26 T.C. 1055 (1956)

When property is transferred to an irrevocable trust, the basis for determining gain or loss on the sale of that property is the donor's basis at the time of the gift, not the fair market value at the time of the grantor's death, unless the grantor retained a complete right of revocation.

Summary

In 1928, Henry K. S. Williams created an irrevocable trust, transferring rental property with the grantor retaining life income and the power to alter the trust terms, but not to revoke the trust or reclaim principal. After the grantor's death, the beneficiaries, including Rosalie Post, sold the property at a loss. The Commissioner determined the basis for calculating the loss was the property's fair market value at the grantor's death, resulting in a capital loss. The Tax Court held the proper basis was the grantor's original basis due to the irrevocable nature of the gift. The Court further found Post's loss to be ordinary, as she was in the business of renting real estate. The court's decision clarified that Section 113(a)(5) applies only when the grantor retains a complete right of revocation.

Facts

On November 28, 1928, Henry K. S. Williams created an irrevocable trust. He transferred rental property to the trust, reserving a life income. He retained the right to alter the trust's terms and change beneficiaries, but not to revoke the trust or reclaim any principal. Williams died on May 16, 1944, and Post received an undivided one-fifth interest in the property. Post and the other beneficiaries rented the property until February 1, 1945, when they sold it. The adjusted basis of the property on November 28, 1928, was $87,024.39, while the fair market value at that time was $155,000. The property was properly included in Williams' gross estate for estate tax purposes, valued at $35,000. Post claimed a long-term capital loss on her 1945 tax return, using the grantor's basis, and carried this loss over to subsequent years. The Commissioner determined the basis to be the fair market value at the grantor's death, resulting in a capital loss. Post claimed the loss was an ordinary loss.

Procedural History

The petitioner, Rosalie Post, filed income tax returns for 1945, 1946, and 1947. The Commissioner of Internal Revenue determined deficiencies in Post's income taxes for these years. The petitioner claimed a long-term capital loss on the sale of the property. She subsequently filed a claim for a refund, arguing the loss was ordinary, not capital. The respondent (Commissioner) determined the property's basis and treated the loss as capital. The case was heard by the U.S. Tax Court.

Issue(s)

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1. Whether the proper basis for computing the loss sustained on the sale of the Beaver Street property was the grantor's basis at the time of the transfer or the fair market value at the time of the grantor's death?

2. Whether the loss sustained was a capital or an ordinary loss?

Holding

1. No, because the grantor did not retain a complete right of revocation, the basis for computing the loss was the grantor's basis at the time of the initial transfer in 1928, as the gift was irrevocable.

2. Yes, because Post was engaged in the business of renting the real property, and the loss was from the sale of property used in her trade or business, it was an ordinary loss.

Court's Reasoning

The court analyzed whether Section 113(a)(5) of the 1939 Code applied, which dictates basis when property is acquired by a transfer in trust where the grantor retained the right to revoke. The court determined that because Williams did not have a complete right of revocation, Section 113(a)(5) did not apply. "Here the grantor reserved the right to alter any and all of the terms and provisions of the trust except that those powers could not be used to revoke the trust or to revest in him or his estate, in whole or in part, any part of the principal of the trust estate." The court found the applicable section was 113(a)(2), which applies to gifts. The court concluded that the gift occurred in 1928 when the trust was established, because at that time "the grantor irrevocably parted with the corpus of the trust." The court also found that the petitioner was engaged in the business of renting the real property; therefore, the loss on its sale was an ordinary loss under Section 117(j), which applies to the sale of property used in a trade or business.

Practical Implications

This case reinforces the importance of the terms of a trust agreement in determining the tax consequences of property transfers. When a grantor does not reserve a complete power of revocation, the basis of the property is determined by the original transfer, and the property is treated as a gift under Section 113(a)(2). This has implications in estate planning and gift tax law. This case informs how to characterize the nature of losses from the sale of real property, confirming that if the owner is engaged in the business of renting that property, a loss on its sale will generally be ordinary. This case highlights that merely retaining the power to alter the trust terms, without the power to revoke, does not trigger the application of a stepped-up basis at death as would occur under 113(a)(5). Subsequent cases citing *Post* will likely focus on whether the grantor had a complete power of revocation or merely the power to amend the trust. This also underscores that the timing of a

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gift is crucial to determining tax basis under the gift tax provisions and the income tax provisions; the gift occurs at the time the donor relinquishes substantial dominion over the property. This case also shows that the determination of whether a taxpayer is engaged in a trade or business is a question of fact, as evidenced by the court's conclusion that the taxpayer was involved in the business of renting out real estate.

Meta Description

This case clarifies how to determine the basis and character of loss on property transferred through an irrevocable trust, emphasizing the importance of the grantor's rights. It clarifies the difference between a grantor's right of revocation and a right to amend a trust.

Tags

Post v. Commissioner, U.S. Tax Court, 1956, Basis, Irrevocable Trust, Ordinary Loss, Section 113(a)(2)

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