

Bond Case Briefs

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IRS Publishes Proposed Regs on Determining Basis in Interests in Tax-Exempt Trusts.

The IRS has published proposed regulations (REG-154890-03) that provide rules for determining a taxable beneficiary's basis in a term interest in a charitable remainder trust (CRT) upon a sale or other disposition of all interests in the trust to the extent that basis consists of a share of adjusted uniform basis. Comments and hearing requests are due by April 17.

In October 2008 the IRS designated (Notice 2008-99) a CRT transaction, and other substantially similar transactions as transactions of interest under reg. section 1.6011-4(b)(6). In the identified transaction, a sale or other disposition of all interests in a CRT after the contribution of appreciated assets to, and their reinvestment by, the CRT results in the grantor or other non-charitable beneficiary — the taxable beneficiary — receiving the value of the taxable beneficiary's trust interest while claiming to recognize little or no taxable gain. The taxable beneficiary contends that the entire interest in the CRT has been sold, and thus, section 1001(e)(1) does not apply to the transaction. As a result, the taxable beneficiary computes gain on the sale of its term interest using the portion of the uniform basis allocable to the term interest under reg. sections 1.1014-5 and 1.1015-1(b). The taxable beneficiary takes the position that this uniform basis is derived from the basis of the new assets acquired by the CRT rather than the grantor's basis in the assets contributed to the CRT.

In response to Notice 2008-99, commentators agreed that a taxable beneficiary of a CRT shouldn't benefit from a basis step-up attributable to tax-exempt gains and supported amending the uniform basis rules to prevent this benefit. The IRS and Treasury also believe that it is inappropriate for a taxable beneficiary to share in the uniform basis obtained through the reinvestment of income not subject to tax due to a trust's tax-exempt status.

Accordingly, the proposed regs provide a special rule for determining the basis in some CRT term interests in transactions to which section 1001(e)(3) applies. Under the regs, the basis of a term interest of a taxable beneficiary is the portion of the adjusted uniform basis assignable to that interest reduced by the portion of the sum of the following amounts assignable to that interest: (1) the amount of undistributed net ordinary income described in section 664(b)(1) and (2) the amount of undistributed net capital gain described in section 664(b)(2). The regs don't affect the CRT's basis in its assets, but the IRS and Treasury may consider whether there should be any change in the treatment of the charitable remainderman participating in such a transaction.

The rules in the proposed regs apply only to charitable remainder annuity trusts and charitable remainder unitrusts as defined in section 664. Comments are requested on whether the rules also should apply to other types of tax-exempt trusts. The regs don't affect the disclosure obligation provided in Notice 2008-99. The regs are proposed to apply to sales and other dispositions of interests in CRTs occurring after January 15, 2014, except for sales or dispositions occurring under a binding commitment entered into before January 16, 2014. However, the inapplicability of the regs to an excepted sale or disposition doesn't preclude the IRS from applying all available legal arguments to contest the claimed tax treatment of such a transaction.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide rules for determining a taxable beneficiary's basis in a term interest in a charitable remainder trust upon a sale or other disposition of all interests in the trust to the extent that basis consists of a share of adjusted uniform basis. The regulations affect taxable beneficiaries of charitable remainder trusts.

DATES: Written or electronic comments and requests for a public hearing must be received by April 17, 2014.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-154890-03), room 5205, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-154890-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C., or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-154890-03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Allison R. Carmody at (202) 317-5279; concerning submissions of comments and requests for hearing, Oluwafunmilayo (Funmi) Taylor, at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Statutory and Regulatory Rules

Charitable Remainder Trusts

A charitable remainder trust (CRT) is a trust that provides for the distribution of an annuity or a unitrust amount, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or for a limited term of years, with an irrevocable remainder interest held for the benefit of, or paid over to, charity. Thus, there is at least one current income beneficiary of a CRT, and a charitable remainder beneficiary. A CRT is not subject to income tax. See section 664(c).

Uniform Basis Rule

Property acquired by a trust from a decedent or as a gift generally has a uniform basis. This means that property has a single basis even though more than one person has an interest in that property. See §§ 1.1014-4(a)(1) and 1.1015-1(b). Generally, the uniform basis of assets transferred to a trust is determined under section 1015 for assets transferred by lifetime gift, or under section 1014 or 1022 for assets transferred from a decedent. Adjustments to uniform basis for items such as depreciation are made even though more than one person holds an interest in the property (adjusted uniform basis).

