The New Estate Planning Lexicon: SUGRITs and Other Grantor-Retained Interest Step-Up Trusts

AUSTIN W. BRAMWELL, BRAD DILLON, AND LEAH SOCASH

The GRISUT takes familiar estate tax planning techniques and adapts them for income tax planning purposes. By creating a step-up GRISUT, a married couple can guarantee that a Section 1014(a) step up in basis will take place no matter which spouse dies first.

The tax-free step up in basis at death under Section 1014 has been condemned as a "loophole" for the wealthy.[1] It also treats married couples differently depending on coincidences of title and order of death. To illustrate, suppose that a couple's appreciated assets are separately owned by one spouse. Section 1014(a) provides that the basis of property acquired or passing from a decedent is equal not to its cost but (in general) to its fair market value as of the decedent's death (or on the alternate valuation date, if an election is made under Section 2032).[2] If the spouse holding the appreciated assets dies first, they will normally qualify for a step up in basis under Section 1014(a) and can be sold at no capital gains tax cost.[3] However, if the other spouse dies first, the assets' basis will remain unchanged and a sale or other disposition of the assets will trigger a capital gain. The benefits of Section 1014(a), in short, turn on which spouse happens to die first and which spouse happens to hold the couple's property.[4]

The potential difference in outcomes is less severe for couples living in community property states. Section 1014(b)(6) provides that the surviving spouse's one-half share of any property that is community property under the laws of any state, U.S. possession, or foreign country is deemed to have passed from the first spouse to die. Thus, the surviving spouse's share of appreciated community property qualifies for a step up in basis at the death of the first decedent. The first decedent's one-half share, meanwhile, also qualifies for a step up in basis under the general rule of Section 1014(a). All of a married couple's community property, therefore, generally qualifies for a change of basis at the death of the first decedent, even though only

half of the property actually passes from the first decedent.[5]

The Code's failure to grant a similar increase in basis to couples who own their property separately can cause a painful depletion of wealth. Many surviving spouses cannot feasibly avoid selling appreciated property. For example, they may need to liquidate assets in order to pay medical and other bills. Meanwhile, the American Taxpayer Relief Act of 2012 increased long-term capital gains tax rates to 20%,[6] while the Health Care and Education Reconciliation Act of 2010 enacted, for tax years beginning after 2012, a new 3.8% surtax on net investment income, including most capital gain.[7] These taxes, and any state or local taxes that may be due, leave surviving spouses who sell their appreciated separate property after the death of the first decedent with substantially less wealth than they would have been able to retain had their property instead been acquired from the first decedent within the meaning of Section 1014(a).

For married couples living outside of community property jurisdictions, therefore, Section 1014(a) presents both an opportunity and a conundrum. The opportunity is that, if only the couple's appreciated property could be retitled so that it will be treated as having been acquired from the first decedent at his or her death, regardless of which spouse dies first (and no exception applies), the surviving spouse would always have the benefit of a tax-free step up in basis. The conundrum is how that retitling can be achieved. Simply giving all of the couple's appreciated assets to the spouse who is expected to die first, for example, may not work. Indeed, that strategy could backfire: if the spouse who makes a gift of appreciated property to the other happens to die first, the donee surviving spouse will hold the property without the benefit of the basis step up. Even if the donee spouse does die first, a step up in basis may still be denied under Section 1014(e), which provides an exception to Section 1014(a) if a gift of appreciated property is made within one year of the donee's death and the property passes back from the donee decedent to the donor.[8]

This article proposes a new solution to the Section 1014(a) conundrum for married couples owning separate property. The general form of the solution is known as the "grantor retained interest step up trust" or "GRISUT." The GRISUT takes familiar estate tax planning techniques, such as QPRTs, GRITs, GRATs, and GRUTs, and retools them for income tax planning purposes. By creating a GRISUT, a married couple can ensure that a Section 1014(a) step up in basis will occur regardless of which spouse dies first. The GRISUT and its variations are described in detail below. Married couples who own separate and appreciated property may wish to consider creating one or more GRISUTs as part of their basic estate planning.[9]

STEP-UP PERSONAL RESIDENCE TRUST

To introduce the GRISUT, consider Harry and Wendy, a happily married couple who are both U.S. citizens. Harry has a vacation residence that he acquired as his separate property many years ago for much less than it is currently worth. Although Harry and Wendy would like to sell the residence, they do not wish to pay the substantial capital gains taxes that would be triggered if Harry sells it while both spouses are living. Instead, they would like to wait until the death of either Harry or Wendy and have the survivor sell the residence after a Section 1014 step up in basis occurs.[10]

To achieve their objectives, Harry transfers the vacation home to an ir-

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1 See, e.g., White House Fact Sheet: A Simpler, Fairer Tax Code That Responsibly Invests in Middle Class Families, January 17, 2015, available at www.whitehouse.gov/the-press-office/2015/01/17/fact-sheet-simpler-fairer-tax-code-responsibly-invests-middle-class-families.

2 Exceptions to the general rule apply, for example, in the case of income in respect of decedent. Section 1014(c).

3 While Section 1014(a) is commonly said (including in this article) to cause a "step up" in basis, it can also cause a "step down" in basis if a decedent's assets had declined in value from their original cost basis.

4 These results are inconsistent with Congress's policy, expressed in other Sections, of treating a married couple as a single unit. See, e.g., Section 1041(a) (providing that no gain or loss shall be realized on a transfer of property to a spouse); Section 2523 (providing an unlimited marital gift tax deduction).

5 It should be noted that just because a couple lives in a community property state does not mean that all their property will qualify for a step up in basis. The spouses may still hold separate property, for example, by agreement (such as valid prenuptial agreement), because they hold separate property acquired before the marriage, or because they hold separate property acquired before the spouses moved to a community property jurisdiction. See generally Ware, "Section 1014(b)(6) and the Boundaries of Community Property," 5 Nev. L.J. 704 (2005).

6 P.L. 112-240, 126 Stat. 2313, 1/2/13.

7 Section 1411.

8 That section, as discussed later in the text, 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.

9 Other commonly discussed strategies for achieving a step up in basis at the death of the first spouse to die include the so-called "joint-exempt step up trust" or "JEST," the Alaska or Tennessee community property trust, and the lifetime estate marital trust. For more on these strategies, see Gassman, Denicolo, and Hohnadell, "JEST Offers Serious Estate Planning Plus for Spouses-Part 1," 30 Est. Plan. 3 (October 2013); Gassman, Denicolo, and Hohnadell, "JEST Offers Serious Estate Planning Plus for Spouses-Part 2," 40 Est. Plan. 14 (November 2013); Blattmachr, Zaritsky, and Ascher, "Tax Planning with Consensual Community Property: Alaska's New Community Property Law," 33 Real Prop. Probate and Tr. J. 615 (Winter 1999); Handler, "The Estate Trust Revival: Maximizing Full Basis Step-Up," LISI Estate Planning Newsletter #2094 (4/30/13). A discussion of these strategies and a comparison to the GRISUT are beyond the scope of this article. Nevertheless, three points are worth noting here. First, unlike the JEST, the success of the GRISUT does not depend on the taxpayer's ability to defeat the IRS's interpretation of Section 1014(e). Second, unlike an Alaska or Tennessee community property trust, a GRISUT does not require a couple to convert their property into community property or to create a trust under the laws of a state other than the state of their domicile. (The consequences of a GRISUT may also be more certain than a community property trust, whose tax consequences the IRS has never addressed. Cf. IRS Publication No. 555, "Community Property" (revised January 2014) (stating that the publication "does not address the federal tax treatment of income or property subject to the 'community property' election under Alaska state laws"). Finally, unlike a lifetime estate marital trust, the GRISUT does not require one spouse to create an irrevocable trust for the exclusive benefit of the other. The GRISUT also avoids uncertainty as to whether the donor spouse "relinquishes dominion" over the remainder interest within the meaning of Reg. 1.1015-1(c) and, therefore, makes a transfer "by gift" to the donee spouse within the meaning of Section 1014(e).

