

IRS Issues Rev. Rul. 2023-2: No Step-Up in Basis for Assets Held in an Irrevocable Grantor Trust

BACKGROUND

In most cases, irrevocable grantor trusts are intended to remain outside the grantor's estate. However, there are times when these trusts are includable in the estate, either by accident or design. In the case of irrevocable grantor trusts that are excluded from the grantor's estate, on March 29, 2023, the IRS issued Revenue Ruling 2023-2, affirming its long-held position that the basis of assets is not adjusted to its fair market value at the death of the grantor. The ruling held that the basis adjustment under IRC §1014 does not apply to these assets.

Understanding IRC §1014

Section 1014 provides the rules that are used to determine the income tax basis of property acquired from a decedent. Generally, the basis of property acquired or passed from a decedent, if not sold, exchanged, or otherwise disposed of before the decedent's death, is the fair market value of the property at the date of the decedent's death. For this general rule to apply, the property is "required to be included in determining the value of the decedent's gross estate" under §1014(b)(9).

There are exceptions to this general basis rule. §1014(c) excludes assets classified as income in respect of a decedent, such as annuities, Section 529 plans, qualified retirement plan balances, and IRAs. Inforce life insurance contracts, though not specifically mentioned in the statute or its accompanying regulations, are covered by the exclusion of "annuities described in Section 72" in §1014(b)(9)(A). As such, inforce life insurance contracts do not receive a step-up in basis.

The Holding

Under the facts outlined and presented in Rev. Rul. 2023-2, transfers to an irrevocable trust which are completed gifts at the time of transfer are not "required to be included in determining the value of the decedent's gross estate." As a result, the basis of the trust assets immediately after the grantor's death is the same as the basis of the trust assets immediately prior to death, i.e., no step-up occurs.

The Role of Irrevocable Grantor Trusts

Congress enacted IRC §§ 671-678 to cause income earned by or paid to an irrevocable trust to be taxed to its grantor if any of the powers enumerated in them are either 1) included in the trust document or 2) the parties to the trust act as if they are. They allow assets to be excluded from the grantor's estate for federal estate tax purposes but remain "owned" by the grantor for income-tax purposes.¹ Because of the structure, the grantor pays tax on income from trust assets during their lifetime without actually receiving it. The effect is to shift income from the compressed income tax brackets applicable to trusts to the more liberal bracket structure afforded to individual taxpayers. It also permits trust assets to grow and benefit heirs without the effect of "tax drag." Because of these unique features, irrevocable grantor trusts have become a valuable estate planning tool that can help clients transfer wealth more efficiently to the next generation.



Conclusion

Practitioners have been waiting on guidance from the IRS to answer the question of whether assets in an irrevocable grantor trust could get a step-up in basis at the death of the grantor for some time. Now that the guidance is here, practitioners can apply it when engaging in sophisticated and advanced estate planning for wealthy clients, helping to ensure drafted plans achieve their desired outcomes.

Prudential's Advanced Planning team is available to support you as you develop estate plans for clients. The team can customize case designs to meet the unique needs of the high-net-worth individuals and equip you with the tools and resources needed to demonstrate the value of the proposed strategies. Contact Advanced Planning at 800-800-2738, option 4 to discuss your next case opportunity today.

¹Per IRC §671-679 and IRC §2036-2038.

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