When a taxable trust sells assets, any gain is taxed currently to the trust, to one or more beneficiaries, or apportioned among the trust and its beneficiaries. If the trust reinvests the proceeds from the sale in new assets, the trust's basis in the newly purchased assets is the cost of the new assets. See section 1012. Thus, the adjusted uniform basis of that taxable trust is attributable to basis obtained with proceeds from sales that were subject to income tax.

However, a CRT does not pay income tax on gain from the sale of appreciated assets. A CRT may sell appreciated assets and accumulate undistributed income and undistributed capital gains, and may reinvest the proceeds of the sales in new assets. The treatment of distributions from a CRT to its income beneficiary depends upon the amount of undistributed income and undistributed capital gains in the CRT. Sections 664(b)(1) and (2).

Basis in Term and Remainder Interests in a CRT

Section 1001(e) governs the determination of gain or loss from the sale or disposition of a term interest in property, such as a life or term interest in a CRT. In general, section 1001(e)(1) provides that the portion of the adjusted basis of a term interest in property that is determined pursuant to sections 1014, 1015, or 1041 is disregarded in determining gain or loss from the sale or other disposition of such term interest. Thus, the seller of such an interest generally must disregard that portion of the basis in the transferred interest in computing the gain or loss.

Section 1001(e)(3), however, provides that section 1001(e)(1) does not apply to a sale or other disposition that is part of a transaction in which the entire interest in property is transferred. Therefore, in the case of a sale or other disposition that is part of a transaction in which all interests in the property (or trust) are transferred as described in section 1001(e)(3), the capital gain or loss of each seller of an interest is the excess of the amount realized from the sale of that interest over the seller's basis in that interest. Each seller's basis is the seller's portion of the adjusted uniform basis assignable to the interest so transferred. See § 1.1014-5(a)(1).

The basis of a term or remainder interest in a trust at the time of its sale or other disposition is determined under the rules provided in § 1.1014-5. See also §§ 1.1015-1(b) and 1.1015-2(a)(2), which refer to the rules of § 1.1014-5. Specifically, § 1.1014-5(a)(3) provides that, in determining the basis in a term or remainder interest in property at the time of the interest's sale or disposition, adjusted uniform basis is allocated using the factors for valuing life estates and remainder interests. Thus, the portions of the adjusted uniform basis attributable to the interests of the life tenant and remaindermen are adjusted to reflect the change in the relative values of such interests due to the lapse of time.

Notice 2008-99

The IRS and the Treasury Department became aware of a type of transaction involving these provisions and, on October 31, 2008, the IRS and the Treasury Department published Notice 2008-99 (2008-47 IRB 1194) ("Notice") to designate a transaction and substantially similar transactions as Transactions of Interest under § 1.6011-4(b)(6) of the Income Tax Regulations, and to ask for public comments on how the transactions might be addressed in published guidance. In this type of transaction, a sale or other disposition of all interests in a CRT subsequent to the contribution of appreciated assets to, and their reinvestment by, the CRT results in the grantor or other noncharitable beneficiary (the taxable beneficiary) receiving the value of the taxable beneficiary's trust interest while claiming to recognize little or no taxable gain.

Specifically, upon contribution of assets to the CRT, the grantor claims an income tax deduction under section 170 of the Internal Revenue Code (Code) for the portion of the fair market value of the assets contributed to the CRT (which generally have a fair market value in excess of the grantor's cost basis) that is attributable to the charitable remainder interest. When the CRT sells or liquidates the contributed assets, the taxable beneficiary does not recognize gain, and the CRT is exempt from tax on such gain under section 664(c). The CRT reinvests the proceeds in other assets, often a portfolio of marketable securities, with a basis equal to the portfolio's cost. The taxable beneficiary and charity subsequently sell all of their respective interests in the CRT to a third party.

The taxable beneficiary takes the position that the entire interest in the CRT has been sold as described in section 1001(e)(3) and, therefore, section 1001(e)(1) does not apply to the transaction. As a result, the taxable beneficiary computes gain on the sale of the taxable beneficiary's term interest by taking into account the portion of the uniform basis allocable to the term interest under §§ 1.1014-5 and 1.1015-1(b). The taxable beneficiary takes the position that this uniform basis is derived from the basis of the new assets acquired by the CRT rather than the grantor's basis in the assets contributed to the CRT.