10 Note that converting ownership to a joint tenancy with rights of survivorship will only achieve half a basis step up at the death of the first decedent. Section 2040(b).

revocable trust that is structured as a "qualified personal residence trust" or "QPRT" that meets all the requirements of Reg. 25.2702-5(c).[11] For example, Harry retains the right to the rent-free use of the property during the term of the trust and is entitled to all of the income. The trust provides that, upon the first to die of Harry and Wendy, the property shall be paid over to Wendy (if she survives Harry) or to Wendy's estate (if she predeceases Harry).[12] Finally, in her will, Wendy, as she was already planning to do, bequeaths the property of her estate to Harry.[13]

In most respects, the trust that Harry creates is similar to a conventional QPRT of the kind that, for more than two decades, wealthy taxpayers have created in order to save estate taxes. With a conventional QPRT, the grantor funds a trust with a personal residence and retains the right to use the residence for a fixed period of years. (The grantor also normally provides that the property reverts to the grantor's estate if the grantor does not survive the fixed term.) The value of the grantor's gift, for gift tax purposes, is equal to the then value of the residence, reduced by the value of the grantor's retained interest (including any reversion to the grantor's estate). The reminder of a conventional QPRT, if the grantor survives the fixed term, passes to members of the grantor's family, such as the grantor's children. In this manner, so long as the grantor survives the fixed term,[14] the conventional QPRT permits the value of a personal residence, plus appreciation after the date of the gift, to pass to descendants at a reduced gift and estate tax cost.

Harry's QPRT departs from convention in two important respects. First, the remainder of Harry's QPRT passes in all events to Harry's spouse, Wendy, or her estate. The remainder will not in any circumstance pass to Harry's descendants. Harry's QPRT, therefore, does not cause any wealth to pass down a generation but instead keeps the couple's wealth within the marital unit.

Second, Harry does not retain an interest in the residence for a fixed period of years. Instead, his retained interest terminates upon the earlier of Harry's or Wendy's death. If Harry dies first, the residence will be included in his gross estate under Section 2036(a)(1).[15] If instead Wendy dies first, the residence will be conveyed to her estate and included in her gross estate under Section 2033.[16] Unlike with the conventional QPRT, therefore, the property of Harry's QPRT is guaranteed to be included in the gross estate of either Harry or Wendy.

Why would Harry create such an apparently pointless trust? The answer is that the purpose of Harry's QPRT is not to save estate taxes at all. The purpose, rather, is to achieve a step up in basis in the residence at the death of the first of Harry and Wendy to die, but without using up any of his lifetime gift tax exclusion. For that reason, we call Harry's QPRT a "step up QPRT" or "SUPRT."[17]

As discussed below, for the SUPRT to achieve its objectives—namely, a step up in basis upon the death of the first spouse to die without gift or estate tax downside—four premises must be true: First, the value of Harry's gift must be determined under general gift tax valuation principles and not under the special valuation rule of Section 2702(a). Second, Harry's gift to Wendy must qualify for the gift tax marital deduction. Third, the QPRT must qualify for a Section 1014(a) step up in basis at the death of either spouse. Finally, the value of the property passing at the death of either spouse must qualify for the estate tax marital deduction. We consider each of these premises below.

AUSTIN W. BRAMWELL is a partner in the Trusts & Estates Group of Milbank, Tweed, Hadley & McCloy LLP in New York City and an Adjunct Professor of Law at New York University School of Law. BRAD DILLON is a Vice President and Senior Wealth Planner at Brown Brothers Harriman & Co. in New York City. LEAH SOCASH is an associate in the Trusts & Estates Group of Milbank, Tweed, Hadley & McCloy LLP in New York City. The authors gratefully acknowledge the thoughtful comments of Prof. Jerome M. Hesch and Prof. David Herzig on an earlier draft of this article. Copyright © 2015, Austin W. Bramwell, Brad Dillon, and Leah Socash.

Value of Harry's Gift

Reg. 25.2511-1(e) provides that, when the donor retains an interest in the property subject to the donor's gift, the gift tax is applied only to the interest transferred. For example, if the grantor retains a life estate in property and makes a gift only of a remainder interest (or vice versa), then the value of the gift is limited to the value of the remainder interest.[18] On the other hand, if the retained interest is not susceptible of measurement, the gift tax applies to the entire value of the property subject to the gift.[19] For example, if the grantor's retained interest is contingent on whether another beneficiary will have children or not—an event at whose probability "actuarial science . . . could do [no] more than guess"[20]—the gift tax will be imposed on the entire value of the property transferred.[21]

In the case of Harry's SUPRT, Harry makes a gift of a remainder interest in the SUPRT property to Wendy. Harry retains an income interest in the property for a period measured by the shorter of the lives of Harry and Wendy. Under actuarial factors published by the IRS, that type of retained interest is susceptible of measurement.[22] (IRS Publication 1457 contains helpful examples showing how a first-to-die remainder factor is calculated.[23]) Thus, under general gift tax valuation rules, the value of Harry's gift should be limited to the actuarial value of Wendy's remainder interest.

That said, Section 2702(a) imposes a special rule for determining the value of a gift in trust to a member of the donor's family, including a spouse.[24] Generally, under that Section, any non-qualified interest retained by the donor is valued at zero. Thus, if Section 2702(a) applies to Harry's gift to Wendy and his retained interest is not a qualified interest, Harry's retained income interest would be valued at zero. His gift to Wendy would, in consequence, be equal to the entire value of the residence transferred to the SUPRT.

Fortunately, Treasury Regulations provide that Section 2702(a) does not

apply to a transfer to a trust, like Harry's SUPRT, that meets the requirements of a QPRT.[25] To be sure, unlike in the case of a conventional QPRT, Harry does not retain an interest that terminates within a fixed number of years. Rather, Harry's interest will terminate at his death, if he predeceases Wendy, or Wendy's death, if Wendy predeceases Harry. That unconventional term interest, however, does not cause Harry's SUPRT to fail to qualify as a QPRT. The QPRT is a creature of regulations promulgated under Section 2702(a)(3)(A)(iii). Those regulations provide that Section 2702 does not apply to a transfer to a trust that meets the requirements of a QPRT (or a less common alternative known simply as a "personal residence trust").[26] None of the QPRT requirements restricts the length of the initial term.

The QPRT requirements do posit that a QPRT always has a "term holder"[27] of a "retained term interest."[28] The phrase "term interest," although not defined in the QPRT regulations, is defined under Section 2702(c)(3)(A) to include a "life interest in property." Thus, it seems that a QPRT is valid even if the grantor retains an interest measured by the life or lives of one or more individuals rather than an interest for a period of years. Rev. Proc. 2003-42, 2003-1 CB 993, which contemplates that the grantor's interest will terminate upon the earlier of the grantor's death and the expiration of fixed period of years, confirms that conclusion.[29] The SUPRT simply varies the formula approved by Rev. Proc. 2003-42 by causing the grantor's interest to terminate upon the earlier of the grantor's death and the grantor's spouse's death, rather than the earlier of the grantor's death and a period of years. In other words, with a SUPRT, the grantor retains a "life interest" within the meaning of Section 2702(c)(3)(A), but the life interest happens to be measured by the shorter of two lives.[30] (The value of a life interest for the shorter of two lives can be computed using standard IRS actuarial factors.[31]) Thus, Harry's SUPRT should be treated as a valid QPRT and, notwithstanding Section 2702, the value of his gift should be limited to the actuarial value of Wendy's remainder interest.

