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OVERVIEW OF COST, ADJUSTED AND STEPPED-UP BASIS

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I. Introduction. The tax basis of an asset essentially represents that portion of an asset's value that is exempt from future income taxation. When we understand that feature, we become more interested in establishing the highest basis of an asset that can be supported. This discussion is intended to take us though the life cycle of an asset's basis, with a brief review of the general concepts of cost and adjusted basis and a more detailed discussion of stepped-up basis. Due to the countless issues related to the many forms of basis, it is beyond the scope of this outline to even attempt to cover all the variations and nuances related to basis. This outline is intended to cover some of the more common issues related to basis that practitioners encounter.

II. Cost Basis. Under IRC §1012 and the related regulations, subject to certain exceptions related primarily to corporate or partnership assets, the cost basis of an asset includes the fair market value of assets paid and debts assumed to acquire the asset. The cost can also include additional items such as legal and accounting fees, freight, installation, commissions, settlement or closing costs, and related sales taxes and government fees. When an asset is built or constructed, costs related to the construction, such as architect and engineer fees, permits and inspections, can also be included (or capitalized) in the basis.

A. Allocation of Basis. When more than one asset is purchased for a lump sum, the purchase price must be allocated among the assets. IRC §1060 requires both buyer and seller to allocate the purchase and sales price among the assets purchased and sold. Form 8594 is used to report the allocation information to the IRS. If the buyer and seller agree in writing to an allocation, each will be bound by such allocation unless the IRS determines that the allocation is not

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appropriate. The residual method under IRC §338(b)(5)[1] must be used for the allocation. With some exceptions within the classes, the purchase price is generally allocated to each of the following classes based on the value of the assets:

Class I:	Cash and cash equivalents
Class II:	Certificates of deposits, U.S. government securities, readily marketable stock and securities, and foreign currency
Class III:	Accounts receivables, mortgages, and credit card receivables
Class IV:	Inventory
Class V:	All assets not in classes I – IV, VI, and VII (such as equipment, land and buildings)
Class VI:	Section 197 intangibles such as copyrights, trademarks, business records, covenants not to compete, etc., except goodwill and going concern,
Class VII:	Goodwill and going concern

B. Partnership Basis. There are two types of basis that apply to partnerships. Each partner has what is a referred to as an outside basis in the partnership, which represents the partner's interest in the partnership. The partnership has a separate basis in the assets owned by the partnership, referred to as the inside basis.

C. Corporation Basis. With large publically traded C corporation stock, the taxpayer's basis in the stock is simply what they paid for the stock. With closely held C corporations or S corporations, the taxpayer's basis in the stock is the amount of money or other assets used by the taxpayer to either fund the company or purchase the stock. IRC §351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation. Section 368(c) defines control to mean the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

III. Adjusted Basis. The adjusted basis of an asset represents its initial cost plus allowable items paid that add to its value and minus items that reduce its value for basis purposes. Some examples of items that increase the value or basis of an asset are a new roof on a building, paving or concrete, infrastructure for new or additional utility services, impact fees and related professional fees. Adding the cost of an item to the basis is referred to as capitalizing the cost. Items that were paid for and for which a current year deduction is allowed and taken, cannot be capitalized.

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[1] Under IRC §338 and its regulations, the residual method allocates the value of the assets in excess of the value of the tangible assets to assets with longer depreciable lives, such as goodwill or some similar intangible.

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Certain items must be capitalized and cannot be expensed or deducted in the year paid.[2] Items that decrease the basis include annual depreciation expenses taken for the item along with other items such as tax credits allowed and casualty and theft losses and insurance reimbursement.

