Reg. 1.691(a)-1(b).

[35] The same question of the interplay between the treatment of IRD-type items and estate tax inclusion could arise in the case of a grant of a general power or Section 2038 formula reversion, assuming the trust is not a grantor trust.

[36] Cf. Held, 3 BTA 408 (1926) (personal service income earned but not received at date of death not subject to income tax). Before 1934, income accrued but not received at the death of a cash-method taxpayer was not subject to income tax. In 1934 the law was amended to tax accrued income on the decedent's final return. However, that resulted in excessive clumping of income onto the final return. Consequently, in 1942 the concept of IRD was introduced into the tax regime. See Gordon, "Income in Respect of a Decedent' and Sales Transactions," 1 Wash U. L .Rev. 30 (1961), observing that "Since there is no evidence that the enactment of the predecessor of section 691 was initiated because of a general dissatisfaction with the policy of section 1014, the limitation which in fact resulted from section 691 arose as its consequence rather than as its purpose."

[37] Sections 691(a)(1) and (3).

[38] Reg. 1.691(a)-1(b). Cf. Estate of Soberdash, TCM 1997-362 (QTIP stub income was includable in gross estate and was IRD; estate seemingly conceded income was IRD, and was disputing inclusion). The decedent in Soberdash was entitled to the income because the trust at issue was a QTIP trust, unlike the situation involving a discretionary trust being considered here.

[39] See also Section 691(c)(3) which seeks to provide a deduction for GST tax purposes in the case of any IRD items in a manner similar to that provided for estate tax purposes under Section 691(c)(1). It seems this section attempts to eliminate any disparity between property subject to estate tax and property subject to GST tax. However, there are some flaws in the drafting of the section that may affect its efficacy. See Harrington, Kwon, Plaine, and Zaritsky, *Generation Skipping Transfer Tax* ¶ 5.08 [2][b].

[40] Even if an asset is not community property, it almost always can be transmuted into community property during the marriage. See generally Hayes, Pearl, and Moore, "Community Property Issues in Estate Planning," ALI-ABA Continuing Legal Education (2/27/2014).

[41] Section 2040(b). There is an exception for certain joint tenancies created before 1977. See Gallenstein, 975 F.2d 286, 70 AFTR2d 92-6228 (CA-6, 1992), *acq.* AOD 2001-06. It has been suggested that a couple in a common law state may obtain a full basis step up by using a joint exempt step up trust or "JEST." See Gassman, Denicolo, and Hohnadell, "JEST Offers Serious Estate Planning Plus for Spouses—Part 1," 40 ETPL 10 (October 2013), but the IRS has yet to bless this method. As discussed below, it also raises some issues under Section 1014(e).

[42] See Blattamchr, Chapman, Gans, and Shaftel, "New Alaska Law Will Enhance Nationwide Estate Planning—Part 2," 40 ETPL 10 (October 2013); Blattmachr, Zaritsky, and Ascher, "Tax Planning with Consensual Community Property: Alaska's New Community Property Law," 33 RPPTJ. 615 (1999); Blattmachr and Zaritsky, "Alaska Consensual Community Property Law and Property Trust," Tr. & Est. 65 (November 1988).

[43] Alaska Stat. 34.75.060(b). See also Tennessee Community Property Act of 2010, Tenn. Code Ann. § 33-17-103 et. seq.

IRD to the decedent and his or her entitlement to have received the income in the first instance.

Similarly, under the regulations, IRD is defined as "those amounts to which *a decedent was entitled as gross income* but which were not properly includible in computing his taxable income for the taxable year under the method of accounting employed by the decedent."[38] (Emphasis added.) By its terms, this definition does not encompass income earned by the discretionary trust, and that view is consistent with the general understanding that IRD is income to which the decedent was entitled at death or which is attributable to the decedent's efforts, as in the case of post-death bonuses and the like.[39] Consequently, it seems that the value of all property subject to inclusion in a beneficiary's estate by virtue of triggering the Delaware Tax trap should receive a step up in basis.

Married couple—Alaska community property trust

If a married couple resides in a community property state, property acquired during the marriage may automatically be community property (unless the couple agrees otherwise and subject to certain exceptions, such as for gifts and inheritances received during marriage by either spouse).[40] One of the chief benefits of community property is that upon the death of the first spouse to die, the basis of the entirety of the community property is stepped up to the date-of-death value under Section 1014(b)(6). If a couple owns property separately in a common law state, obviously, only the property owned by the deceased spouse receives the full step up. That may or may not work out favorably for the couple overall, depending on property ownership and the order of death.

