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No Gain at Death: in the Context of an Installment Sale, Gain is NOT Triggered by the Grantor's Death - and the IRD Regime is NOT Applicable

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In the context of an installment sale, gain is *not* triggered by the grantor's death—and the IRD regime is *not* applicable

In a 2002 article,[1] we examined at length the income-tax effects of the termination of a grantor trust by reason of the death of the grantor in the context of an installment sale.[2] Acknowledging then that the law was unsettled, we considered the plausibility of various approaches. Still, we reached firm conclusions about two critical issues: first, that gain is not recognized at the time of the grantor's death; and second, that the income in respect of a decedent (IRD) regime, largely contained in Internal Revenue Code Section 691, cannot apply.

We continue to believe that these conclusions are correct.

No Gain at Death

We start by noting that even the Internal Revenue Service has now informally agreed with our first conclusion: death does not trigger gain.

In Chief Counsel Advice 200923024, the Service, analyzing a tax-shelter-type transaction, reviewed what it called the primary authorities on the cessation of grantor trust status.[3] In each of these authorities, it was determined that, when grantor trust status ended during the grantor's lifetime, gain was recognized on the rationale that the encumbering liability exceeded the basis in the asset that, until cessation, was deemed to be owned by the grantor.[4] This determination is nothing more than a corollary to the now well-accepted notion that the gift of an asset can trigger gain when the asset is encumbered by a liability that exceeds basis[5]—which is a narrow exception to the general rule that a donor does not recognize gain when gifting an asset.

Most significant, after reviewing the cited authorities, the Service concludes in the CCA that these authorities apply only in the inter vivos setting and not when grantor trust status ends by reason of the grantor's death. Acknowledging the inveterate principle that death cannot trigger gain and that this principle is to be applied when the grantor of a grantor trust dies, the Service states: "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally *not* treated as an income tax event." (Emphasis added.)

As we indicated in 2002, we believe that this no-gain-at-death rule can be traced back to the Supreme Court's 1947 decision in *Crane v. Commissioner.*[6] In *Crane*, the decedent's asset had been encumbered by a liability. The court, applying the predecessor of IRC Section 1014, determined that the legatee's basis was equal to the


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asset's fair market value (FMV) on the date of death, undiminished by the amount of the encumbering debt.[7] While the court did not explicitly address the decedent's income tax consequence, it implicitly viewed the decedent as not having made a sale to the legatee at the time of death. For, if the court had taken the view that a sale had occurred, the legatee would have necessarily been treated as having made a purchase, in which case her basis would have been determined under the predecessor of Section 1012. Thus, in applying Section 1014 in the determination of the legatee's basis, the court implicitly treated the decedent as not having made a sale.

As a result, it is quite clear that, as we stated earlier, a person who dies with an asset that is encumbered by a liability in excess of the asset's basis does not recognize gain.

In contrast, a person making an inter vivos gift of a liability-in-excess-of-basis asset would recognize gain.[8] While some might find this distinction between inter vivos and testamentary transfers unsatisfying, it is a well-accepted one. We continue to believe that the distinction does make sense: While a failure to recognize gain in the case of an inter vivos transfer of a liability-in-excess-of-basis asset could lead to taxpayer abuse, there is no potential for such abuse in the case of a testamentary transfer inasmuch as taxpayers can only take advantage of the no-gain-at-death rule by dying.

Thus, we must reject any suggestion that, under the authorities cited in the CCA, cessation of grantor trust status by reason of the grantor's death should be treated as a sale that triggers gain—as acknowledged by the recent CCA.

While the impulse to treat the testamentary and inter vivos transfer of a liability-in-excess-of-basis asset in the same fashion is understandable, the deeper understanding one acquires in tracing the treatment of such testamentary transfers back to *Crane* illuminates why the impulse is wrong. Indeed, ignoring this distinction would lead one, by necessity, to conclude that the decedent in *Crane* had recognized gain at the time of death (assuming the encumbering liability exceeded the decedent's basis). And no one has ever suggested such a result would be appropriate[9]—not even, as the CCA reflects, the Service.[10]

This is not to say, however, that *Crane* itself dictates the treatment of the termination of grantor trust status at the grantor's death. To be sure, the decedent in *Crane* had never transferred the asset to a grantor trust. But once Revenue Ruling 85-13 is taken into account, it becomes clear that a grantor is deemed to own the assets in the trust for all income tax purposes throughout his entire lifetime (where grantor trust status is not turned off prior to death.) And if the grantor is treated as owning the asset, gain cannot be recognized at death—just as gain is not recognized at death in the case of an asset that the decedent had owned outright. Thus, we continue to hold that the combined effect of the no-gain-at-death rule and the principle in Rev. Rul. 85-13 that the grantor is deemed to own the trust's assets precludes the recognition of gain at the grantor's death.