> **Under both Sections 1014(b)(1) and (9), the SUPRT residence should qualify for a Section 1014(a) step up in basis**

Gift Tax Marital Deduction

Harry's gift to Wendy of the remainder interest in the SUPRT should also qualify for the gift tax marital deduction. Section 2523(a) generally allows a marital deduction for the value of a gift of an interest in property to the donor's spouse. An important exception to this general rule is contained in Section 2523(b)(1), which disallows a deduction if an interest in property may terminate or fail upon the occurrence of an event or contingency, and the donor has transferred an interest to another who may possess or enjoy the property after the termination or failure of the spouse's interest. The Section 2523(b)(1) exception for nondeductible "terminable interests," however, does not apply to gifts of vested remainder interests payable either to the spouse or to the spouse's estate.[32] On the contrary, as the IRS has long recognized,[33] gifts of vested remainders interests qualify for the gift tax marital deduction. As Harry's gift to Wendy is of a vested remainder interest, the value of the gift should qualify in full for the gift tax marital deduc-

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11 For a discussion of these requirements, see Blattmachr, Slade, and Zeydel, 836-2nd T.M., Partial Interests—GRATs, GRUTs, QPRTs (Section 2702).

12 On the need for careful drafting of a remainder interest in favor an individual's estate, see generally Fox, "Estate: A Word to be Used Cautiously, If at All," 81 Harv. L. Rev. 992 (1968).

13 For simplicity, an outright disposition is assumed. In fact, however, sound planning for marital couples often involves having the first decedent create one or more trusts for the survivor. For an overview, see Blattmachr, Bramwell, and Zeydel, "Portability or No: The Death of the Credit Shelter Trust?," 118 JTAX 5 (May 2013). Harry may make a parallel disposition in his will, although whether he does so or not does not affect the tax consequences of the trust.

14 If the grantor dies during the fixed term, the residence is included in the grantor's gross estate under Section 2036(a)(1), just as if the grantor had not created the QPRT.

15 Reg. 20.2036-1(c)(1)(ii), Example 2.

16 Reg. 20.2041-1(b)(2) confirms that a remainder interest payable to a beneficiary's estate is included in the beneficiary's gross estate under Section 2033.

17 Although Harry's SUPRT is structured as a QPRT, the awkward and potentially embarrassing "Q" if "SUQPRT" is pronounced aloud is omitted from the acronym.

18 Reg. 25.2511-1(e); see also Reg. 25.2511-1(h)(7).

19 Reg. 25.2511-1(e); cf. *Robinette v. Helvering*, 318 U.S. 184, 30 AFTR 384 (1943) (holding that the gift tax applied to the value of the entire property transferred when the value of donor's retained reversion was contingent on unpredictable contingencies, such as whether the donor's daughter would marry and have children) with *Smith v. Shaughnessy*, 318 U.S. 176, 30 AFTR 388 (1943) (holding that the value of the donor's gift was equal to the value of the property transferred in trust, reduced by the actuarial value of the donor's retained reversion upon the death of the income beneficiary).

20 *Robinette v. Helvering*, 318 U.S. at 188 (1943).

21 Reg. 25.2511-1(e).

22 Regs. 25.2512-5(c)(ii) and (d)(4).

23 Publication 1457 at p.8, www.irs.gov/pub/irs-pdf/p1457.pdf.

24 See Section 2701(e)(2).

25 Reg. 25.2702-5(a).

26 *Id.*

27 See, e.g., Reg. 25.2702-5(c)(3) (requiring income to be distributed to the term holder at least annually) and Reg. 25.2702-5(c)(5)(i) (generally prohibiting the trust from holding assets other than a residence used or held for use as a personal residence of the term holder).

28 See, e.g., Reg. 25.2702-5(c)(4) (prohibiting distributions of corpus to any beneficiary other than the transferor prior to expiration of the retained term interest).

29 Rev. Proc. 2003-42 should be binding on the IRS. Cf. *Rauenhorst*, 119 TC 157 (2002).

30 Hyper-cautious practitioners who doubt that a QPRT term can be measured solely by life interests could provide that the SUPRT terminates upon the earlier of the death of the first spouse to die and a fixed term that is likely to exceed the lives of both spouses.

31 IRS Publication 1457, p. 8.

32 Technically, with the QPRT format, the donee spouse's remainder interest *could* fail, as many QPRTs provide that upon the trust ceasing to be a QPRT during the fixed term, the property may be returned to the donor. The failure does not necessarily cause loss of the marital deduction, as the property would not pass from the donor to any other person. Nevertheless, to avoid possible loss of the marital deduction, it may be prudent to require the trust in that case to convert to a GRAT, as permitted under Treasury Regulations and the IRS sample form of QPRT. Rev. Proc. 2003-42.

33 Rev. Rul. 54-470, 1954-2 CB 320.

tion. Consequently, no taxable gift results from Harry's gift to the SUPRT: Harry simply makes a gift of a remainder interest to Wendy that qualifies for the marital deduction.

Basis Step Up at Death

The next question is whether the SUPRT property qualifies for a step up in basis at the death of either Harry or Wendy. Suppose that Harry is the first decedent. In that case, the entire SUPRT property will be included in his gross estate under a straightforward application of Section 2036(a)(1).[34] The result is the same as in the case of a conventional QPRT when the donor dies during the fixed term.

In addition, the property will qualify for a step up in basis at Harry's death. Section 1014(a) generally provides that the basis of property acquired or passing from a decedent is equal to its fair market value as of the decedent's death (or on the alternate valuation date if a Section 2032 election is made). Section 1014(b)(9) goes on to provide that property is considered to have passed from a decedent if it is acquired from the decedent by reason of death, form of ownership, or other conditions and if, by reason of the decedent's death, the form of ownership, or other conditions, it is included in the decedent's gross estate for estate tax purposes.[35] As noted, the SUPRT property, if Harry dies first, is included in his gross estate under Section 2036(a)(1). In addition, Wendy acquires the property by reason of Harry's death. Thus, under Section 1014(b)(9), the property should be considered to have been acquired by Wendy from a decedent (Harry) and should qualify for a step up in basis under Sections 1014(b)(9) and (a).

Now suppose that Wendy dies first. In that case, the residence will be conveyed to Wendy's estate and the property should be included in her gross estate for estate tax purposes under Section 2033.[36] A step up in basis should once again be available. Section 1014(b)(1) provides that property is considered to have passed from a decedent if it is acquired by bequest, devise, or inheritance. If Wendy dies first, the property will pass from Wendy's estate and be devised by Wendy back to Harry.[37] In addition, as just discussed, Section 1014(b)(9) provides that property is considered to have passed from a decedent if it is acquired from the decedent by reason of death, form of ownership, or other conditions, and if, for those reasons, it is also included in the decedent's gross estate for estate tax purposes. Once again, Section 1014(b)(9) should apply, as the property is included in Wendy's gross estate by reason of her death and the form of ownership, and is acquired by Harry from Wendy for those reasons as well. Thus, under both Sections 1014(b)(1) and (9), the SUPRT residence should qualify for a Section 1014(a) step up in basis (assuming no exception applies).

Section 1014(e) Risk if Donee Spouse Dies Within One Year of Creation

That said, if Wendy dies first within one year of Harry's gift to the SUPRT, a step 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.[38] For example, if the surviving spouse made a gift of low basis assets to the deceased spouse shortly before the deceased spouse's death, and the deceased spouse bequeathed the same assets back to the surviving spouse, a step up in basis will be denied under Section 1014(e).