Transfers within a year of death to try to secure a step up in basis are generally ineffectual by reason of Section 1014(e), which provides that if property is given to a decedent within one year of death and then re-inherited by the donor, no step up in basis occurs. If a married couple owns property jointly under common law, upon the death of the first spouse to die, only one-half of the property receives a step up.[41]

Even if a married couple resides in a common law state, however, they can secure the advantage of community property treatment and the full step up by establishing an Alaska Community Property Trust.[42] The Alaska Act specifies the requirements for such a trust, including:

- A declaration that the trust property is to be community property.
- The signature of both spouses (even if only one spouse is making the transfer).
- Appointment of an Alaska Trustee with certain administrative duties.
- An acknowledgement that there are extensive consequences to creating the trust, including creditors right and rights upon divorce.[43]

If those requirements are met, an Alaska Community Property Trust should be effective to constitute the trust assets as community property for purposes of Section 1014(b)(6), except, perhaps, for certain real and tangible personal property located outside of Alaska. As to such real or tangible personal property, transfer it to an Alaska LLC, partnership, or corporation; then transfer the LLC, partnership, or stock interest to the trust. This may offer the ability to obtain community property treatment.

Section 1014(b)(6) provides for a step up for "property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State...." By its terms, the statute should apply to assets held as community property under Alaska law in an Alaska Community Property Trust regardless of the residence of the trust grantors. But no case or IRS ruling has considered the efficacy of an Alaska Community Property Trust under Section 1014 so there is a risk that the consequences could be different than anticipated. Therefore, clients should be advised not to create such a trust unless it otherwise comports with their wishes for the treatment and devolution of the property held in the trust.

Married couple—Supercharged Credit Shelter Trust℠

Another option for a married couple is to use a qualified terminable interest property (QTIP) trust (described in Section 2523(f)) that becomes a credit-shelter grantor trust after the death of the benefi-

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ciary-spouse.[44] In this plan, each spouse creates a QTIP trust for the other during lifetime (both spouses must be U.S. citizens).[45] Each QTIP trust is by definition a grantor trust with respect to the creator spouse under Sections 677(a)(1) and (2) by virtue of the fact that the other spouse is the beneficiary.[46] When the beneficiary-spouse dies, the property in the trust is included in the beneficiary-spouse's gross estate under Section 2044. As a result, the property in the trust receives a step up in basis under Section 1014(b)(10).[47]

Thereafter, the property continues in trust with the surviving (creator) spouse as a beneficiary in a form that will not be included in the surviving spouse's estate—that is, as a credit shelter (or bypass) trust. But because the surviving spouse was the creator of the QTIP trust of which the credit shelter is a continuation, for income tax purposes the credit shelter trust can potentially remain a grantor trust with respect to the surviving spouse. The surviving spouse is viewed as remaining the grantor of the trust for income tax purposes even though, at the death of the beneficiary-spouse, the QTIP trust was included in the gross estate of the beneficiary-spouse under Section 2044.[48] That offers a unique opportunity to further improve the basis of the trust assets during the surviving spouse's lifetime, because the surviving spouse will bear the income tax on all trust income and taxable gain.[49]

Caveat. There is one proviso, which arises from a potential application of the "creditor's rights doctrine." Under common law, the general rule is that the grantor's creditors can compel a trustee to make distributions from a trust to the maximum extent that the trustee could potentially exercise discretion in favor of the grantor. That continues to be the rule in most states (although some—such as Alaska, Delaware, South Dakota, and Nevada, for example—have changed it by statute if certain requirements are met). Under the federal tax law, if governing state law provides that the grantor's creditors can access the trust, then the value of the trust is included in the grantor's gross estate under Sections 2036 and 2038 to such extent. That is referred to as "the creditor's rights doctrine."

The QTIP trust regulations specifically provide that inclusion under Section 2044 cuts off the application of Section 2036 or 2038.[50] However, it is still possible that Section 2041 governing powers of appointment could apply so as to cause the surviving spouse to have a general power of appointment over the credit shelter trust, by virtue of the "creditor's rights doctrine." Under Section 2014(b)(1) a power to appoint property to oneself or one's creditors is a general power. If the surviving spouse had a general power, that would cause the value of the credit shelter trust to be included in the surviving spouse's

[44] See Gans, Blattmachr, and Zeydel, "Supercharged Credit Shelter℠ versus Portability," 28 Probate & Property 10 (March/April 2014); Gans, Blattmachr, and Zeydel, "Supercharged Credit Shelter Trust℠" 21 Probate & Property 52 (July/August 2007), http://www.alaskatrust.com/assets/files/articles/why_alaska_trust/SuperCharged CreditShelterTrust.pdf.

