Ensuring a Basis Step Up at the First Spouse's Death

By William E. Sigler

With the increase in the Federal estate tax exemption to $11,180,000, fewer people have had to concern themselves with the Federal estate tax, with the consequence that planners have increasingly turned their attention to income tax issues. Chief among these issues is how to achieve a full step-up in the basis of a married couple’s assets upon the death of the first spouse.

Many ideas have been discussed which achieve a partial or full step-up in basis including, for example, the following:

- Have the spouse who is expected to survive transfer his or her appreciated property to the spouse who is expected to die first;
- Have the spouse holding the appreciated property transfer it to a marital estate trust for the benefit of the other spouse;
- Make deathbed transfers of appreciated property to the first decedent just prior to his or her death;

- Have the couple hold their property as joint tenants with rights of survivorship;
- Convert the couple’s property to community property;
- Establish an Alaska, Tennessee or South Dakota community property trust with a local co-trustee pursuant to the those states’ community property statutes (note that there has not been any definitive IRS guidance on the treatment of community property trusts and elective community property generally, and that IRS Publication No. 555, “Community Property” [revised February 2016] states that it “does not address the Federal tax treatment of income or property subject to the ‘community property’ election under Alaska state laws”);
- Have each spouse give the other a general power of appointment over his/her property (here, there is an issue as to whether the lapse of the surviving spouse’s general power of appointment over the deceased spouse’s interest in the trust property upon the death of the deceased spouse would, notwithstanding the inclusion of such trust property in the

deceased spouse’s estate, constitute a release of the power under Section 2041(a)(2) that would cause the surviving spouse to be treated as the transferor of the property that was previously subject to the power, thereby creating potential transfer tax problems for the surviving spouse); or

- Have each spouse give the other a general power of appointment over his/her property using a “joint exempt step-up trust” or “JEST” (here, there is a possible risk that the IRS may challenge the stepped-up basis on the death of the second spouse because of the funding of the credit shelter trust using assets transferred by the first spouse to die).

Another idea that planners have been discussing involves having the spouse with the appreciated property transfer it to a step-up grantor retained interest trust or “GRISUT.” In the past, a grantor retained annuity trust (“GRAT”) or a traditional qualified personal residence trust (“QPRT”) was used to obtain a valuation discount for Federal gift tax purposes while removing the trust property from an individual’s estate for Federal estate tax purposes, provided that the individual survives the term of the trust. A GRISUT is premised on the idea that by modifying a few provisions a GRAT or QPRT can be used to obtain a stepped-up income tax basis for appreciated property, regardless of which spouse dies first.

For example, with a traditional QPRT the donor transfers a personal residence, vacation home or second residence to the trust, while retaining the right to live in it for a term of years. After the term of the trust ends, the residence passes to the donor’s children or other beneficiaries. The gift tax value of the remainder interest is discounted because it will be received in the future. If the donor wishes to live in the residence after the term of the trust ends, then he or she must pay a fair market rental.

In order to convert a traditional GRAT or QPRT into a GRISUT, several trust provisions must be changed when the trust is created. First, the trust should terminate upon the earlier of the death of the donor or the donor’s spouse, rather than at the end of a term of years. Second, the trust should provide that when that death occurs, the trust property will pass to the donor’s spouse or to the donor’s spouse’s estate if the donor’s spouse predeceases the donor, instead of to the donor’s other beneficiaries. The donor’s spouse’ Will should then provide that the property will pass back to donor if the spouse predeceases the donor.

The initial transfer of a remainder interest in the trust to the donor’s spouse should qualify for the marital deduction for gift tax purposes. If the donor dies first, then the property in the GRISUT should be included in the donor’s gross estate under Section 2036(a)(1) and receive a stepped-up basis under Sections 1014(a) and 1014(b)(9). If the donor’s spouse dies first, then the property should be included in the donor’s spouse’s gross estate under Section 2033 and receive a stepped-up basis under Sections 1014(b)(1) and/or 1014(b)(9). In either case, the property passes to the surviving spouse and should qualify for the estate tax marital deduction under Section 2056(a).

If the donor’s spouse dies first, but within one year of the donor’s transfer of the property to the trust, then a stepped-up in basis may be denied under Section 1014(e). That Section provides that, if a decedent acquired appreciated property by gift within one year of death, and the same property is acquired from the decedent by the donor or the donor’s spouse (or “passes from” the decedent to the donor or the donor’s spouse), then, notwithstanding the general rule of Section 1014(a), the property’s basis is the same as its basis in the hands of the decedent the moment before death.

It may be possible to defeat the application of Section 1014(e) by devising the property back in trust for the donor’s benefit, instead of devising the property back to the donor outright. The argument in that case is that the property is neither acquired from the decedent “by . . . the donor,” nor “pass[es] from the decedent to . . . the donor,” as required for Section 1014(e) to apply.

Notwithstanding the foregoing, there is the potential for a mismatch between the amount of the transfer qualifying for the gift tax marital deduction and the amount of the transfer qualifying for the estate tax marital deduction. When the donor creates a GRISUT, he or she is treated as making a gift equal to the value of all property transferred to the GRISUT. The marital deduction, meanwhile, is limited to the value of the remainder. The donor, therefore, makes an artificial taxable gift as a result of the mismatch between the value of the gift and the gift tax marital deduction.

However unfortunate that result may be, the donor is likely to be indifferent to the mismatch. Having made no prior taxable gifts, the donor’s gift tax exclusion under Sections 2010 and 2505 is $11,180,000 in 2018. That exclusion will, in most cases, be large enough to cancel out any gift tax that would otherwise be due when the GRISUT is created.

Although the GRISUT seems to be a very plausible planning technique, it may take a few rulings from the IRS before it becomes widespread in practice. However, it illustrates how rapidly the planning in this area is changing. If you have questions concerning this or any other planning idea, please do not hesitate to contact the Maddin Hauser Tax and Estate Planning Group.