A. Capital Improvements to Business Assets. When a cost is paid for an item related to a business asset, the taxpayer most often wants to take a current year §179 deduction for the amount paid, without having to capitalize or add the amount paid to the basis of the asset. Being able to deduct a current expense reduces current income and accordingly the current year's income taxes. For taxpayers that (i) produce real or tangible personal property for use in their business, (ii) produce real or tangible personal property or sale to customers, or (iii) or acquire property for resale, the Uniform Capitalization Rules under §263A must be applied to determine which costs have to be capitalized.[3]

B. Depreciation and Amortization. There are number of methods used to depreciate the basis of an asset over its useful life. The most common are the Modified Accelerated Cost Recovery System (MACRS)[4], which is not allowed under Generally Accepted Accounting Principals (GAAP), but used by companies that are not required to report under GAAP, and the straight-line method, which is one of the allowed methods under GAAP for publically traded companies. Other methods of depreciation allowed under GAAP include Declining Balance, Double Declining Balance, Sum of the Year's Digits, and Units of Production.[5]

C. Examples of Adjustments to Basis. IRS Publication 551 provides the following examples of how to calculate an adjusted basis.

Example 1. In January 2019, taxpayer paid $80,000 for real property to be used as a factory. Taxpayer also paid commissions of $2,000 and title search and legal fees of $600, with a total cost of $82,600 allocated between the land and the building—$10,325 for the land and $72,275 for the building. Taxpayer spends $20,000 in remodeling the building before it is placed

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[2] For a detailed discussion about the capitalization of repairs to a personal residence, please see IRS Publication 523.

[3] The uniform capitalization (UNICAP) rules apply to business assets and explain which costs associated with the production of property and the acquisition of property for resale must be capitalized. However, there is an exception if the company's average annual gross receipts (for the prior three years) do not exceed the index adjusted gross receipts test as outlined under IRC §448, which is $30,000,000 for 2024.

[4] MACRS is further broken down into the general depreciation system (GDS) and the alternative depreciation system (ADS).

[5] Please see IRC §§ 167 and 168 and Rev. Proc. 87-56 for a more detailed discussion of depreciation methods and time periods.

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in service. Allowable depreciation of $14,526 was taken for years 2019 through 2023. In 2023, taxpayer had a $5,000 casualty loss from a storm that wasn't covered by insurance on the building, and claimed a deduction for the loss. Taxpayer spent $5,500 to repair the damages and to otherwise improve the building. The adjusted basis of the building on January 1, 2024, is calculated as follows:

Original cost of building incl. fees & comm.		$72,275
Adjustments to basis:		
Add:		
Improvements		20,000
Repair of damages		5,500
		$97,775
Subtract:		
Depreciation	$14,526	
Deducted casualty loss	5,000	
		(19,526)
Adjusted basis on January 1, 2024		$78,249

The $10,325 basis of the land remains unchanged, as it is not affected by the adjustments.

Example 2. Taxpayer purchased a building in 2000 for $75,000 to be used in his business. The building is a MACRS asset. Taxpayer removed and abandoned the roof on the building and replaced it with a new roof, making the partial disposition election to recognize loss on the abandonment of the old roof by reporting the loss on a timely filed tax return. The loss is the adjusted basis of the roof as of the first day of the tax year of the abandonment. The abandoned roof was placed in service in 2000 with the building. The unadjusted basis of the building attributable to the roof is $5,000, and after depreciation of $3,500 on the roof, its adjusted basis as of the first day of the tax year of the abandonment is $1,500. The $1,500 ordinary loss is reported in Part II of Form 4797. The depreciation records must be documented to show the reduction to the unadjusted basis of the building, $75,000, by the unadjusted basis of the roof, $5,000, as well as a reduction of the accumulated depreciation of the building by the accumulated depreciation on the roof, $3,500. The cost of the replacement roof must then be capitalized and added to the basis, to be depreciated as a separate asset from the building.

D. Adjustments to Basis in Company Interests. While a full discussion of how closely held partnerships and corporation basis is adjusted each year is beyond the scope of this outline, it is important to understand that an owner's basis in their company ownership is normally altered or adjusted each year based on several items, such as the revenue and profit of the company, any losses or expenses taken during the year, and distributions made to the owners by the company.