[45] It is unclear whether the reciprocal trust doctrine under Grace, 395 U.S. 316, 23 AFTR2d 69-1954 (1969), and progeny may apply. In order to reduce that risk, it is advisable for the trusts to be created at different times, for each beneficiary spouse to have a special power of appointment over the remainder at death (each of which should be slightly different), and for the terms of the QTIP trusts to also be slightly different during each spouse's respective lifetime. *Id.* Note that no gift tax marital deduction is allowed if the spouse to whom or for whom the gift is made is not a U.S. citizen. Section 2523(i).

[46] In order to secure full grantor trust status, the trustee should have discretion to distribute principal (including up to all of the principal) to the spouse.

[47] See Gans, Blattmachr, and Zeydel, *supra* note 44: "The income tax basis of property that is included under Section 2044 is changed to its estate tax value under Section 1014(a). See Section 1014(b)(10). Ordinarily, in the case of a grantor trust, the grantor is deemed to own the trust's assets. See Rev. Rul. 85-13, *supra* note 5. As a consequence, one might question whether the grantor trust rules or Section 1014(b)(10) should control. In other words, if, as suggested, the trust is treated as the grantor trust of the grantor spouse, does Rev. Rul. 85-13 preclude any change in basis at the death of the donee spouse on the theory that the assets were owned by the grantor for income tax purposes at all times? It would seem that the specific provision in Section 1014(b)(10) should control. Indeed, in all lifetime QTIP trusts, the trust is deemed the grantor spouse's grantor trust. See section 677. And Section 1014(b)(10), in providing for a basis adjustment in the case of all QTIPs, clearly does not contemplate an unstated exception for lifetime QTIPs."

[48] See Reg. 1.671-2(e)(5) (no change in identity of the grantor unless someone exercises a general power of appointment over the trust). See generally discussion in Gans, Blattmachr, and Zeydel, *supra* note 44.

[49] The surviving spouse would also be in a position to engage in the grantor trust exchange discussed above. Although one commentator has suggested there is no step up in basis for the assets included in the gross estate of the beneficiary spouse on account of an effective date provision, the commentator is wrong. See Gans, Blattmachr and Zeydel, "The Supercharged Credit Shelter Trust℠ Is Alive and Well," Steve Leimberg's Estate Planning Email Newsletter # 2165 (11/19/2013).

[50] See Reg. 25.2523(f)-1(f), Example 11 (foreclosing the application of Sections 2036 and 2038 in the surviving spouse's gross estate for a QTIP trust previously included in the other spouse's gross estate under Section 2044).

[51] See Gans, Blattmachr, and Zeydel, *supra* note 44: "In those states permitting creditors access, creditors will typically be able to reach only the amount that the trustee could distribute to the grantor under a maximum exercise of discretion. See, e.g., Vanderbilt Credit Corp. v. Chase Manhattan Bank, NA, 473 N.Y.S.2d 242 (App. Div. 1984); comment f to Restatement (3d) of Trusts § 60. Thus, in such jurisdictions, if the trustee can make distributions only to the extent necessary for the grantor's health, education, maintenance, and support, the grantor's creditors are similarly limited. They can reach the trust's assets only to the extent the trustee could properly make payments to the grantor for such purposes. And because Section 2041 excludes from the definition of a general power of appointment a right to property circumscribed by such a standard, including an appropriate standard in the instrument would preclude the IRS from invoking Section 2041, even if the trust were located in a state permitting creditors access. (Further limitations also might be incorporated, such as requiring the trustee to consider other resources before making distributions.) Practitioners should carefully check applicable state law to ensure that creditors of the grantor would be so limited in their access to the trust property."

[52] For an extensive and thorough analysis of Section 1014(e) basis issues, and especial-

gross estate—contrary to the intent of the arrangement.

One way to address this concern is to limit distributions to the surviving spouse to an ascertainable standard relating to health, education, maintenance, and support, constituting a non-general power under Section 2041(b)(1)(A).[51] The other, probably preferable, option is to establish the trust in accordance with the statutory requirements in one of those jurisdictions that has changed the common law so that the creditor's rights doctrine would not apply. Or both options could be used together.

