

How Does Internal Revenue Rule 2023–2 Impact Estate Plans?

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Most taxpayers do not have to worry about estate taxes with today's Federal Exemption Credit which is \$13.99 million per person and almost \$28 million for married couples for 2025. However, this credit is set to sunset on December 31, 2025 unless Congress intervenes by extending it. If Congress does not intervene, the credit will be restored to a much lower amount \$5.490 million per person and, as a result, you may have more people contemplating creating trusts. Proper estate and trust planning can yield protections against estate tax, but a new revenue ruling clarifies existing law as it applies to the transfer of assets of an irrevocable trust and our clients should understand the effect that this revenue ruling might have on their heirs.

Rev. Rul. 2023-2 clarifies which assets transferred by a decedent to a beneficiary receive the coveted step-up in basis to fair market value under Sec. 1014 of the IRS Code and which do not. The IRS concluded that no step-up in basis is available for assets in an irrevocable trust where the individual creating the trust retains a power that causes the individual to be the owner of the entire trust for income tax purposes, but does not cause the trust assets to be included in the individual's gross estate.

Implications of the revenue ruling: In estate planning, two basic types of trusts are used to move assets from a trustee to a beneficiary: revocable and irrevocable. A revocable trust is one in which the grantor retains the right to make significant changes to its terms, including taking the property back out and terminating the trust. As a result of the grantor's control over the assets of a revocable trust, the assets would be included in the grantor's taxable estate upon death. Accordingly, any assets later distributed to the beneficiaries of a revocable trust would enjoy the Section 1014 step-up in basis.

Example: D transfers all of her assets to her revocable living trust. D's basis in the assets was \$5 million. Upon her death in 2026, the trust distributes all of her assets to her only child A. At the time of D's death, the trust's assets were valued at \$10 million. Assuming no change in current law delaying the sunset of the credit, D's gross estate would report \$10 million of assets and pay any tax after the credit is applied. Immediately, upon receiving the assets, A sells them for \$11 million and reports a taxable gain of only \$1 million.

In contrast, the grantor of an irrevocable trust generally does not enjoy the same control over trust assets during their lifetime. Although they may terminate some limited powers, they cannot make large, sweeping changes, recall the property, or end the trust without court intervention. As a result, the assets of an irrevocable trust would generally not be included in the grantor's taxable estate upon death unless the powers retained by the

grantor were so significant that it was essentially deemed to be the equivalent of a revocable trust for purposes of valuing the gross estate. Consequently, any assets later distributed to the beneficiaries of most irrevocable trust would benefit from the Section 1014 step-up in basis.

Under revenue ruling 23-2, in the above example, upon the death of the grantor in an irrevocable trust, the trust assets valued at \$10 million will be sold for \$11 million, A the son will have to report a taxable gain of \$1 million but will not be obligated to pay any estate tax.

Does this mean clients should abandon the use of irrevocable trusts? Of course not, but it is critical importance to review the consequences of creating an irrevocable trust as well as reviewing the need for asset protection, privacy, probate avoidance, and estate tax planning. In making your estate planning decisions, it is essential for clients with the assists of counsel and accountants to understand all of the consequences, including any potential effect upon their beneficiaries, to ensure that the desire outcome is achieved without any unpleasant surprises to their beneficiaries.

Please note that this is a general overview of the law and does not constitute legal advice, and nothing herein creates an attorney-client relationship between the sender and recipient.

Practices

- Trusts and Estates

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