E. Cost Segregation Study. Taxpayers are often looking for ways to increase deductions to reduce annual income taxes. One of the ways this is done with respect to the basis of an asset is with a cost segregation study. For real estate that has been constructed, purchased or remodeled, a study can be done to pull out certain parts of the cost and allocate them to shorter

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depreciation recovery periods rather than the typical 27.5 and 39 year recovery periods for real estate. The larger deductions reduce the current taxable income and resulting tax liability.[6]

F. How to Establish the Basis of an old Asset? It is often difficult to determine the basis of an asset that is being sold because the taxpayer has owned the asset for several years and has not maintained an ongoing record of all transactions and events that effect the basis of the asset. As required by the IRS, the taxpayer needs to keep an accurate record of all capital improvements made to assets and all depreciation that has been taken against the asset. Also, if a person inherits property, it is important to know the fair market value of the asset that existed when the taxpayer received the asset. As discussed below, a person generally receives a stepped-up tax basis under IRC §1014 when an asset is inherited. The basis of inherited property is sometimes found on the inventory filed as part of the probate administration. While a personal representative can generally choose the value they put on the inventory, it is important for IRS purposes that the value can be supported. There is also an option of commissioning an appraiser to determine the fair market value of an asset as of the date it was inherited.

G. Gifted Assets - Carry-over Basis. Gifts between spouses are tax exempt under §2523(a). Gifts to anyone other than a spouse are subject to a gift tax unless an exclusion applies. Section 2503 of the IRC includes certain exclusions from the gift tax. The most notable is the annual gift tax allowance under §2503(b)(2), which is $10,000 indexed for inflation, with the current indexed amount for 2024 being $18,000. This amount can be doubled or what is referred to as "split" for married couples. Section 2503(e) also provides exclusions for certain medical and education expenses paid for another person. For assets gifted to another person that exceed the annual gift tax allowance, the giver or donor is responsible for filing a 709 Gift Tax Return and paying any resulting gift taxes. The donor would most often not have to pay any tax because each person has a unified credit against estate and gift taxes that would be used before any taxes would be due. The current 2024 unified estate and gift tax credit is $13,610,000.[7]

The important point regarding basis under this item is that under IRC §1015 the donee of the gift will receive a carry-over basis with the asset received. The carry-over basis is simply the same basis that the donor had in the asset prior to the gift. However, in certain circumstances a non-spouse recipient or donee of an asset could receive a lower basis if the fair market value of the asset is lower than its basis when the transfer is made, or a higher basis if the donor pays a gift tax when the transfer is made.[8]

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[6] For a more detailed discussion of how cost segregation studies work and an indication of how the IRS works with them, please see the IRS Cost Segregation Audit Technique Guide found at www.irs.gov/pub/irs-pdf/p5653.pdf.

[7] Please see IRC §§ 2010 and 2505. This amount is set to sunset at the end of 2025, unless Congress acts to extend the related tax provisions.

[8] See IRC § 1015(a), (d) and (e) and § 1041(a) and (b)(2).

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H. Like Kind Exchanges. A way to maintain the adjusted basis of an asset sold and transfer it to another asset without recognizing gain is to sell the asset and purchase another asset as part of a IRC §1031 tax-free like-kind exchange. The underlying idea behind a like-kind exchange is to exchange properties of similar nature or character rather than liquidating the investment and paying tax on any gain. With an exchange, the government allows the taxpayer to defer any gain until later when the replacement property is sold. The most common type of exchange is a deferred-exchange. Other types of exchanges include a simultaneous exchange, a build-to-suit exchange, and reverse exchange.

Under the Tax Cuts and Jobs Act of 2017, §1031 now applies only to exchanges of real property and not to exchanges of personal or intangible property. Real estate, improved or unimproved, held for investment will normally constitute like kind property to other real estate, improved or unimproved, to be held for investment or business purposes. Real estate held as inventory by a dealer in real estate, such as a builder or developer, would not qualify for an exchange. Sometimes, real estate dealers will set up a separate investment company to purchase and hold real estate and then later sell it at a profit, which would be taxed at a lower capital gains rate, to the dealer's retail real estate company, which would then improve the property and sell it to a consumer. This would afford a lower tax rate for some of the appreciation in the land. Property sold by a real estate dealer would be taxed at ordinary income rates instead of the capital gains rate.

To comply with the §1031 rules, the taxpayer must identify replacement property for the exchange within 45 days of selling the relinquished property, and must close on the replacement within 180 days from the sale of the relinquished property. The identified property can be either up to three potential replacement properties of any value, or any number of properties that do not exceed two times the value of the relinquished property.