A step up in basis may likewise be denied if Wendy dies within one year of the SUPRT's creation and Harry survives her. Harry in that case would have made a gift to Wendy of a remainder interest in a residence. The gift would also have occurred within one year of Wendy's death.[39] As Wendy devises the property directly back to Harry, all the requirements of Section 1014(e) would be met and that Section, rather than Section 1014(a), would determine basis.

Section 1014(e), if it applies, provides that the donor's basis equals "the adjusted basis of the property in the hands of the decedent immediately before the death of the decedent." If Wendy dies first, she will not have acquired any basis in the SUPRT property, as the property will never have been acquired by her for income tax purposes. On the contrary, as the SUPRT will be a "grantor trust" for income tax purposes under Section 677, the residence will be treated as owned by Harry up until Wendy' death.

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34 Reg. 20.2036-1(c)(1)(ii), Example 2.

35 The effect of Section 1014(b)(9) is to make the general rule as provided in Section 1014(a) applicable to practically all property includable in the decedent's gross estate for estate tax purposes. See Report of Committee on Finance, United States Senate No. 1622, 83d Congress, at 108.

36 Reg. 20.2041-1(b)(2) confirms that a remainder interest payable to a beneficiary's estate is included in the beneficiary's gross estate under Section 2033.

37 Cf. Ltr. Rul. 201245006 (holding that property in a retained income trust qualified for a change in basis under Section 1014(b)(1)). Private letter rulings may not be not cited as precedent. Section 6110(k)(3).

38 As discussed in the text, if the donor spouse dies first, Section 1014(e) will not apply, even if the gift to the SUPRT is made within one year of the donor spouse's death.

39 Reg. 1.1015-1(c) (providing that a gift of an interest in trust is made at the time of creation).

40 See the example given in Joint Committee on Taxation General Explanation of the Economic Recovery Tax Act Of 1981 at 265 (H.R. 4242, 97th Congress, 1st Sess., P. L. 97-34, 8/13/81).

41 The IRS reached that conclusion in Ltr. Rul. 9026036.

42 Reg. 1.1015-1(c); see also *Post*, 26 TC 1055 (1956), acq., 1958-1 CB 5.

43 Reg. 1.1015-1(c); see also Ltr. Rul. 9109027.

44 See Ltr. Ruls. 9109027 and 9026036.

45 TAM 9308002; Ltr Ruls. 200101021 and 200210051.

46 Joint Committee on Taxation General Explanation of the Economic Recovery Tax Act Of 1981 at 265 (H.R. 4242, 97th Congress, 1st Sess., P. L. 97-34, 8/13/81) (explaining that Section 1014(e) applies if property "passes, directly *or indirectly*, from the donee-decedent to the original donor or the donor's spouse") (emphasis added).

47 See Section 1014(e)(2)(B).

48 For an excellent discussion of Section 1014(e), see Scroggin, "Understanding Section 1014(e)," LISI Estate Planning Newsletter #2182 (2/6/14).

49 Reg. 20.2056(a)-1(b)(1).

50 Reg. 20.2056(c)-1(a)(5).

51 Reg. 20.2056(a)-2(b).

52 Reg. 20.2056(c)-1(a)(5).

Technically, therefore, Section 1014(e) fails to dictate what Harry's basis will be, as the property will not have a basis in the hands of the decedent (i.e., Wendy) immediately before her death. That said, as the purpose of Section 1014(e) is to deny a Section 1014(a) change of basis (while accounting for any adjustments to basis in the brief period when the property was owned by the decedent),[40] and there does not appear to be a plausible alternative treatment, it seems that Harry should simply take over his original basis in the residence.[41]

Note that, if Harry takes back the residence at his original basis, the result is the same as if had Harry not transferred the residence to the SUPRT in the first place. That is, if Harry had not done any planning but Wendy had once again predeceased him within one year of the creation of the SUPRT, Harry would still own the residence at his original basis after Wendy's death. Even if Section 1014(e) ends up applying because the donee spouse dies within one year, therefore, there is no downside (other than set-up costs) to creating a SUPRT.

Further, Section 1014(e) should not apply so long as Wendy, even if she dies first, survives at least one year from creation of a SUPRT. For purposes of determining basis, the date that a donee acquires an interest in property "by gift" is the date that the interest is created and not when ownership of the property passes to the donee.[42] Thus, a gift of a remainder interest in trust property is complete when the interest is created.[43] An irrevocable gift over which the grantor retains no dominion or control should be considered complete even though, during the term of the trust, the grantor continues to be treated as the owner of trust property under the grantor trust rules of subpart E of part I of subchapter J of chapter 1 of the Code.[44] In the case of Harry's SUPRT, Wendy receives a remainder interest in the trust property at the time that the trust is created. Thus, so long as Wendy survives at least one year from creation, Section 1014(e) would not deny a step up in basis.

Planning Around Section 1014(e)

Although it is not certain, it may be possible to defeat the application of Section 1014(e), even if Wendy dies within one year. Wendy, instead of devising the residence outright back to Harry, could devise it under her will in trust for Harry's benefit. In that case, it may be 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. Relying on a strict reading of "by . . . the donor" and "to . . . the donor," as those phrases are used in Section 1014(e), the trustee of a trust created under Wendy's will for Harry's benefit could take the position that the trust, not Harry, acquired the property from Wendy and that the property passed to the trust, not to Harry. If the position is sustained, then Section 1014(a) rather than Section 1014(e) would, arguably, determine basis and a basis step up would occur.

On the other hand, the IRS has consistently rejected the position that Section 1014(e) is avoided through the device of having the donee bequeath property back in trust for the benefit of the donor.[45] The IRS position, moreover, has some support in both the legislative history of Section 1014(e)[46] and other portions of the statutory text.[47] Thus, at a minimum, any couple who hope to escape Section 1014(e) by arranging for property bequeathed back in trust or the donor spouse should be prepared for an IRS challenge.[48]

The final premise of the SUPRT strategy is that the property passing from the deceased spouse to the survivor qualifies for the estate tax marital deduction.

Estate Tax Marital Deduction

The final premise of the SUPRT strategy is that the property passing from the deceased spouse to the survivor qualifies for the estate tax marital deduction. If Harry dies first, that conclusion is straightforward. Section 2056(a) allows an unlimited estate tax marital deduction for the value of any property interest that passes from the decedent to the decedent's surviving spouse, so long as the interest is a deductible interest.[49] Upon Harry's death, Wendy will be his surviving spouse, and the property will pass to her under the terms of the SUPRT. (The "passing" requirement of the estate tax marital deduction is met even though Harry transfers the remainder interest to Wendy during his lifetime.[50]) Wendy's outright interest in the SUPRT property is a deductible interest.[51] Thus, SUPRT property, although included in Harry's gross estate under Section 2036(a)(1) if Harry dies first, will qualify in full for the estate tax marital deduction.

If instead Wendy dies first, the SUPRT property will be conveyed to her estate under the terms of the SUPRT and devised under Wendy's will outright (or in a trust qualifying for the marital deduction) back to Harry. Once again, the conclusion that Wendy's devise to Harry qualifies for the marital deduction is straightforward. Harry is Wendy's surviving spouse, the property passes from Wendy to Harry,[52] and Harry's interest in the property is deductible. All the requirements of the estate tax marital deduction, therefore, are met.

Income vs. Estate Tax Planning

To be clear, the marital deduction does not cause the SUPRT property to escape estate tax altogether. On the contrary, the SUPRT property, or the proceeds from the sale of the property, will still be subject to estate tax at the death of the survivor of Wendy and Harry.

The marital deduction merely permits a couple to defer estate tax until the death of the surviving spouse.