Because grantors are deemed to own a trust's assets throughout their lifetimes, the IRD regime cannot apply.

We have written several other observations supporting our no-gain-at-death conclusion. Although we do not want to repeat them here, we briefly mention one for the reader's convenience: In the preamble to the final regulations under IRC Section 684, the Treasury acknowledges that, as a general rule, no gain is recognized at the death of the grantor of a grantor trust. It then goes on to justify a narrow exception for foreign trusts, claiming that the language of the IRC makes it appropriate (specifically, Sections 684, 679 and 6048(a)(3)(A)(ii)). But it is important to emphasize that, in doing so, the Treasury did not abandon the general rule that cessation of grantor trust status at death does not trigger gain.[11]

IRD Cannot Apply

We also explained in our earlier article that, because the grantor is deemed to own the trust's assets throughout his lifetime, the IRD regime cannot apply. In other words, when a sale is not deemed to occur before the decedent's death, gain cannot be treated as IRD. We cited Treasury Regulations Section 1.691(a)-2(b), Example 4, which deals with a buy-sell agreement. The example concludes that the sale under such an agreement cannot trigger IRD because the sale becomes effective only upon the decedent's death.

It has been suggested that we misread this example. Under this view, completion of the buy-sell agreement did not result in IRD because the sale was consummated after the decedent's death.[12] But this understanding of the example is incorrect. To support our understanding, we cited *Estate of Peterson v. Comm'r*[13] in which the Tax Court cites the example to demonstrate the principle that a sale that becomes effective upon the decedent's death cannot result in IRD. The court stated: "This situation may be best exemplified by a typical *date-of-death* buy-sell agreement between a decedent and his corporation; since, by its terms, the sale is only effective *upon the decedent's death,* the decedent could not have received the sale proceeds if he had lived. Therefore, the proceeds from such a sale are not income in respect of a decedent. See sec. 1.691(a)-2(b) (example (4)), Income Tax Regs." (Emphasis added.)[14] Thus, suggestions that the example should be read as ruling out IRD on the ground that the sale becomes effective after death is inconsistent with the reading the Tax Court gave the example in *Peterson.*

Applying this principle in the context of an installment sale to a grantor trust, we previously concluded that, because the grantor is deemed to own the assets in the trust until death, the IRD regime cannot apply. In short, any sale that is deemed to occur upon the decedent's death or thereafter cannot generate IRD. We continue to believe that conclusion is correct.[15]

There is even a more fundamental reason why the IRD regime cannot apply. IRD is tax income to which the decedent was entitled before death but which was not properly reportable on a pre-death return.[16] On account of Rev. Rul. 85-13, there is no sale during the decedent's lifetime; concomitantly, there is no note outstanding during the decedent's lifetime and no interest due, accrued or imputed during the decedent's lifetime, for income tax purposes. Hence, a decedent could never have had an entitlement that would trigger IRD.[17]

Endnotes

1. *See* Jonathan G. Blattmachr, Mitchell M. Gans and Hugh M. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 *Journal of Taxation* 149 (2002).
2. The issue arises when the outstanding balance on the note at the time of the grantor's death is greater than the grantor's pre-death basis in the trust's assets.
3. These are the authorities to which Chief Counsel Advice 200923024 refers: Treasury Regulations Section 1.1001-2(c), Example 5 (treating the cessation of grantor trust status during the lifetime of the grantor as a gain-recognition event, by reason of Section 752, because the trust owned a partnership interest in which liabilities exceeded outside basis); *Madorin v. Commissioner,* 84 T.C. 667 (1985) (applying and upholding Example 5 in Treas. Regs. Section 1.1001-2(c)); and Revenue Ruling 77-402, 1977-2 C.B. 222.
4. *See* Rev. Rul. 85-13, 1985-1 C.B. 184 (holding that the grantor of a grantor trust is deemed to own the assets in the trust as long as it remains a grantor trust).
5. *See Diedrich v. Commissioner,* 457 U.S. 191 (1982).
6. *Crane v. Comm'r,* 331 U.S. 1 (1947).
7. Some commentators misunderstand *Crane*, conceptualizing it as permitting the inclusion of the encumbering liability in basis. This misunderstanding may be attributable to a visceral sense that *Crane* treated the legatee as a purchaser and the decedent as a seller. Properly understood, the court's holding fixes the legatee's basis, under the predecessor of Internal Revenue Code Section 1014, at the fair market value of the asset on the date of death. The legatee is not treated as a purchaser, and the decedent is not treated as a seller. Rather, the legatee is treated for purposes of Section 1014 as an inheritor. In adopting this approach, the court rejected the argument that the legatee's basis should be equal to the value of the asset's net equity. Instead, the court held that the amount of the liability is irrelevant in the determination of basis. It is worth noting, however, that the court did not elaborate on the determination of basis when the encumbering liability exceeds the asset's value. It may well be that, in such a case, the legatee's basis would be zero. *See* Mitchell M. Gans, "Re-Examining the Sham Doctrine: When

Should an Overpayment Be Reflected in Basis?" 30 *Buff. L. Rev.* 95 (1981). But, of course, if one conceptualizes *Crane* as permitting encumbering liabilities to be included in basis, he might fail to appreciate the zero-basis possibility.