Timing considerations. Under Section 1014(e)(1), if appreciated assets are transferred to a decedent within a year of death and then re-inherited by the transferor, there is no step up in basis regardless of otherwise applicable provisions of Sections 1014.[52] If the creation of the QTIP trust occurs at least one year prior to the death of the beneficiary-spouse, Section 1014(e) will not apply. If the QTIP trust were created within a year of the beneficiary-spouse's death, it still seems that Section 1014(e)(1) should not apply because the surviving spouse is only a discretionary beneficiary of the credit shelter trust. However, there is extremely limited authority under Section 1014(e)(1). The issue has been discussed in considering a "JEST" structure where property was transferred in trust subject to immediate withdrawal by the deceased spouse, and subsequently funded a credit shelter trust post-death. In that circumstance, in order to avoid Section 1014(e), it has been recommended that:

- The surviving spouse should not be a trustee of the credit shelter trust.
- The credit shelter trust should be discretionary.[53]
- The surviving spouse should not even be a beneficiary of the credit shelter trust at all (but might be eligible to be added as a beneficiary).[54]

For this purpose as well, it may also be helpful to create the trust in a jurisdiction that has changed the common law so that the creditor's rights doctrine would not apply. Therefore, if Section 1014(e) were anticipated to be an issue, one option might be to have the credit shelter trust be for the sole benefit of the children, and give someone, such as a "trust protector"—but, perhaps, not acting in a fiduciary capacity—the power to add the spouse and other family members to the class of beneficiaries, thereby causing the credit shelter trust to be a grantor trust under Section 674(b). In the alternative or in addition, the spouse could have a substitution power over the credit shelter trust under Section 675(4)(C).

Thus, the QTIP trust would be a grantor trust by its terms under Section 677, and the credit shelter trust would be a grantor trust as well although under different Code sections (Sections 674(b) and 675), so the trust overall should remain a grantor trust continuously throughout the grantor's lifetime.[55] It should be noted that ideally no transfers would be made in any event from the credit shelter trust to the surviving spouse because the overall goal would be to preserve and grow those assets for children and keep the trust out of the surviving spouse's estate.

Alternate valuation under 2032 and IRD items

Normally, the point of reference for determining the basis of inherited property is the value on the date of death. However, if certain requirements are met, an estate may elect alternate valuation and use the date that is six months after the date of death for estate tax purposes under Section 2032.[56] Under Section 2032(c), in order to elect alternate valuation, the value of the gross estate and the sum of the estate tax and the GST tax must be reduced. Section 2032 is intended to alleviate hardship in cases where the value of the estate declines short-

ly the little discussed (e)(2)(B) provision, see Scoggin, LISI Estate Planning Newsletter #2192 (2/6/2014), republished in the NAEPC Tax and Estate Planning Journal, April 2014, http://www.wealthstrategiesjournal.com/ (2014).

53 *Id.*

54 Gassman, Denicolo, and Hohnadell, *supra* note 41. See Ltr. Rul. 200210051 (not precedent) (stating Section 1014(e) would apply to joint revocable trust where deceased spouse held a general power and property passed to surviving spouse "directly or indirectly"—under facts of ruling at death property was divided into a QTIP and a family trust, and the family trust provided that the surviving spouse would receive all income and that principal could be distributed to the surviving spouse or children for health, education, maintenance, and support); Ltr. Rul. 200101021 (not precedent) (similar result with lifetime withdrawal power); Ltr. Rul. 9321050 (not precedent) modifying an aspect of TAM 9308002 (not precedent) (applying Section 1014(e) where the property passed outright back to the donor spouse). Cf. Estate of Kite, TCM 2013-43 (assets were transferred to decedent spouse shortly before death and passed to a QTIP trust—the issue involved a private annuity transaction by the QTIP trust—the IRS apparently did not raise the question of the basis of the QTIP trust assets under Section 1014(e) so the assets received a full step up at death).

55 The situation would be analogous, for example, to a GRAT or QPRT that continues after the retained term as a grantor trust for a different reason, perhaps because the grantor's spouse is a beneficiary of the continuing trust. Cf. Reg. 20.2056(b)-5(g)(1)(iii) (spouse has requisite general power under Section 2056(b)(5), where until age 50 she has power to appoint to herself and after age 50 she has power to appoint to her estate); Ltr. Ruls. 200848017, 200848016, and 200848006 (contemplating trust could become a grantor trust as a result of reformation to create substitution power if facts indicated it was held in a non-fiduciary capacity); Notice 2007-73, 2007-2 CB 545 (a "transaction of interest" where trust is initially a grantor trust, ceases to be one, and then becomes one again; complex facts involved securing a specific income tax result relating to losses).