However, reducing estate tax is not the objective of the SUPRT. The goal, rather, is to achieve a step up in basis so that capital gain on the sale of the SUPRT property could be eliminated at the death of the first spouse. The elimination of inherent capital gains liability upon the death of the first spouse by itself increases the wealth of Harry, Wendy and their heirs. The SUPRT technique, in other words, achieves efficient results no matter what the estate tax laws may provide.

In recent years, the focus of estate planning has shifted away from estate tax planning and toward income tax planning. Increases in income tax rates, combined with decreases in estate tax rates and increased estate tax exclusion amounts, have certainly made income tax planning more salient. However, the GRISUT, insofar as it saves income taxes at no gift or estate tax cost, preserves family wealth even if the estate tax rates increase and exclusion amounts decline.

In any event, Harry's vacation residence was never a strong candidate for estate tax planning. The typical estate tax planning strategy, such as a conventional QPRT, attempts to cause property, plus appreciation, to pass outside of an individual's gross estate at death. Achieving that objective usually comes at the cost of foregoing a step up in basis at death, as the assets that successfully pass outside of the grantor's gross estate normally will not qualify for the step up.[53] (The loss of the basis step up is especially difficult, perhaps impossible, to prevent in the case of a conventional QPRT.[54]) With a low-basis asset such as Harry's vacation home, the income tax savings from a step up in basis may equal or even exceed the potential estate tax savings from causing the property to pass outside the decedent's estate.[55] Thus, the failure to achieve any estate tax savings is not a downside of the SUPRT strategy.

SUPRT Recap

To summarize: with a SUPRT, one spouse makes a gift of a remainder interest in a residence to the other spouse through a trust that meets the requirements of a qualified personal residence trust or "QPRT." The trust provides that, at the death of the first spouse to die, the property is paid over to the donee spouse or the donee spouse's estate. The donor spouse does not make a taxable gift when the SUPRT is created, as the gift of the remainder qualifies in full for the gift tax marital deduction. At the death of either spouse, regardless of who dies first, the property will be included in the deceased spouse's gross estate and will qualify for a step up in basis, unless Section 1014(e) applies. Section 1014(e) would apply only if the donee spouse dies first within one year of the SUPRT's creation. Even in that unlucky circumstance, however, there is no downside to creating the SUPRT, other than the costs of setting up the strategy.

NON-QUALIFIED SUGRITS FOR LESS WEALTHY COUPLES

As discussed, Section 2702 does not apply to the donor spouse's retained interest in a SUPRT. Consequently, the donor does not make a taxable gift, as the donor's gift is limited to the value of the remainder and the value of the remainder qualifies in full for the marital deduction. The donor spouse does not, therefore, pay gift tax or use up any of his or her unified gift and estate tax exclusion under Sections 2010 and 2505.

Not all couples, however, need to avoid making taxable gifts. Suppose, for example, that Harry and Wendy together own only $5 million of assets and that neither has made any prior taxable gifts. Suppose, further, that their assets consist entirely of low-basis oil stocks held as Wendy's separate property in a custody account owned by Wendy. Harry and Wendy would like to diversify her portfolio but are reluctant to do so until a step up in basis occurs.

To achieve their objectives, Wendy creates an irrevocable, step-up grantor-retained income interest trust or "SUGRIT." Wendy retains the right to all of the income from the trust until the death of the first spouse to die. Upon termination of the trust, the principal is directed to be paid over to Harry (if Harry survives Wendy) or to Harry's estate (if Harry predeceases Wendy). In his will, Harry bequeaths the property he receives from the SUGRIT from his estate to Wendy, if she survives him.

Unlike the grantor's retained interest in a SUPRT, the value of Wendy's retained income interest in her SUGRIT is governed by Section 2702(a). That Section provides that, to determine the value of any gift in trust to members of the donor's family, any interest retained by the donor (or an "applicable family member") is valued at zero, unless it is a qualified interest. Section 2702(b) defines "qualified interest" as the right to receive fixed amounts payable at least annually (i.e., an annuity), a right to receive at least annually a fixed percentage of the value of trust property (known as a "unitrust" interest), or a noncontingent remainder interest in a trust when all of the other interests consist of annuity or unitrust interests.[56] Wendy's retained right to the income from the SUGRIT fits none of those categories. Consequently, the retained income interest is valued at zero for gift tax purposes. Thus, the value of Wendy's gift for gift tax purposes is equal to the full $5 million transferred to the SUGRIT.

On the other hand, as with a gift of a vested remainder interest in a SUPRT, Wendy's gift to Harry of a vested remainder interest in her SUGRIT should qualify for the gift tax marital deduction.[57] Logically, it might seem that the amount of the marital deduction should equal the full value of Wendy's gift to Harry. As the value of Wendy's gift to Harry, thanks to the special valuation rule of Section 2702(a)(1)(A), is equal to the $5 million, the marital deduction should, it seems, also equal $5 million. No taxable gift would then result.

That conclusion, however, is premature. Section 2702 applies solely for purposes of determining whether a transfer of an interest in trust to or for the benefit of the donor's family is a gift, and the value of the gift. It does

not apply for other purposes, including for purposes of determining the value of the marital deduction under Section 2523. On the contrary, it seems that the value of the marital deduction for the gift of a remainder interest in a non-qualified SUGRIT is determined under Reg. 25.2523(a)-1(e). That regulation provides that the value of the marital deduction in the case of a gift of a remainder interest is determined under the "normal" valuation principles of Section 7520. Under those principles, the value of the donee spouse's remainder interest does not include the value of the donor's retained income interest. Thus, there will be a mismatch between the value of Wendy's gift and the amount of the marital deduction: While the value of Wendy's gift will be equal to the entire value of the property transferred to the SUGRIT, i.e., $5 million, the value of the marital deduction will be limited to the value of the remainder interest.

Suppose, for example, that the value of the remainder interest in Wendy's SUGRIT, as determined by Section 7520 actuarial tables, is $3 million. Wendy's gift tax marital deduction amount, therefore, is $3 million. However, because Wendy's retained income interest is valued at zero under Section 2702(a), she is deemed to make a gift of the full $5 million transferred to the SUGRIT. Consequently, Wendy is deemed to have made a taxable gift of $2 million, even though she did not transfer property to any person other than herself and her spouse.

Puzzling as that result may be, Harry and Wendy are indifferent to the mismatch. Having made no prior taxable gifts, Wendy's gift tax exclusion amount under Sections 2010 and 2505 amount is $5,430,000 in 2015.[58] The exclusion is large enough to cancel out any gift tax that would otherwise be due when the SUGRIT is created. Even though Wendy's estate and gift tax exclusion may be artificially wasted as a result of Section 2702, she does not have enough wealth to be subject to gift or estate tax liability in the first place. Instead, Wendy's planning can focus on achieving a step up in basis without fear of federal estate tax liability.

Now suppose that one of the spouses dies. Just as with a SUPRT, if Wendy, the donor spouse, dies first, the property will be included in her gross estate under Section 2036(a)(1). A step up in basis occurs under Sections 1014(a) and 1014(b)(9). As the entire remainder passes outright to Harry, her estate will also qualify in full for the estate tax marital deduction under Section 2056(a). In addition, although Harry and Wendy do not need estate tax planning, it is worth noting that Wendy's entire unused applicable exclusion amount may be "ported" to Harry if Wendy's executors make a timely portability election.[59]

If instead Harry, the donee spouse, dies first, the property will be included in his gross estate under Section 2033. Further, a step up in basis should be available under Section 1014(b)(1) and/or Section 1014(b)(9), so long as Section 1014(e) does not apply. And, once again, it appears that Section 1014(e) will not apply so long as the SUGRIT is created more than one year before Harry's death.[60] Thus, the SUGRIT achieves a step up in basis regardless of which spouse dies first. For couples who are not at risk of paying gift or estate tax, in sum, the SUGRIT can achieve a step up in basis at the death of the first spouse to die without gift or estate tax downside.

