30 T.C. 845 (1958)

The basis of property sold by an irrevocable trust, where the settlor retained the income for life but did not retain the power to revoke the trust, is the cost of the property to the settlor, not the fair market value at the date of the settlor's death.

Summary

In 1939, Harold Spero created an irrevocable trust, transferring stock to his brother, Gerald, as trustee. The trust provided that Harold would receive the income for life. Harold did not retain the power to revoke the trust. After Harold's death, the trust sold some of the stock. In calculating the capital gain, the trust used the stock's fair market value at the date of Harold's death as its basis. The IRS determined that the basis should be the cost of the stock to Harold. The court sided with the IRS, holding that because Harold had not reserved the power to revoke the trust, the basis of the stock was its cost to Harold.

Facts

Harold Spero created an irrevocable trust on March 29, 1939, naming his brother, Gerald, as trustee. Harold transferred stock in United Linen Service Corporation and Youngstown Towel and Laundry Company to the trust. The trust instrument provided that Harold would receive the income for life. The trustee had the discretion to invade the corpus for Harold's benefit. Harold did not retain the power to revoke the trust. Harold died in 1946. The trust later sold some of the stock in 1949 and 1950. The trust used the fair market value of the stock at the time of Harold's death to calculate its basis and determine the capital gain. The IRS determined that the basis of the stock should have been its original cost to Harold.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in income tax for the trust for 1949 and 1950, resulting from the IRS's determination of the proper basis for the stock. The Trust contested the deficiencies in the U.S. Tax Court.

Issue(s)

1. Whether the basis of the stock sold by the trust should be determined under Section 113(a)(2) or Section 113(a)(5) of the 1939 Internal Revenue Code?

2. Whether the amount paid to Harold's widow, attorneys' fees, and estate taxes, should be included in the basis of the stock sold by the trust?

Holding

1. No, because the trust was irrevocable, Section 113(a)(2) of the 1939 Internal Revenue Code applied, so the basis was the cost of the stock to Harold.

2. No, the amounts paid to Harold’s widow, attorneys’ fees, and estate taxes were not includible in the basis.

Court’s Reasoning

The court relied on Section 113(a)(5) of the Internal Revenue Code of 1939, which provides that the basis of property transferred in trust is its fair market value at the grantor’s death if the grantor retained the right to income for life AND retained the right to revoke the trust. Here, Harold retained the income for life, but did not retain the power to revoke the trust. The power to invade the corpus was vested solely in the trustee. Therefore, the basis was determined by Section 113(a)(2) of the 1939 Internal Revenue Code, which states that the basis is the same as it would be in the hands of the donor. The court also held that the settlement paid to Gladys, Harold’s widow, was not an increase to the basis, and that the attorneys’ fees were not a proper addition to the basis of the stock.

Practical Implications

This case is critical for any attorney advising on trust and estate planning, particularly when structuring irrevocable trusts. The case clarifies that to obtain a stepped-up basis (fair market value at the grantor’s death) for assets held in trust, the grantor must retain the right to revoke the trust. Without the power to revoke, the basis remains the grantor’s original cost. This ruling affects how capital gains are calculated when trust assets are sold after the grantor’s death and guides estate planners in drafting the terms of an irrevocable trust. Because the decision turns on the language of the trust instrument, attorneys must ensure that the trust language explicitly reflects the grantor’s intent. This case also underscores the importance of a clear power of revocation to obtain a stepped-up basis. Moreover, payments to settle claims against a trust are not added to the basis of trust assets.

