eighty-five thirteen and all that

by Russell A. Willis III, J.D., LL.M.

Last March, IRS dropped a long-anticipated revenue ruling[1] ostensibly negating a questionable argument that had been promoted for quite a few years by some tax planning lawyers.

Unfortunately, the ruling is expressly limited by conditions that largely swallow the rule. And it leaves intact another revenue ruling, from the mid 1980s, that is the actual source of the problem.

where to begin

In the typical case, the settlor sells to an "intentionally defective grantor trust" an interest in a closely held business entity, maybe at a discount for lack of control and/or marketability, and takes back a promissory note paying slightly more than the then applicable federal rate.[2]

The idea is to "freeze" the value of the transferred asset in a transaction that is not treated as a recognition event for income tax purposes because the "grantor" trust is "disregarded" as to the settlor.[3] Future appreciation will occur within the trust, outside the settlor's taxable estate.[4] At worst, if the settlor dies before the note is fully paid, only the unpaid balance will be included.

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1 Rev. Rul. 2023-2, released 03/29/23, published at 2023-16 I.R.B. 658 (04/17/23).

2 26 U.S.C. § 1274(d)(1).

3 Rev. Rul. 85-13, 1985-1 C.B. 184. The "eighty-five thirteen" of the title.

Throughout this article we refer specifically to the "settlor" of an IDGT, but the same principles apply more broadly to the deemed income tax "owner" of any irrevocable "grantor" trust.

4 If the transferred interest is undervalued and/or if the interest rate on the note is inadequate, IRS might argue we do not have "a bona fide sale for an adequate and full consideration," and the note itself might be treated as a retained interest in the trust under 26 U.S.C. § 2036 or 2038.

But see PLR 9515039, citing Rev. Rul. 77-193, 1977-1 C.B. 273, which in turn cites *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), rev'g 241 F.2d 690 (3rd Cir. 1957).

Tl;dr, if the payment obligation falls on a third party, you do not have a retained interest that can trigger estate tax inclusion.

The tradeoff is, forgoing an adjustment in the income tax basis of the transferred asset to its fair market value at the settlor's death. Unless.

Unless the trustee were to report gain or loss on a later disposition of the asset measured against its value at the settlor's death, on the theory that the sale of appreciated property to an IDGT in exchange for a promissory note was in substance a "testamentary" transfer, somehow bringing it within Code section 1014(b)(1).[5] As unlikely as that might sound.

The question then would be whether the trustee should disclose this reporting position on a form 8275, to avoid penalties for understating its tax liability.

under the radar

Although "adequate disclosure" might otherwise prevent the three-year limitations period for assessing an underpayment of tax from being extended to six,[6] if the "omission" of reportable gain arises from an "overstatement of unrecovered basis," as would be the case here, disclosure will not help.[7]

Still, the trustee might avoid penalties for "substantial underpayment" of tax on realized gains even without disclosing the details, if the reporting position had a "reasonable basis"[8] in one or more "types of authority" specified in reg. section 1.6662-4(d)(3).[9] These include quite a range of informal as well as formal IRS guidance.

And as it happens, an argument to that effect was rather thoroughly developed more than twenty years ago in an article in the Journal of Taxation co-authored by three tax law rock stars.[10]

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5 26 U.S.C. § 1014(b)(1). That subparagraph provides a basis adjustment for property "acquired from a decedent" by "bequest, devise, or inheritance." To similar effect, see the interpretive regulation, 26 C.F.R. § 1.1041-2(a)(1).

6 26 U.S.C. § 6501(e)(1)(A).

7 26 U.S.C. § 6501(e)(1)(B)(iii).

8 26 C.F.R. § 1.6662-3(b)(3).

9 26 C.F.R. § 1.6662-4(d)(3)(iii).

10 The argument first appeared in Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobson, "Income tax effects of termination of grantor trust status by reason of the grantor's death," 97 Journal of Taxation 149 (Sept. 2002).

Your correspondent has argued elsewhere that he finds the argument unpersuasive, see, Jack Straw Fortnightly, vol. 4, no. 7, posted to https://www.plannedgiftdesign.com/jack-straw-fortnightly.html.