Some additional nuances of like kind exchanges involve selling property held in an entity, selling a partial interest, and purchasing property from a related person. The §1031 rules require that the party purchasing the new replacement property is the same party that sold the relinquished property. Taxpayers are allowed to sell a partial interest in real estate as well. If some but not all of the owners of an LLC that owns property want to do a §1031 exchange, it may be possible to distribute the property out of the LLC to its owners pro rata and then each owner can sell its portion and choose whether to do a §1031 exchange with their portion. With related parties, there are special rules regarding how long the replacement property must be held. In a normal like kind exchange, there is no minimum holding period. However, when a related party is involved, if the taxpayer disposes of the replacement property within two years after acquiring it, the taxpayer could lose its tax deferral and be required to recognize gain income and pay tax from the sale of the relinquished property.

IV. Stepped-up Basis. One of the few bonuses found in the Internal Revenue Code is the stepped-up basis that recipients acquire for assets received from a decedent. This allows the recipient to reset the basis of the asset received to the fair market value of the asset as of the date of the decedent's death. This tax law is set forth in IRC §1014 and provides that certain assets included

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in the gross estate of the decedent will receive a stepped-up basis. There are twists and turns with these tax provisions as will be outlined below. It is helpful to start with reviewing the pertinent portions of §1014 and then some of the estate inclusion provisions.

IRC §1014

(a) In general. Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be—

(1) the fair market value of the property at the date of the decedent's death,...

(b) Property acquired from the decedent. For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

(1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;

(2) Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;

(4) Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;

(5) In the case of decedents dying after August 26, 1937, and before January 1, 2005, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent's death was, under the law applicable to such year, a foreign personal holding company. In such case, the basis shall be the fair market value of such property at the date of the decedent's death or the basis in the hands of the decedent, whichever is lower;

(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State,

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or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

[(7), (8) Repealed, Dec. 19, 2014, 128 Stat. 4049]

(9) In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. Such basis shall be applicable to the property commencing on the death of the decedent. This paragraph shall not apply to—

(A) annuities described in section 72;

(B) property to which paragraph (5) would apply if the property had been acquired by bequest; and

(C) property described in any other paragraph of this subsection.

(10) Property includible in the gross estate of the decedent under section 2044 (relating to certain property for which marital deduction was previously allowed). In any such case, the last 3 sentences of paragraph (9) shall apply as if such property were described in the first sentence of paragraph (9).

A. Assets Must be Included in Decedent's Gross Estate. The assets received from a decedent under §1014(a) must have been included in the decedent's gross estate. IRC §2031(a) provides that a decedent's gross estate shall include the value of all items of property, real or personal, tangible or intangible, wherever situated, to the extent provided for in Part III of Subchapter A of Chapter 11 of the IRC. This Part includes sections 2031 through 2046.

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B. Not all Assets in Decedent's Gross Estate Receive a Stepped-up Basis. Certain assets included in the gross estate of the decedent do not receive a stepped-up tax basis, such as tax deferred retirement accounts and annuities. The recipient of those assets will be responsible to pay for the related income taxes when those assets are received.[9]

C. Certain Estate Inclusions Sections included in §1014. The primary sections of the estate inclusion provisions of the Internal Revenue Code that apply to a stepped-up basis are Sections 2036, 2038, and 2041. The issue with Sections 2036 and 2038 is whether assets transferred into a trust will be included in the estate of decedent and receive a new basis when the creator or grantor of the trust dies.

IRC §2036 provides that when the grantor of a trust transfers an asset into the trust and reserves the right to receive the income of the asset[10], that the grantor will be treated as owning the asset for estate tax purposes upon their later death. The main intent of this provision is to make sure that the asset will be included in the taxable estate of the grantor and be subject to an estate tax. Since the law was initially enacted, the estate tax credit has risen to a point that the vast majority of estates are not taxable. This leaves a resulting effect of using the provision to support a stepped-up basis upon the death of the grantor. This provision, along with Section 2038, is referred to as a string provision, because the grantor is looked at as transferring the asset into the trust with strings attached, such as the right to receive income from the asset[11].