NON-QUALIFIED SUGRIT FOR WEALTHIER COUPLES

It may seem at first that a SUGRIT to which Section 2702(a) applies is not an efficient strategy for wealthier couples. As discussed, when the donor spouse creates a SUGRIT, he or she is treated as making a gift equal to the value of all property transferred to the SUGRIT. The marital deduction, meanwhile, is still limited to the value of the remainder. The donor spouse, therefore, makes an artificial taxable gift as a result of the mismatch between the value of the gift and the gift tax marital deduction. The SUGRIT achieves a basis step up at the death of one of the spouses but at the apparent cost of gift and estate tax inefficiency.

That said, the inefficiency of a SUGRIT, even for wealthier couples, may not be as great as it appears. Suppose, once again, that Wendy creates a $5 million SUGRIT whose property is paid over to Harry or Harry's estate at the death of the first spouse to die. Suppose, further, that the value of the remainder, as determined under Section 7520, is equal to only $3 million. Thus, Wendy is deemed to make a $5 million gift, offset only by a $3 million marital deduction. The result is a $2 million taxable gift. That artificially large taxable gift is apparently inefficient, given that the entire SUGRIT property still belongs to Wendy and Harry and has not passed to any of their descendants.

Suppose, however, that Wendy predeceases Harry. In that case, the SUGRIT property will be included in Wendy's gross estate under Section 2036(a)(1). Her gift to the SUGRIT is not an adjusted taxable gift within the meaning of Section 2001(b) and, therefore, is not added to the amount with respect to which estate tax is computed. Wendy's unified estate tax credit under Section 2010 is effectively restored. As some have put it,

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53 However, see Blattmachr, Gans, and Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 JTAX 149 (2002) (arguing that grantor trusts should qualify for a step up in basis); cf. Ltr. Rul. 201245006 (holding that the basis of the property of an irrevocable grantor trust created by a nonresident alien was determined at the grantor's death under Section 1014(a)).

54 The reason is that the QPRT must prohibit the grantor or the grantor's spouse from purchasing the property. Reg. 25.2702-5(c)(9). The prohibition prevents the grantor from "swapping" out a low-basis residence in exchange for cash or high-basis assets, and thereby causing the low-basis residence to qualify for a Section 1014(a) step up in basis at death.

55 For further discussion of this issue, see McCaffrey, "Tax Tuning the Estate Plan by Formula," 33 Univ. Miami Heckerling Inst. On Est. Pl. ch. 4, ¶ 403.5 (1999).

56 See Reg. 25.2702-3(b).

57 Rev. Rul. 54-470, 1954-2 CB 320.

58 Rev. Proc. 2014-61, 2014-47 IRB 860.

59 The amount that may be ported is not reduced by Wendy's gift to the SUGRIT. On the contrary, Wendy's taxable gift to the SUGRIT, because it is included in her gross estate, is effectively expunged from the computation of estate tax under the estate tax computation rules of Section 2001(b), and her estate tax unified credit under Section 2010 is effectively restored in full.

Wendy's gift is "purged" from the wealth transfer tax base.[61]

Consequently, Wendy does not lose any estate tax exclusion as a result of creating the SUGRIT. Even if Wendy paid gift tax upon creating the SUGRIT, her estate would enjoy the equivalent of a credit for gift tax payable under Section 2001(b)(2). The gift tax, in other words, would be restored at death in the form of a credit.[62] Other than the lost opportunity to use Wendy's exclusion amount or to expend the funds used to pay gift tax in other ways (including in the couple's estate planning), it seems that there is no gift and estate tax downside, so long as Wendy dies first.[63]

Now suppose that Harry predeceases Wendy. The SUGRIT property will be included in Harry's gross estate. Suppose, further, that Harry bequeaths all of the SUGRIT property back to Wendy in a form that causes the property to be included in Wendy's gross estate at her death. For example, Harry could bequeath the SUGRIT property to a marital trust meeting the requirements of Section 2056(b)(5), including that Wendy is given a general power of appointment. Any estate tax in that case would be deferred until Wendy's death, thanks to the marital deduction, while the (former) SUGRIT property would be included in Wendy's gross estate under Section 2041.

Although it is not certain, it seems that Wendy's original gift to the SUGRIT, just as if Wendy died first, would not be treated as an adjusted taxable gift within the meaning of Section 2001(b), which provides that an "adjusted taxable gift" is a gift made after 1976, "other than gifts which are includible in the gross estate of the decedent." If Harry bequeaths the SUGRIT property back to Wendy in a form that qualifies for the estate tax marital deduction, the property that Wendy initially transferred to the SUGRIT would, in fact, be included in Wendy's gross estate at her death. It does not, therefore, come within the definition of adjusted taxable gift.

To be sure, the property was included in Harry's gross estate at his prior death. However, the text of Section 2001(b) does not suggest that, if property transferred by gift before the donor dies is included in another's gross estate, the gift must always be classified as an adjusted taxable gift, even if later included in the donor's gross estate. On the contrary, the only requirement of avoiding an adjusted taxable gift (other than for gifts made before 1977) is that the gift be included in the donor's gross estate. That is the case with the SUGRIT property, even if it is included in Harry's gross estate and later held in trust for Wendy in a form that causes it to be included in Wendy's gross estate. Thus, Wendy's taxable gift of the SUGRIT property should not be treated as an adjusted taxable gift and should be expunged from the wealth transfer tax base.

The conclusion that Wendy's gift to the SUGRIT is not an adjusted taxable gift is consistent with the design and purposes of Section 2001(b). If Wendy's gift to the SUGRIT *were* considered an adjusted taxable gift, it would incur a double tax: namely, a tax on the SUGRIT property included in her gross estate, plus an additional tax on Wendy's taxable gift of the very same property.[64] As the IRS has reasoned in other contexts,[65] such double taxation is improper. In sum, both the text and purpose of Section 2001(b) suggest that a gift of SUGRIT property should not be treated as an adjusted taxable gift, even if the donor spouse survives the donee spouse, so long as the property is later included in the donor spouse's gross estate.

If Wendy's SUGRIT gift is not an adjusted taxable gift, then, just as if Wendy had predeceased Harry, any unified gift and estate tax exclusion used up by the gift will be restored under the estate tax computation rules of Sections 2001(b) and 2010. Any gift tax payable by Wendy would also be credited to her estate under Section 2001(b)(2). In sum, just as if Wendy had predeceased Harry, there is no loss of Wendy's exclusion amount as a result of creating the SUGRIT (and any gift tax paid will effectively be restored at death in the form of an estate tax credit). Once again, other than the lost opportunity to use Wendy's exclusion amount in other ways or to expend or invest the funds used to pay gift tax in other ways, it seems that there should be no gift and estate tax downside, even if Harry dies first.[66]

THE TANGIBLE PROPERTY SUGRIT: BOTH AN INCOME AND A GIFT AND ESTATE TAX PLANNING OPPORTUNITY?

Another variation of the SUGRIT technique is a SUGRIT funded exclusively with nondepreciable tangible property. Section 2702(c)(4) contains a seldom-invoked exception to the

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60 As discussed in the context of the SUPRT, it may be possible to defeat the application of Section 1014(e) if the donee spouse bequeaths his or her estate in trust for the donor spouse rather than outright.

61 For more on the "purge" rule, see Bramwell and Mullen, "Gift-by-Promise Plan Works as Advertised," LISI Estate Planning Newsletter #2033 (12/3/12).

62 On the other hand, if gift and estate tax rates decrease, Wendy will end up having paid a higher wealth transfer tax than necessary. See *Estate of Smith*, 94 TC 872 (1990) (noting that Section 2001(b)(2), by only providing a credit for gift tax that "would have been payable had the gifts been subject to the rate schedule in effect upon the decedent's death," prevents a decline in gift and estate tax rates from having retroactive effect at death).