Explanation of Provisions

In response to the request for comments in the Notice, the IRS and the Treasury Department received three written comments. All three commenters agreed that a taxable beneficiary of a CRT should not benefit from a basis step-up attributable to tax-exempt gains, and each supported amending the uniform basis rules to foreclose this benefit. The IRS and the Treasury Department agree that it is inappropriate for a taxable beneficiary to share in the uniform basis obtained through the reinvestment of income not subject to tax due to a trust's tax-exempt status.

Accordingly, these proposed regulations provide a special rule for determining the basis in certain CRT term interests in transactions to which section 1001(e)(3) applies. In these cases, the proposed regulations provide that the basis of a term interest of a taxable beneficiary is the portion of the adjusted uniform basis assignable to that interest reduced by the portion of the sum of the following amounts assignable to that interest: (1) the amount of undistributed net ordinary income described in section 664(b)(1); and (2) the amount of undistributed net capital gain described in section 664(b)(2). These proposed regulations do not affect the CRT's basis in its assets, but rather are for the purpose of determining a taxable beneficiary's gain arising from a transaction described in section 1001(e)(3). However, the IRS and the Treasury Department may consider whether there should be any change in the treatment of the charitable remainderman participating in such a transaction.

In addition to the comments supportive of a basis limitation described above and proposed to be adopted herein, the commenters addressed additional issues in response to the Notice. One commenter requested guidance specifying what valuation methods the IRS will accept as a reasonable method for determining the amount of a life-income recipient's gain on the termination of certain types of CRTs. Another commenter suggested that the IRS and the Treasury Department could create a rule requiring a zero basis for all interests in CRTs in order to prevent an inappropriate result while still allowing for early termination of CRTs. The commenter also proposed that this rule be made applicable to all early terminations of CRTs. The IRS and the Treasury Department did not adopt a rule requiring a zero basis for all interests in CRTs because the IRS and the Treasury Department believe that the rule provided in the proposed regulations will prevent inappropriate results while treating parties to the transaction fairly. Additionally, the IRS and the Treasury Department believe that rules addressing early terminations other than those arising from a transaction described in section 1001(e)(3), and rules prescribing valuation methods, are beyond the scope of the issues intended to be addressed in these proposed regulations, and thus will not be considered as part of this guidance.

Finally, the rules in these proposed regulations are limited in application to charitable remainder annuity trusts and charitable remainder unitrusts as defined in section 664. The IRS and the Treasury Department request comments as to whether the rules also should apply to other types of tax-exempt trusts.

Effect on Other Documents

The issuance of these proposed regulations does not affect the disclosure obligation set forth in the Notice.

Proposed Effective/Applicability Date

These regulations are proposed to apply to sales and other dispositions of interests in CRTs occurring on or after January 16, 2014, except for sales or dispositions occurring pursuant to a binding commitment entered into before January 16, 2014. However, the inapplicability of these regulations to an excepted sale or disposition does not preclude the IRS from applying legal arguments available to the IRS before issuance of these regulations in order to contest the claimed tax treatment of such a transaction.

Availability of IRS Documents

The IRS notice cited in this preamble is published in the Internal Revenue Bulletin or Cumulative Bulletin and is available at the IRS website at <http://www.irs.gov> or the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C., 20402.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply to these regulations because the regulations do not impose a collection of information on small entities. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department also request comments on the administrability and clarity of the proposed rules, and how they can be made easier to understand. All comments will be available for public inspection and copying at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person who timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place of the public hearing will be published in the Federal Register.

Drafting Information

The principal author of these proposed regulations is Allison R. Carmody of the Office of Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§ 1.1001-1 [Amended]

Par. 2. Section 1.1001-1, paragraph (f)(4), is amended by removing the language “paragraph (c)” and adding “paragraph (d)” in its place.

§ 1.1014-5 [Amended]

Par. 3. Section 1.1014-5 is amended by:

1. In paragraph (a)(1), first sentence, removing the language “paragraph (b)” and adding “paragraph (b) or (c)” in its place.
2. Re-designating paragraph (c) as newly-designated paragraph (d) and adding new paragraph (c).
3. In newly-designated paragraph (d), adding new Example 7 and Example 8.

The additions read as follows:

§ 1.1014-5 Gain or loss.