IRC §2038 provides that when the grantor of a trust transfers an asset into a trust and retains the power to alter, amend, revoke, or terminate the trust, the grantor will be treated as the owner of the asset for estate tax purposes upon their later death. The part about being able to revoke the trust is simple, such as when a revocable trust is established. However, it gets more interesting when a grantor establishes an irrevocable trust that they cannot revoke but within which

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[9] The receipt of tax deferred retirement accounts can be delayed based on who receives the account. For example, (i) a surviving spouse can essentially make the received account their account and treat it as if they funded it; (ii) a disabled person or a person less than ten years younger than the account owner can spread it out over their life, (iii) and children of the age of majority can spread it out over a ten year period. However, if the account owner was receiving required minimum distributions before their death, the recipient must continue to receive such distributions. See IRS Notice 2022-53.

[10] The right to reside in a real property rent-free is also treated as an income interest for purposes of this provision. See Estate of Linderme v. Commissioner, 52 T.C. 305 (1969).

[11] IRC §2037 is also considered a string provision and could bring in the value of a reversionary interest retained by the grantor to the grantor's estate tax calculation and thus invoke IRC §1014(b)(9). However, since this provision is often invoked only when a grantor unintentionally retains some sort of a reversionary interest and such reversionary interest is difficult to calculate, it is rarely used to support a stepped-up basis upon death.

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the grantor retained the power to alter the beneficiaries of the trust through a retained limited power of appointment. When a grantor retains the right to later appoint the assets to limited members of a class, this provision will bring the assets back into the estate of the decedent for estate tax purposes, and also for the purpose of the beneficiary of the trust receiving a stepped-up basis. Note that the limited power of appointment mentioned in this paragraph is different than the general power of appoint which will be discussed below. It is also important to note that the limited power of appointment in this context must have been one reserved or retained by the grantor of the trust. It would not apply in this context when a grantor gives someone other than themself the limited power to appoint assets of the trust. Again, this is considered a string provision. The provisions of Sections 2036 and 2038 are incorporated in IRC §1014(b)(2) & (3).

IRC §2041 provides that when a person possesses a general power of appointment over an asset, the asset will be included in their estate for estate tax purposes. This will apply whether the grantor retains a general power of appointment over an asset or if the general power of appointment was previously given to the person from someone else. For that reason, this is generally not considered one of the string provisions. A general power of appointment is the power to appoint an asset to anyone, even the general creditors of the person that has the general power of appointment. This provision is incorporated in IRC §1014(b)(4). General powers of appointment are often used in estate plans and need to be considered for stepped-up basis purposes. They can also be helpful in avoiding generation skipping taxes by including them in trusts where a non-skip person only has an income interest. Granting a general power of appointment to the non-skip person would have the effect of including the assets of the trust in their estate upon their death. To avoid having a power of appointment considered a general power of appointment, it can be limited by an ascertainable standard.[12]

D. Community Property. IRC §1014(b)(6) provides that property which represents a surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939, the surviving spouse will receive a stepped-up basis in all the property. This is different than non-community property states that only allow a stepped-up basis in the property included in the decedent's estate. There are nine community property states in America, which include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

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[12] Under § 20.2041-1(c)(2) of the Estate Tax regulations, a power of appointment is limited by an ascertainable standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his or her needs for health, education, or support (or any combination of them). Typical language would allow a person to appoint assets to someone for their health, education, maintenance, and support in reasonable comfort, taking into consideration other assets of the person.

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This is important for practitioners in non-community property states to know, because if someone owns property in a community property state and moves to a non-community property state and retains the property, they may also want to retain the status of the existing property as community property for stepped-up basis purposes.