63 Of course, the opportunity cost may very well still dissuade wealthy couples from employing the SUGRIT strategy. The point is simply that gift and estate tax exclusion is not wasted as one might initially assume and gift tax payable is paid back to the estate in the form of the credit.

64 However, cf. *Johnstone*, 76 F.2d 55, 15 AFTR 382 (CA-9, 1935) (holding that property subject to a general power of appointment that was revocable by the donor at the time of the decedent's death was included in the decedent's gross estate, thereby creating the potential for the simultaneous imposition of gift and estate tax on the same property).

65 Rev. Rul. 84-25, 1984-1 CB 191 (holding that a gift-by-promise is not an adjusted taxable gift, as the assets out of which the promise is satisfied are already included in the decedent's gross estate under Section 2033); but see Bramwell and Weissbart, "The Dueling Transferors Problem in Generation-Skipping Transfer Taxation," forthcoming in ACTEC L. J. (Fall 2015) (observing several ways in which double taxation is a well-established feature of the gift and estate system).

66 Once again, this is not to diminish the significance of the opportunity cost, but merely to point out that the gift and estate tax downside is not what one may initially assume.

67 Reg. 25.2702-2(c)(2). In addition, the property must be tangible property "as to which the failure to exercise any rights under the term interest would not increase the value of the property passing at the end of the term interest." *Id.*

68 See 136 Cong. Rec. S15,682 (10/10/90).

69 Section 2702(c)(4).

70 Reg. 25.2702-2(c)(1).

71 Reg. 25.2702-2(c)(3).

special valuation rules of Section 2702(a). The exception applies in the case of a retained term interest in tangible property, if "the nonexercise of rights under [the term interest] would not have a substantial effect on the valuation of the remainder interest." Treasury regulations clarify that this exception is limited to tangible property for which no deduction for depreciation or depletion would be allowed, if the property were used in a trade or business or held for the production of income.[67] As an example, the regulations cite a trust funded exclusively with a painting. Other examples of nondepreciable tangible property might include jewelry, other types of artwork, or vacant land.[68]

If a GRIT is funded with nondepreciable tangible personal property meeting the requirements of Section 2702(c)(4), the value of the term interest, for gift tax purposes, is the value that the term holder "establishes as the amount for which such interest could be sold to an unrelated third party."[69] Regulations add that the holder must be able reasonably to establish the value of the term interest.[70] Comparable rental values or sales are the best evidence of the value of the term interest, whereas "[l]ittle weight is accorded appraisals in the absence of such evidence."[71] Thus, an individual who hopes to reduce the value of his or her gift to a tangible property GRIT must provide evidence of the rental value of comparable property or the prices at which term interests in similar property have exchanged hands. Well-regarded institutions in the art market are reportedly now able to appraise the rental value of art based on comparable transactions.

The possibility of funding a GRIT with nondepreciable tangible property creates another potential basis planning opportunity for married couples. To illustrate, suppose that Wendy owns a $2 million sculpture that she purchased years ago for just $20,000. Wendy and Harry would like to sell the sculpture but are unwilling to pay tax on the amount of the gain at the 28% rate for long-term gain from collectibles, plus the 3.8% tax on net investment income under Section 1411, plus any state or local income taxes that may be due. Instead, they would like to wait until a step up in basis occurs at the death of one of the spouses before selling.

To achieve their objectives, Wendy transfers the sculpture to a SUGRIT. Similar to a SUPRT (which is simply a SUGRIT funded with a residence), Wendy retains the right to use and enjoy the sculpture until the death of the first spouse to die. The remainder upon the death of the first decedent passes outright to Harry (if he survives) or his estate (if he predeceases Wendy). In his Will, Harry bequeaths the property of his estate to Wendy.

As with a SUPRT, the value of Wendy's gift for gift tax purposes is equal to the entire value of the property transferred (i.e., the sculpture), less the value of the Wendy's term interest. Unlike in the case of a SUPRT, however, Wendy may not rely on IRS actuarial tables to value her retained interest. Instead, under Reg. 25.2702-2(c)(1), she must establish the value of the term interest through evidence of comparable rentals or sales. If Wendy succeeds, the value of her gift is reduced by the value of the term interest.

In addition, as with a SUPRT or any other form of GRISUT, the value of the gift of the remainder interest should qualify for the gift tax marital deduction. The amount of the marital deduction, under Reg. 25.2523(a)-1(e), is determined in accordance with IRS actuarial tables published under Section 7520. As discussed, by contrast, the value of Wendy's retained interest is determined based not on Section 7520 actuarial tables but on comparable sales or rentals. The two opposing methods for computing the value of the remainder may produce different and mismatched results.

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Suppose, for example, that Wendy is able to establish that the value of her retained term interest in the sculpture is equal to $500,000, so that the amount of her gift of the remainder interest is $1.5 million. Under Section 7520, suppose that the value of the remainder is equal to only $1 million. In that case, Wendy would have only $1 million of marital deduction to offset a gift of $1.5 million. She would be treated as making a taxable gift of $500,000.[72]

On the other hand, the nondepreciable tangible property SUGRIT may in some cases create a gift and estate tax planning opportunity. Suppose that the value of the tangible property transferred to Wendy's SUGRIT is once again $2 million, but Wendy is able to establish that the value of her retained interest is $1.5 million, so that the amount of her gift is only $500,000.

Suppose, further, that under Section 7520 actuarial principles, the amount of the marital deduction is $1.5 million. In that case, the marital deduction of $1.5 million is more than triple the amount of Wendy's gift of $500,000. No taxable gift results. Indeed, not only is there no taxable gift but the transaction generates $1 million of "excess" marital deduction. Possibly, although it is unclear, the excess could be used to shield other taxable transfers from gift tax.[73]

STEP-UP GRANTOR RETAINED UNITRUSTS AND STEP-UP GRANTOR RETAINED ANNUITY TRUSTS

A final pair of techniques that enable a married couple to achieve a step up in basis, regardless of which spouse dies first, is the step-up grantor retained unitrust or "SUGRUT" and the step-up grantor retained annuity trust or "SUGRAT." With either strategy, just as with a SUGRIT, one spouse creates an irrevocable trust that terminates in favor of the other spouse (or the other spouse's estate) upon the death of the first spouse to die. Unlike a SUPRT or a tangible property SUGRIT, a SUGRUT or SUGRAT need not be funded with a residence or nondepreciable tangible property. Instead, the donor may fund a SUGRUT or SUGRAT with any property. So long as the donor retains a "qualified interest" within the meaning of Section 2702(b), no taxable gift results.

Qualified interests (other than qualified remainder interests) come in only two forms: Either the donor spouse may retain the right to fixed amounts payable not less frequently than annually, known as an annuity, or the right to receive a fixed percentage, payable at least annually, of the fair market value of the property in the trust (determined annually), known as a "unitrust."[74] If the donor's retained interest satisfies the requirements of either a qualified annuity interest or a qualified unitrust interest, it is valued using standard actuarial tables under Section 7520, which reduces the value of the donor's gift.[75] Consequently, there is no marital deduction mismatch of the kind that can occur in the case of a SUGRIT: the value of the donor's gift equals the value of the remainder interest, as determined in Section 7520, and the amount of the marital deduction also equals the value of the remainder interest, as also determined under Section 7520. Thus, a SUGRUT or SUGRAT avoids a taxable gift.