8. *See Diedrich v. Comm'r, supra* note 5.
9. *See, for example*, H. R. No. 107-84, 107th Cong., 1st Session 113 (2001) ("The bill clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property.")
10. Similarly, anyone ignoring this distinction would have to conclude that, when a liability-in-excess-of-basis asset is held in a revocable trust, the grantor would have to recognize gain at death. Again, that is a result that no one would endorse.
11. In our previous article, we also discussed the trustee's basis. We reviewed alternative approaches to the question. Under one of the approaches we discussed, the trustee's basis would be determined under IRC Section 1014 once the grantor has died. We suggested that, even though the trust's assets are excluded from the grantor's gross estate, this might be the correct outcome given Revenue Ruling 85-13. In other words, if we are to engage fully in the fiction that the grantor continues to own the assets for all income tax purposes as long as grantor trust status remains intact, it would seem that the property in the trust is bequeathed by the decedent and should therefore qualify for Section 1014 treatment by reason of Section 1014(b)(1). We, of course, recognized the counterintuitive nature of permitting a step up under Section 1014 for an asset not included in the gross estate, but we thought it flowed from the fiction adopted in Rev. Rul. 85-13: that, for all income tax purposes, including presumably Section 1014, the assets in a grantor trust should be treated as owned by the grantor. Once this fiction is accepted, it would seem that any asset remaining in a grantor trust until the grantor's death should be treated as owned by the grantor until death and therefore bequeathed by the grantor at the time of death—thus triggering Section 1014(b)(1). This fiction is analogous to Treas. Regs. Section 1.1001-2(c), Example 5, under which the grantor of a grantor trust is treated for income tax purposes as having made an inter vivos gift of a partnership interest held in the trust when grantor trust status terminates during the grantor's lifetime. In any event, the Service recently rejected this argument. In CCA 200937028, without citing Rev. Rul. 85-13 or considering the possibility that the grantor should be deemed to own the asset until death, the Service simply concludes that Section 1014(b)(1)—which provides a step up for assets bequeathed by the decedent—does not apply. It then concludes that Section 1014 cannot apply unless the asset is included in the decedent's gross estate.
12. It should be noted that the termination of the grantor's life as an income taxpayer and the commencement of the existence of the decedent's estate tax as an income taxpayer do not support the notion that the inherent gain in the assets held in the trust is income in respect of a decedent (IRD), because the commencement of the existence of the decedent's estate begins the day after the decedent's date of death. In fact, the date of the decedent's death is the first day of the estate's first tax year. *See* Rev. Rul. 69-563, 1969-2 C.B. 104. This ruling was declared obsolete by T.D. 8996, but not for the proposition cited. *See also* General Counsel Memoranda 38960 that states: "The moment of death determines the end of the decedent's tax year and the beginning of the estate's tax year."
13. *Estate of Peterson v. Comm'r*, 74 T.C. 630 (1980), *aff'd* 667 F.2d 675 (8th Cir. 1981)
14. *Ibid*, at p. 641.
15. *Frane v. Comm'r*, 998 F.2d 567 (8th Cir. 1993), does not suggest otherwise. As we discussed in our prior article, the decedent in *Frane* had elected installment reporting at the time of the sale. As a result, cancellation of the note triggered IRD pursuant to Sections 453B(f) and 691(a)(5)(iii). In the case of a sale to a grantor trust, in contrast, no such election is made or could be made given Rev. Rul. 85-13. Indeed, if these sections have any relevance, it is in their implication that, as a general matter, there is no gain at death absent a specific provision to the contrary (such as Sections 453B(f) or 684).
16. *See Peterson, supra* note 13 at p. 638; Treas. Regs. Section 1.691(a)-1(b) ("In general, the term 'income in respect of a decedent' refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent.")
17. In CCA 200937028, the Service itself appears to agree that the IRD regime cannot apply in this context. The IRS states: "Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9)." If the IRD regime were applicable, Section 1014 could not apply, even if it were included in the gross estate. *See* Section 1014(c). In effect, Section 1014 treatment and the IRD regime are mutually exclusive. Thus, in suggesting that an asset sold to a grantor trust could qualify for treatment under Section 1014 (assuming it were included in the gross estate), the Service in effect concedes that the IRD regime can have no application in this context.