E. Revenue Ruling 2023-2. There was a lot of misguided discussion when this Revenue Ruling came out. A cursory reading of the Ruling without understanding Section 1014 could lead to the incorrect conclusion that assets transferred to any irrevocable trust would not receive a stepped-up basis. This Ruling essentially restates that which was already the case. The twist or nuance that caused a confusion was that the trust involved in this ruling included provisions that caused the grantor to be deemed the owner of the assets for income tax purposes under the grantor trust rules included in IRC §§ 671-679 but which excluded the assets from being included in the grantor's estate for estate tax purposes. Trusts of this nature are what are called intentionally defective grantor trusts or IDGTs. They are specifically designed to include the assets in the grantor for income tax purposes (considered the intentionally defective part) but not for estate tax inclusion purposes. All this Ruling did was confirm that assets in these types of trusts would not receive a stepped-up basis. Part of the confusion in this matter is also attributable to the earlier Revenue Ruling 84-139, which provided that a United States citizen who inherits foreign real property from a nonresident alien would receive a stepped-up basis in such property under IRC §1014 even though the property is not includible in the value of the decedent's gross estate. In that case, the property was inherited from the person and not part of a trust, and fell within provisions of IRC §1014(b)(1). Revenue Ruling 2023-2 made it clear that this rationale will not apply to property that is transferred to an IDGT.

F. Single Revocable Trust Provisions that Cause Stepped-up Basis.

(i). Revocation and Amendment. The Grantor reserves the right to revoke or amend this Trust Agreement by a writing (other than the Grantor's Last Will and Testament) signed by the Grantor and delivered to the Trustee during the Grantor's lifetime. The duties or compensation of the Trustee shall not be changed without the consent of the Trustee. If this Agreement has been revoked at the Grantor's death and an insurance policy is payable to the Trustee, the Trustee shall distribute the net proceeds of the policy to the Grantor's estate.

(ii). Power over Assets. The Grantor reserves the right to direct the investment of the Trust Estate and to require the immediate distribution of all or any part thereof.

G. Joint Revocable Trust Provisions that Cause Stepped-up Basis.

(i). Description of Property Transferred. The Grantors hereby pay over, assign, grant, convey, transfer and deliver unto the Trustee the property described in Schedule A, attached hereto, and have caused or will cause the Trustee to be designated as beneficiary of those life insurance policies described in Schedule B, attached hereto. The Grantors also reserve for themselves and other third parties the right to make additional contributions to the Trust. The

insurance policies, and any other insurance policies that may be delivered to the Trustee hereunder or under which the Trustee may be designated as beneficiary, the proceeds of all such policies being payable to the Trustee, and any other property that may be received or which has been received by the Trustee hereunder, as invested and reinvested (hereinafter referred to as the "Trust Estate"), shall be held, administered and distributed by the Trustee as hereinafter set forth. Notwithstanding the foregoing, separate property of a Grantor transferred to the Trust by a Grantor shall retain its character as separate property of such Grantor after the transfer to the Trust.

(ii). Revocation and Amendment. The Grantors reserve the right at any time to revoke or amend this Trust Agreement in any way by a writing signed by both Grantors and delivered to the Trustee. The Grantors further reserve unto the surviving Grantor the right to revoke or amend this Trust Agreement in any way after the death of the first Grantor to die. The duties or compensation of the Trustee shall not be changed without the consent of the Trustee. This Trust shall become irrevocable upon the death of the last Grantor to die.

(iii). Power over Assets. Notwithstanding the other provisions of this Trust Agreement, each Grantor reserves the right to direct the investment of and withdraw from the Trust all or any portion of the property which such Grantor transferred to the Trust, as invested and reinvested, together with the rents, issues and profits therefrom, without the consent of the other Grantor or any other party, and to take any additional action as may be necessary to ensure that such property retains its character as the separate property of the Grantor who transferred such property to the Trustee. *[This language is included so the surviving grantor will get a stepped-up basis in the assets that the first to die grantor transferred into the trust.]* The Grantors further reserve unto the surviving Grantor, the right to direct the investment of and withdraw all or any portion of the entire Trust Estate after the death of the first Grantor to die, without the consent of any other party.

H. Irrevocable Trust Provisions that Cause Stepped-up Basis.

(i). Exercise of Limited Power of Appointment. Notwithstanding any other provision hereunder to the contrary, the Grantor reserves and retains for itself the power to appoint the Trust assets to any one or more of the Grantor's issue in writing with signature acknowledged *[this provision triggers the grantor trust rule under IRC §674(a)]* or by a testamentary provision in the Grantor's will *[this triggers estate inclusion under IRC 2038 and stepped-up tax basis under IRC §1014.]* which makes specific reference to this provision. The Grantor may not exercise this limited power of appointment in favor of the Grantor, its respective estate, or its personal or estate creditors.