* * * * *

(c) Sale or other disposition of a term interest in a tax-exempt trust — (1) In general. In the case of any sale or other disposition by a taxable beneficiary of a term interest (as defined in § 1.1001-1(f)(2)) in a tax-exempt trust (as described in paragraph (c)(2) of this section) to which section 1001(e)(3) applies, the taxable beneficiary’s share of adjusted uniform basis, determined as of (and immediately before) the sale or disposition of that interest, is —

(i) That part of the adjusted uniform basis assignable to the term interest of the taxable beneficiary under the rules of paragraph (a) of this section reduced, but not below zero, by

(ii) An amount determined by applying the same actuarial share applied in paragraph (c)(1)(i) of this section to the sum of —

(A) The trust’s undistributed net ordinary income within the meaning of section 664(b)(1) and § 1.664-1(d)(1)(ii)(a)(1) for the current and prior taxable years of the trust, if any; and

(B) The trust’s undistributed net capital gains within the meaning of section 664(b)(2) and § 1.664-1(d)(1)(ii)(a)(2) for the current and prior taxable years of the trust, if any.

(2) Tax-exempt trust defined. For purposes of this section, the term tax-exempt trust means a charitable remainder annuity trust or a charitable remainder unitrust as defined in section 664.

(3) Taxable beneficiary defined. For purposes of this section, the term taxable beneficiary means any person other than an organization described in section 170(c) or exempt from taxation under section 501(a).

(4) Effective/applicability date. This paragraph (c) and paragraph (d), Example 7 and Example 8, of this section apply to sales and other dispositions of interests in tax-exempt trusts occurring on or after January 16, 2014, except for sales or dispositions occurring pursuant to a binding commitment entered into before January 16, 2014.

(d) * * *

Example 7. (a) Grantor creates a charitable remainder unitrust (CRUT) on Date 1 in which Grantor retains a unitrust interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRUT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor's basis in the shares of X stock used to fund CRUT is \$10x. On Date 2, CRUT sells the X stock for \$100x. The \$90x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRUT uses the \$100x proceeds from its sale of the X stock to purchase Y stock. On Date 4, CRUT sells the Y stock for \$110x. The \$10x of gain on the sale of the Y stock is exempt from income tax under section 664(c)(1). On Date 5, CRUT uses the \$110x proceeds from its sale of Y stock to buy Z stock. On Date 5, CRUT's basis in its assets is \$110x and CRUT's total undistributed net capital gains are \$100x.

(c) Later, when the fair market value of CRUT's assets is \$150x and CRUT has no undistributed net ordinary income, Grantor and Charity sell all of their interests in CRUT to a third person. Grantor receives \$100x for the retained unitrust interest, and Charity receives \$50x for its interest. Because the entire interest in CRUT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained unitrust interest in CRUT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, \$100x, over Grantor's adjusted basis in the interest.

(d) Grantor's adjusted basis in the unitrust interest in CRUT is that portion of CRUT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014-5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRUT's adjusted uniform basis in its sole asset, the Z stock, is \$110x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRUT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031-7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRUT's \$0 of undistributed net ordinary income and its \$100x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031-7 of this chapter to the full \$110x of basis.

Example 8. (a) Grantor creates a charitable remainder annuity trust (CRAT) on Date 1 in which Grantor retains an annuity interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRAT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor funds CRAT with shares of X stock having a basis of \$50x. On Date 2, CRAT sells the X stock for \$150x. The \$100x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRAT distributes \$10x to Grantor, and uses the remaining \$140x of net proceeds from its sale of the X stock to purchase Y stock. Grantor treats the \$10x distribution as capital gain, so that CRAT's remaining undistributed net capital gains amount described in section 664(b)(2) and § 1.664-1(d) is \$90x.

(c) On Date 4, when the fair market value of CRAT's assets, which consist entirely of the Y stock, is still \$140x, Grantor and Charity sell all of their interests in CRAT to a third person. Grantor receives \$126x for the retained annuity interest, and Charity receives \$14x for its remainder interest. Because the entire interest in CRAT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained annuity interest in CRAT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, \$126x, over Grantor's adjusted basis in that interest.

(d) Grantor's adjusted basis in the annuity interest in CRAT is that portion of CRAT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014-5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRAT's adjusted uniform basis in its sole asset, the Y stock, is \$140x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRAT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031-7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRAT's \$0 of undistributed net ordinary income and its \$90x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031-7 of this chapter to determine its actuarial share of the full \$140x of basis.

John Dalrymple

Deputy Commissioner for Services

and Enforcement.

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