Understanding the Stepped-Up Basis Tax Rules and Intentionally Defective Grantor Trusts

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On January 1, 2024, the Federal Gift and Estate Tax Exemption amount increased to $13.61 million (from $12,920,000 in 2023 and adjusted for inflation in 2025). In Rhode Island, the state estate exemption limit increased to only $1,774,583. A Bill was introduced in January 2024 to increase the amount to $4,000,000, but it died in Committee. This amount means that estate planning must have a stronger focus on income tax planning, specifically the step-up in basis rules and capital gains income tax rates.

Stepped-Up Basis Rules

When an asset is passed through inheritance, there are no income tax implications until the asset is sold. The basis for calculating any taxable gain is "stepped up" to the value of the asset on the decedent's date of death. The appreciation during the decedent's lifetime will be untaxed, subject to the estate tax exemption. However, the rule does not apply to retirement assets (401(k) plans or IRAs).

Capital Gains Rules

When an asset (securities, bonds, art, gold, real estate, business interests, etc.) is sold, any resulting gain will be taxed as a capital gain (long or short term). Assets that are sold at a profit after being owned for longer than one (1) year are classified as long-term capital gains and taxed at not more than fifteen (15%) percent (20% for certain high-income individuals). In contrast, assets that are sold at a profit after being owned for less than one (1) year are classified as short-term capital gains and taxed at ordinary income tax rates, as high as thirty-seven (37%) percent. These income tax rules apply to assets owned by an individual and sold during their lifetime. However, different Federal Income Tax rules apply to assets that are inherited.

Intentionally Defective Grantor Trust

A popular estate planning tool to remove assets from an estate for estate tax purposes is an Intentionally Defective Grantor Trust ("IDGT"). An IDGT allows an individual to remove assets from their estate while continuing to be treated as their owner for income tax purposes and shield future asset appreciation from any estate tax. All the while, the grantor continues to pay the trust's income taxes. A transfer to an irrevocable trust is a "completed gift" at the time of the transfer. The grantor will not hold a beneficial interest in or a retained power over the Trust property (certain decision-making provisions that would require the trust asset to be included in the grantor's gross estate).

Many estate planners have taken the position that because the IDGT assets remain taxable to the grantor for income tax purposes, the beneficiaries are entitled to a stepped-up basis upon death. At a taxpayer's request to address this issue, the IRS issued Revenue Ruling 2023-2 on March 29, 2023. It is important to note that a Revenue Ruling is binding on the IRS and can be relied upon by any taxpayer but does not have the same impact as a law or a Tax Court or appellate decision.

Revenue Ruling 2023-2

The issue in question is the language in IRC Section 1014(b)(9), which requires grantor trust assets to be included in the estate of the grantor to receive a basis adjustment. In contrast, IRC Section 1014(b)(1) only requires that the asset be acquired by bequest, devise, or inheritance and does not require inclusion in the grantor's estate.

The analysis begins with IRC Sec. 1014(a), which provides that "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, be… the fair market value of the property at the date of the decedent's death" (or, in the case of an election under Sec. 2032 or 2032A, the value determined under that section). Sec. 1014(b) defines seven (7) types of property[1] as having been acquired or passed from a decedent in three broad categories: (i) Property acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent; (ii) a surviving spouse's one-half share of community property held by the decedent and the surviving spouse; and (iii) other property includible in the gross estate of a decedent under Sec. 2001 or 2044 (Secs. 1014(b)(2), (3), (9), and (10)).

For property to receive a basis adjustment

under § 1014(a), the property must be acquired or passed from a decedent. For property to be acquired or passed from a decedent for purposes of § 1014(a), it must fall within one of the seven types of property listed in § 1014(b).

In issuing the Revenue Ruling, the IRS took note of the fact that upon the decedent's death, the Trust asset(s) were not "bequeathed," "devised," or "inherited" within the meaning of § 1014(b)(1). A "bequest" is the act of giving property (usually personal property or money) by will.[2] The Supreme Court has defined the term "bequest" as a "gift of personal property by will."[3] A "devise" is the act of giving property, especially real property, by will.[4] An "inheritance" is property received from an ancestor under the laws of intestacy or property that a person receives by bequest or devise.[5]

Further, citing **Bacciocco v. United States**,[6] in which "the court found that property transferred in trust prior to the decedent's death is not bequeathed or inherited because it did not pass either by will or intestacy." However, "to be considered property acquired or passed from a decedent, the property must be includible in the gross estate of the decedent for estate tax purposes." The IRS concluded that none of the three categories were applicable and there was no step-up in basis because the assets in the trust were not acquired or passed from a decedent as defined in Sec. 1014(b), but "the beneficiary is receiving the assets from the trust, which does not constitute assets being "bequeathed" or "devised" by the grantor on the grantor's death." As a result, each asset's basis after the grantor's death was the same as the basis immediately before the grantor's death and no step-up in basis applied.

Conclusion

Subject to another IRS Revenue Ruling being issued with similar facts and a different conclusion, Revenue Ruling 2023-2 made it abundantly clear that while IDGT assets remain taxable to the grantor for income tax purposes, they do not constitute assets being "bequeathed" or "devised" by the grantor on the grantor's death." As a result, the beneficiaries are not entitled to a stepped-up basis upon the grantor's death and will be subject to both Federal and State estate tax on the assets in their estate and those in the IDGT.

ENDNOTES

1 *Section 1014(b)(1) – Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent; Section 1014(b)(2) – Property transferred by the decedent during life in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before death to revoke the trust; Section 1014(b)(3) – In the case of decedents dying after December 31, 1951, property transferred by the decedent during life in trust to pay the income for life or on the order or direction of the decedent with the right reserved to the decedent at all times before death to make any change in its enjoyment through the exercise of a power to alter, amend, or terminate the trust; Section 1014(b)(4) – Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will; Section 1014(b)(6) – 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; Section 1014(b)(9) – Property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property must be included in determining the value of the decedent's gross estate under chapter 11 or under the 1939 Code; and Section 1014(b)(10) – Property includible in the gross estate of the decedent under § 2044 (relating to certain property for which the marital deduction was previously allowed).*

2 Black's Law Dictionary *(11th ed. 2019)*.

3 ***United States v. Merriam***, *263 U.S. 179, 184 7 (1923)*.

4 Black's Law Dictionary *(11th ed. 2019)*.

5 Black's Law Dictionary *(11th ed. 2019)*.

6 *286 F.2d 551, 554-55 (6th Cir. 1961),* ◊