The argument depends in part on the premise that while toggling off "grantor" trust status during the settlor's life might trigger recognition of gain to the settlor to the extent of the excess of the outstanding liability on the note over the trust's adjusted (likely carryover) basis in the property,[11] the same result should not obtain when the cessation of "grantor" trust status is occasioned by the settlor's death, *i.e.*, death is not a recognition event.[12]

More to the immediate point, the authors argue that if "swapping" in high basis assets for low pursuant to a reserved power, exerciseable in a nonfiduciary capacity, to "reacquire the trust corpus by substituting other property of an equivalent value"[13] is not a recognition event, again because the "grantor" trust is entirely disregarded as to the settlor, then it would be "inequitable" to deny the benefit of a date of death basis adjustment to taxpayers who did not have access to good advice or who were surprised by an early death.[14]

So there may be an incentive not to disclose. And we have no idea how much tax revenue may have been lost over the years.

But if IRS were to publish guidance clearly stating its view that the income tax basis in assets held in an irrevocable "grantor" trust is not adjusted at the death of the settlor unless the value of the trust assets is included in her gross estate, disclosure of a contrary reporting position would be required to avoid penalties unless the position had "a realistic possibility of being sustained on its merits."[15]

Rev. Rul. 2023-2 is not adequate to this purpose.

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11 See 26 C.F.R. § 1.1001-2(c), example 5, Rev. Rul. 77-402, 1977-2 C.B. 222, and *Madorin v. Commissioner*, 84 T.C. 667 (1985), each of which, however, involves partnership liabilities to a third party, not to the trust settlor.

12 Both questions arise from the fiction that a "grantor" trust is disregarded as to the settlor in the first instance.

13 26 U.S.C. § 675(4)(C). The "equivalent value" might itself be cash or a promissory note.

14 Your correspondent finds this argument somewhat cynical.

15 26 C.F.R. 1.6662-3(a).

missing inaction

There was an e-mail advice memo from someone in the Chief Counsel's office back in November 2008, presumably to an examiner, released as CCA 200937028, saying they "strongly disagree[d] with [the] taxpayer's contention" that section 1014(b)(1) would apply to adjust basis at the settlor's death in assets held in a "grantor" trust. But apparently that dispute was settled.

In June 2015, IRS updated its annual "no rule" list, adding this question to section 5, "areas under study" in which it would no longer issue advance determinations until it had resolved the issue through publication of formal guidance.[16] And they added a summary item to their annual "priority guidance plan."[17]

But they took no further action, and the item was dropped without comment from the priority guidance plan for fiscal 2022. There was a bit of an outcry over this, including a letter to Secretary Yellen from Rep. Bill Pascrell, Jr. (D-NJ),[18] then chair of the Oversight Subcommittee of the House Ways and Means Committee.

The project was reinstated for fiscal 2023 with a much more specific description.[19] And fairly quickly, the agency rolled out a nine-page revenue ruling.[20]

But the ruling is expressly limited to a scenario in which

> the liabilities of [the trust] did not exceed the basis of the assets in [the trust], and neither [the trust] nor [the deemed "owner"] held a note on which the other was the obligor.[21]

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16 Rev. Proc. 2015-37, 2015-26 I.R.B. 1196 (06/29/15). But it does not appear that any such letter rulings had actually been requested, unless perhaps these requests were withdrawn in the face of threatened adverse determinations.

17 2015–2016 Priority Guidance Plan, initial version, issued 07/31/15, p. 13.

18 Copy linked at https://pascrell.house.gov/uploadedfiles/2022.03.08_bp_to_treasury_re_trusts.pdf last visited 08/05/24.

19 2022–2023 Priority Guidance Plan, initial version, issued 11/04/22, p. 10.

20 Rev. Rul. 2023-2, 2023-16 I.R.B. 658 (04/17/23).

21 Ibid.

The latter condition, at least, excludes many or even most IDGTs. The ruling offers no explanation for these limitations. But the discussion above accompanying footnotes 11 and 12 may suggest an explanation. And it has to do with Rev. Rul. 85-13.

how we got here

In that ruling, IRS took the view[22] that an individual who is treated as the income tax "owner" of such a trust is also treated for income tax purposes as owning the trust property itself. The ruling was framed as a "nonacquiescence" in the then-recent decision of a divided Second Circuit federal appeals court in *Rothstein v. United States*.[23]

That decision had allowed the taxpayer a short term capital loss on the liquidation of stock in a closely held corporation he had acquired with an unsecured note from a "grantor" trust, together with a deduction for interest he had paid on the note.

IRS had argued the taxpayer actually realized a significant gain, as measured against his carryover basis in the stock and entirely "disregarding" the transaction with the trust. But Judge Friendly, writing for the majority, rejected this reading of section 671 of the tax Code.[24]

The statute does not, he said, articulate "what might otherwise seem the sensible general principle that a taxpayer may not have meaningful dealings with himself."[25] Which was the government's view.