One downside of a SUGRUT or a SUGRAT is that, unlike in the case of a SUPRT or SUGRIT, it may not always cause gross estate inclusion of the entire value of the trust property if the donor spouse dies first. Treasury regulations provide that if the donor dies during the term of a GRUT or a GRAT, "[t]he portion of the trust's corpus includible in the decedent's gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to provide the decedent's retained use or retained annuity, unitrust, or other payment (without reducing or invading principal)."[76] For example, suppose that Harry creates a SUGRUT that pays him annually an amount equal to 4% of the value of the trust property. If Harry predeceases Wendy at a time when the Section 7520 rate is 8%, approximately only half of the trust (depending on the "adjusted payout rate") will be included in Harry's gross estate.[77] As a result, a step up in basis will apparently occur only with respect to half of the trust property.[78]

To mitigate the risk of partial gross estate inclusion, the grantor could select an annuity amount or unitrust percentage that is sufficiently high so that, even if the Section 7520 rate increases, the entire property of the SUGRUT or SUGRAT will be included in the donor's gross estate if the donor dies first. The unitrust percentage or annuity amount could increase over time so that amount will likely be high enough at the time of the donor's death to cause gross estate inclusion in full.[79] Nevertheless, as future interest rates cannot be predicted with certainty, the possibility remains that the SUGRUT or SUGRAT will not cause 100% gross estate inclusion. Furthermore, the higher the amount required to be paid out to the grantor, the less property will actually be retained in the trust so that it will qualify for a step up in basis. On the other hand, if property is paid out to the grantor, the grantor could then recontribute it to a new SUGRAT or SUGRUT that once again pays an an-

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72 The planning implications if a gift to a SUGRIT is a taxable gift are discussed in the previous two sections.

73 Cf. *Estate of Chenoweth*, 88 TC 1577 (1987) (holding that a bequest to a surviving spouse of 51% of the shares of a corporation may be valued at a "control" premium for marital deduction purposes, even though the other 49% of the shares passed to decedent's daughter).

74 Sections 2702(b)(1)-(2); Reg. 25.2702-3(b).

75 Section 2702(a)(2)(B).

76 Reg. 20.2036-1(c)(2)(i).

77 Reg. 20.2036-1(c)(2)(iv), Example 3.

78 The limited gross estate inclusion amount would prevent all of the trust property from qualifying for a change of basis under Section 1014(b)(9). Perhaps, however, a full basis step up would still be available under another subsection, such as Section 1014(b)(1).

79 Regs. 25.2702-3(b)(1)(ii) and (c)(1)(ii).

80 See Slade, "The Evolution of the Reciprocal Trust Doctrine Since Grace and Its Current Application in Estate Planning," 17 Tax Mgmt. Est. Gifts & Tr. J. 71 (1992).

81 Grace, 395 U.S. at 323 (1969); cf. *Estate of Levy*, TCM 1983-453 (holding that trusts created by husband and wife were not interrelated, as wife was given a special power of appointment over the trust created for her benefit).

nuity amount or unitrust percentage great enough to make full gross estate inclusion very likely.

To mitigate still further the risk of partial gross estate inclusion, the donor could fund the SUGRUT or SUGRAT with both low-basis and high-basis assets or cash. The donor could then select a relatively high annuity amount or unitrust percentage (or an increasing annuity amount or percentage likely to keep pace with the Section 7520 rate). As annuity or unitrust payments are made, cash or high-basis assets can be paid out of the trust. The low-basis assets, meanwhile, remain until the trust terminates at the death of one of the spouses. In this fashion, the donor can ensure that there will be a full basis step up.

RECIPROCAL GRISUTS

In some cases, both spouses might wish to create a GRISUT. Suppose, for example, that Harry and Wendy each have a portfolio of low-basis assets. They would each like to create a GRISUT in order to ensure a step up in basis at the death of the first spouse to die. Until that time, however, each would prefer to be the beneficiary of his or her own portfolio.

To meet their objectives, both Harry and Wendy create a SUGRUT. Each spouse in his or her will bequeaths the property of his or her estate to the survivor. At the death of the first decedent, the property of the SUGRUT created by the deceased spouse passes by its terms to the surviving spouse. The property of the SUGRUT created by the surviving spouse is paid over to the deceased spouse's estate and then bequeathed back to the surviving spouse. Thus, the surviving spouse becomes the owner of the property of both SUGRUTs.

Suppose, for example, that Harry dies first. The SUGRUT that Harry created will terminate and be paid over to Wendy, while the SUGRUT that Wendy created will be paid over to Harry's estate. Harry in his will bequeaths his estate to Wendy. Thus, Wendy ultimately succeeds to the property of both SUGRUTs.

The possibility of reciprocal GRISUTs raises an interesting theoretical question. Had Harry and Wendy done nothing, Wendy would retain her own property at Harry's death. Harry, meanwhile, would still bequeath his estate to Wendy. Thus, Wendy would become the owner of the couple's combined property, which is the same result that obtains when the couple creates reciprocal SUGRUTs. Regardless of whether Harry and Wendy create reciprocal GRISUTs or not, the surviving spouse will always succeed to the couple's property.

The income tax consequences, however, would apparently be very different. If the couple does nothing, only the property of the deceased spouse, i.e., Harry, receives a step up in basis at his death. But because Wendy creates a SUGRUT that terminates in favor of Harry's estate, Wendy obtains a step up in basis in her property as well. Furthermore, Harry and Wendy apparently assured themselves of this result regardless of which spouse died first.

The IRS might seek to deny these favorable results on grounds of substance over form. In particular, the IRS might attempt to extend the reciprocal trust doctrine, most famously explicated in *Grace*, 395 U.S. 316, 23 AFTR2d 69-1954 (1969), to the Section 1014 context. The general form of the IRS's argument might be that remainder interests in reciprocal GRISUTs should be "uncrossed." That is, Harry should be deemed to be the remainder beneficiary of the SUGRUT that he created, and Wendy should be deemed to be the remainder beneficiary of the SUGRUT that she created. So viewed, only the SUGRUT that Harry creates would be deemed to be included in his gross estate and qualify for a step up in basis.

It remains to be seen whether this reasoning would even be raised by the IRS, much less whether it would prevail. To date, the reciprocal trust doctrine has been invoked to *cause* gross estate inclusion, as in *Grace*, but has never been invoked to *prevent* gross estate inclusion (or to prevent property from being considered to have been acquired from a decedent).[80] Further, Section 1014 may not even call for application of the doctrine, given that Section 1014 may cause a decrease or "step down" in basis as much as a step up.

That said, it seems prudent to take steps to avoid the reciprocal trust doctrine. One simple method may be for each spouse to provide in his or her will that all property be held in trust for the surviving spouse's benefit. Upon termination of the reciprocal GRISUTs in that case, the surviving spouse will receive the property of the GRISUT created by the deceased spouse outright, but the property of the GRISUT that he or she created will be held in trust for his or her benefit. That difference may be sufficient to defeat application of the reciprocal trust doctrine, which looks to whether the parties "placed each other in approximately the same objective economic position as they would have been" if the trusts had not been created.[81] Consideration might also be given to having each spouse create a GRISUT with different terms and at different times. For example, one spouse could create a SUGRAT and, one year later, the other could create a SUGRUT. The annuity amounts and unitrust amounts could also be varied.

CONCLUSION

A GRISUT permits married taxpayers to achieve a step up in basis in appreciated property at the death of one of the spouses, regardless of which spouse dies first. By eliminating inherent capital gains tax liability at the death of the first spouse to die, the GRISUT protects and enhances a couple's wealth, both for themselves and their heirs. The result is tax-efficient regardless of estate tax rates and exclusion amounts. That is, the GRISUT can save taxes both in today's relatively favorable estate tax environment and also if estate tax rates increase and exclusion amounts decline. The GRISUT, in short, is a strategy for all seasons. ●