(ii). No Exercise of Limited Power of Appointment. If the Trustee has not received actual notice of the existence of the exercise of this limited power of appointment by the Grantor within ninety (90) days after the Grantor's death, after reasonable search and review, then this Trust may be distributed as if the Grantor had not exercised the limited power of appointment granted herein, and the Trustee shall be released from any liability related thereto.

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(iii). Power of Substitution. The Grantor shall have the right, subject to the approval of the Trust Protector, to direct the distribution of any item or items of Trust property to the Grantor provided the Grantor contemporaneously with such distribution contributes assets of equivalent value to the Trust (a "Substitution Transaction"). At least ten (10) business days in advance of a contemplated Substitution Transaction, the Grantor shall provide the Trustee and Trust Protector a written statement of the assets proposed to be distributed and the assets proposed to be contributed, together with reasonable documentation to enable the Trustee and Trust Protector to verify that the assets to be distributed are of value equivalent to the assets to be contributed. The Trustee or Trust Protector may request from the Grantor additional documentation that may be reasonably necessary to verify the asset values, and in connection therewith, the Trustee or Trust Protector may take as much additional time as may be reasonably necessary to verify asset values. No obligation to verify asset values on the part of the Trustee or Trust Protector, however, shall allow the Trustee or Trust Protector to designate assets to be distributed or demand alternate assets to be contributed in the proposed Substitution Transaction. *[This provision is included in the outline to show how the grantor trust rule under IRC §675 is triggered to make the income in the trust taxable to the grantor during the grantor's life.]*

I. IRC §1014(e). Practitioners familiar with the estate inclusion and stepped-up basis provisions of the Internal Revenue Code may naturally look for ways to take advantage of them by transferring assets into the name of a spouse that is expected to pass in a short time or by granting each spouse a general power of appointment over each other's assets. The intent with this type of thinking is to have the basis in all the couple's assets reset when the first spouse passes. Section 1014(e) was enacted in part to keep this from happening. IRC §1014(e) states:

> (e) Appreciated property acquired by decedent by gift within 1 year of death
>
> (1) In general
>
> In the case of a decedent dying after December 31, 1981, if—
>
> (A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and
>
> (B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

The important points to take away from this section is that to receive a stepped-up basis, any transfers must be made more than one year from the date of death or the assets need to pass to someone other than the person that transferred them to the decedent. With giving each spouse a general power of appointment over each other's assets, Section 1014(e) would, absent some unknown planning technique, always work to prohibit that because upon the death of the first spouse to die the general power of appointment lapses and the surviving spouse is deemed at that time to have gifted assets to the deceased spouse and then immediately receive them back from the deceased spouse, which would clearly be within one year of death.

J. IRC §754 Election. As stated above with partnerships, a partner has an outside basis in his or her partnership interest. The partnership also has an inside basis in the assets owned by the partnership. Under Section 754, when a partner dies, the partnership can file an election that will allow the deceased owner's portion of the partnership assets to be stepped-up to the value of the partner's outside basis in his or her partnership interest. This is often done when a partnership owns real property that has either been depreciated or has increased in value inside the partnership. This election is essentially used to allow the deceased partner to reach inside the partnership and step-up the basis of the assets owned inside the partnership, when without the election the only asset that would receive a step-up would be the deceased partner's partnership interest.

V. Conclusion. The initial thoughts about tax basis may seem simple, but when facts are applied to the rules and the different issues are considered, it becomes evident that tax basis can be a very involved discussion. This outline was intended to generally cover most of the issues that are encountered with tax basis, with the understanding that each issue, depending on the facts encountered by a practitioner, could be drilled into deeper, and with the understanding that more nuanced issues exist that may not have been covered in this outline. The author hopes these materials have been helpful to achieve a better understanding of tax basis.

The information contained in this outline shall not constitute legal or tax advice to any person or entity. Readers of this outline should conduct their own independent research regarding the information set forth herein.

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