Instead, what section 671 says is that if under one or another of the provisions of subpart E the trust settlor or a beneficiary is "treated as the owner of any portion of a trust," then "those items of income, deductions,

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22 A revenue ruling expresses the position IRS would assert in litigation. Courts have accorded these at most "Skidmore" or "Auer" deference, if they are persuaded by the "the thoroughness evident in [the] consideration [of the ruling], the validity of its reasoning, [and] its consistency with earlier and later pronouncements".

The references are to *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944), and *Auer v. Robbins*, 519 U.S. 452 (1997). Where these precedents stand after *Loper Bright Enterprises v. Raimondo*, No. 22-451 (S.Ct. 06/28/24), is anyone's guess.

But a revenue ruling is binding on the agency itself, see, *e.g.*, *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002).

23 735 F.2d 704 (2d Cir. 1984).

24 26 U.S.C. § 671.

25 735 F.2d at 709.

and credits . . . attributable to that portion" are reportable directly by the deemed owner on her own return.[26]

The trust would realize gains in outlying years as principal payments were made on the note, Judge Friendly said, and those gains would then be attributed to the settlor. So it was essentially a matter of timing. Interest payments would not be "disregarded," but they would be a wash.

Judge Feinberg, concurring only in part, would not have characterized the purchase of the stock from the trust with a promissory note as even an indirect "borrowing" for purposes of Code section 675(3),[27] and thus would not have viewed this as a transaction with a "grantor" trust at all.

Judge Oakes, dissenting, would have treated the trust's election to report gain on the sale of the stock in installments[28] as "meaningless" under the circumstances, so that the taxpayer would have reported gain immediately.[29]

IRS did not petition for certiorari from this somewhat mixed result. Instead, they "nonacquiesced" through the revenue ruling.[30]

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26 Quoting here from the statute.

27 26 U.S.C. § 675(3).

28 In fact the mechanism at Code section 453(d) is for an "election out" of installment sale treatment, *i.e.*, an election to treat the entire amount as recognized immediately. 26 U.S.C. § 453(d).

29 Though he did not use the trade phrase "intentionally defective," Judge Oakes suggested that the interposition of a trust "which did not comply with the Clifford trust regulations" was apparently designed specifically to enable the taxpayer to report the gain on liquidation of the stock on an installment basis.

Re "Clifford regulations," see footnote 32.

30 On a separate track, the House bill that eventually became the Tax Reform Act of 1986, Pub.L. 99-514, 100 Stat. 2085 (10/22/86), introduced December 03, 1985 as HR 3838, included language that would have "clarified," in the words of H.Rept. 99-426 (12/07/85), p. 818, that the deemed "owner" of a "grantor" trust is also "treated as the owner of the [trust] property for all federal income tax purposes."

The actual text of the House bill was not at all clear on the point, and in any event the proposal did not survive the Senate substitute or the conference report.

In a footnote, the House report said the legislative proposal was "inconsistent" with the result in *Rothstein*, but "no inference is intended as to whether the decision of that case is correct under present law."

another step back

Subpart E was enacted as part of the 1954 overhaul of the tax Code. There was a certain amount of revision to other sections of subpart E in 1986,[31] with some technical corrections in 1988, but the text of section 671 itself has remained unchanged for seventy years.

So one might ask what the Congress had in mind back in 1954, what provisions of the 1939 Code subpart E was meant to replace or supplement.

And what the legislative history says[32] is that the purpose was to codify existing Treasury regulations that had been at issue in *Clifford v. Helvering*.[33] These regs had sought to prevent income shifting by taxing to the settlor income of a trust over which she had retained specified administrative controls and/or that would revert to her after a "short" term.

Nothing about owning the underlying assets, and nothing about disregarding transactions between the settlor and the trustee.

Rev. Rul. 85-13 is simply wrong. It should be revoked.

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31 See footnote 29.

32 H.Rept. 83-1337 (03/09/54), pp. 63-54, S.Rept. 83-1622 (06/18/54), pp. 86-87.

33 105 F.2d 586 (8th Cir. 1939), rev'd sub nom. *Helvering v. Clifford*, 309 U.S. 331 (1940). The appeals court disapproved the regulations, but the Supreme Court reached the result advocated by the Treasury, short term trust income taxable to the settlor, ostensibly without resort to the regulations at all, see 309 U.S. at 334, fn. 1.