56 There are exceptions under Section 2032(a) if assets are disposed of within six months of death or if the value of an asset changes because of the lapse of time.

ly after death by reducing the estate tax burden commensurately.

If an estate elects alternate valuation, the alternate valuation date is also used to determine the basis of assets in the estate under Section 1014(a)(2). In most cases, if the value of the gross estate is reduced, the basis of property under Section 1014 is also reduced.

This is true only in *most* cases because the estate may contain items, notably the right to IRD, that will not receive a step up in basis under Section 1014 in any case. With respect to such assets, there is no effect on basis regardless of whether (or not) the estate decreases in value.[57]

In general when considering whether alternate valuation will be beneficial for an estate overall, estate tax savings must be weighed against the income tax cost of a lower basis. In many cases the estate tax savings will be greater than the income tax cost, but that is not always true—for example, if the decedent's taxable estate is only slightly greater than the estate tax exclusion equivalent, the income tax cost may be greater than the estate tax savings.[58]

Another situation in which alternate valuation may not be helpful is where there is an increase in value of the right to IRD that is the decedent's entitlement to gross income not properly included on a predeath income tax return of the decedent. Although the overall value of the estate may diminish, if the value of such an IRD item increases substantially between the date of death and the alternate valuation date, it may not be beneficial to elect alternate valuation treatment.

Example. A decedent's exemption is $3.5 million on the date of death. The gross estate includes stocks valued at $3.5 million and the right to IRD valued at $100,000. There are no deductions. The estate tax on the $3.6 million taxable estate is $40,000 at a 40% effective estate tax rate (40% of $100,000). If, on the alternate valuation date, the stocks are worth $3 million and the right to IRD is worth $550,000, the estate tax would be cut in half to $20,000 if alternate valuation is elected (40% of $50,000). Although the election yields an estate tax savings, it would result in a decreased step-up in basis that potentially would expose an additional $500,000 to income tax.[59]

On the other hand, if an estate consists substantially of IRD items, a decline in the value of the IRD may result in an overall decline in the value of the gross estate, even as assets that are eligible for a step up may have increased in value. Such an estate might be one, for example, that consists largely of retirement benefits such as an IRA or a 401(k) plan. In such a case, electing alternate valuation might actually result in a higher basis for those estate assets that are eligible for the step up.

Example. A decedent's exemption is $3.5 million on the date of death. The gross estate includes a residence and shares of stock valued at $1 million, and IRD valued at $2.6 million. There are no estate tax deductions. The estate tax on the $3.6 million taxable estate is $40,000 at a 40% effective estate tax rate (40% of $100,000). If, on the alternate valuation date, the residence and stocks are worth $1.55 million and the IRD is worth $2 million, the estate tax would be cut in half to $20,000 if alternate valuation is elected (40% of $50,000). Nonetheless, alternate valuation would result in a $550,000 increase in the basis of the residence and stocks.

Conclusion

Although income tax planning has always been a part of estate planning, the tremendous increase in the federal estate tax exemption suggests it may now be the primary focus of the plan for many property owners. A key element is to ensure that appreciated assets are included in the gross estate of the taxpayer so they receive a step up in basis at the owner's death.

Using a trust to make any lifetime transfers offers options to control whether assets will be included in the gross estate. Even if such assets are transferred prior to death, their value may nonetheless be included in the gross estate if they are held in a grantor trust, the Delaware Tax Trap is available and is triggered, or other action is taken.

Although the right to IRD does not receive a step up in basis, it may be possible to achieve a step up for that type of asset if it is held in a non-grantor trust that is included in the gross estate of the decedent. Married couples can also take advantage of special trust structures, such as an Alaska community property trust, to improve the basis of assets. Of course, hundreds of other income tax considerations may arise after a taxpayer's death as they may during lifetime, and there are many other important techniques available for taxpayers in search of basis. ■

[57] The federal estate tax due may, however, affect the deduction under Section 691(c) that will be allowed to the taxpayer who must include the IRD in gross income.

[58] See Blattmachr and Lo, "Alternate Valuation—Now Perhaps More Important than Ever," 11 J Tax'n 90 (August 2009).

[59] This example is adapted from Blattmachr and Lo, *supra* note 58, also discussing Estate of Aldrich, TCM 1983-543, where a contingent fee constituting IRD increased in value by the alternate valuation date.