Transferee's Basis in Estate Property Acquired from a Decedent Who Died in 2010

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Prior to 2010, property transferred from the estate of a decedent received a new tax basis. The new tax basis was the fair market value of the transferred property, determined either on the date of death or on the alternative valuation date. For decedents who died in 2010, there is a new estate property transfer procedure. Generally, for decedents who died in 2010, the transferee's basis in the acquired property is the lessor of the decedent's basis in the property or the fair market value of the property on the date of death.

Introduction

Lawyers, accountants, financial advisers, and valuation analysts who practice in the estate planning and administration discipline face a unique set of circumstances related to the estates of decedents who died in 2010.

The question facing these professionals (and the estates that they advise) is: If property is inherited or otherwise received from a decedent who died in 2010, how does the estate (or its beneficiaries) determine the transferee's tax basis in the property acquired?

Prior to 2010, the general estate tax procedure was that property received from a decedent acquired a new tax basis. The transferee's new tax basis was generally equal to the fair market value of the transferred property either:

1. at the date of the decedent's death or
2. at the alternate valuation date, if applicable.

This historical transferred property tax basis adjustment procedure is codified in Internal Revenue Code Section 1014. The change in the historical basis adjustment procedure for decedents who died after the year 2009 is codified in Section 1014(e).

However, for property acquired from a decedent who died during 2010, a modified carryover basis procedure will apply. See Section 1022.

The 2010 modified carryover basis procedure is the result of the repeal of the estate and generation-skipping transfer (GST) taxes that became effective on January 1, 2010.

The Economic Growth and Tax Relief Reconciliation act of 2001 (EGTRRA), repealed the estate and GST taxes for the one-year period beginning January 1, 2010. EGTRRA also adopted the modified carryover basis procedure for 2010.

Although both Congress and the President indicated their intention to revise the estate tax law (so that the 2009 estate tax rates and exemptions and the 2009 property step-up basis rules would apply during 2010), that has not happened. Accordingly, effective January 1, 2010, the estate tax and the GST tax were both repealed for 2010.

Some Congressional members have indicated the desire to retroactively impose the estate and GST taxes and to repeal the modified carryover basis back to January 1, 2010. However, there is some uncertainty as to whether such a retroactive enactment of the estate and GST taxes would even be constitutional.

In 2010, the modified carryover tax basis procedure provides that the estate or the beneficiary will receive property transferred from the decedent at a tax basis equal to the lesser of:

1. the decedent's basis in the transferred property or
2. the transferred property's fair market value as of the date of death. See Section 1022(a).

Therefore, this 2010 modified carryover basis procedure places a burden on estate executors, trustees of a decedent's revocable trusts, beneficiaries, heirs, and their legal/financial advisers.

This burden is to determine the basis of assets that are acquired from a decedent. And, this burden is particularly relevant if the decedent's estate has a built-in gain in excess of $1.3 million.

The 2010 Transferred Property Basis Procedure

The 2010 tax basis procedure is that property acquired from a decedent who died in 2010 is treated as if the property is acquired by gift.

The tax basis of the acquired property to the transferee is equal to the lesser of:

1. the adjusted basis of the decedent's property or
2. the fair market value of the property at the date of the death. See Section 2011(a).

With the temporary repeal of the estate tax, the step-up in the tax basis of the decedent's property is lost. In fact, the tax basis of the decedent's property will step down if it has an fair market value that is less than its basis. However, the tax basis of the decedent's property will not step up.

For the modified carryover basis procedure to apply, the transferred property should be "property acquired from the decedent." See Section 1022(a)(1).

Such transferred property includes the following:

1. property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent
2. property transferred by the decedent during lifetime to a qualified revocable trust, as defined in Section 645(b)(1)
3. property transferred by the decedent during his/her lifetime to any other trust for which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of the power to alter, amend, or terminate the trust
4. any other property passing from the decedent by reason of death, to the extent that the property passed without consideration. See Section 1022(e).

Accordingly, property passing through the decedent's estate will fall within this modified carryover basis procedure. Property transferred during the decedent's lifetime into a typical revocable living trust will also be subject to this modified carryover basis procedure. This is because such a trust will qualify as a qualified revocable trust.

A qualified revocable trust is any trust (or portion thereof) that, on the date of death, was treated as owned by the decedent under Section 676. The trust will be considered owned by the decedent due to the power to revest to the decedent the title to the property of the trust.

There is an important difference between the 2010 modified carryover basis procedure and the previous step-up in basis procedure as set forth in Section 1014.

That is, the phrase "property acquired from the decedent" under Section 1014 included property required to be included in determining the fair market value of the decedent's gross estate under the estate tax. See Section 1014(b)(9).

Since there is now no federal estate tax in 2010, the concept of allowing a change in the tax basis of property included in the decedent's gross estate is simply not relevant.

Estate Executor May Still Allocate Tax Basis Adjustments so as to Increase Property Basis

The estate's executor may allocate certain tax basis adjustments on a return to be filed with the Service under Section 6018.

The information that is to be supplied on this tax return includes the following:

1. the name and tax identification number (TIN) of the transferee of the decedent's property
2. a description of the transferred property
3. the adjusted tax basis of the property in the hands of the decedent and the fair market value of the property at the date of death
4. the decedent's property holding period

5. information sufficient to determine whether any gain on the sale of the property would be treated as ordinary income
6. the amount of any tax basis increase allocated to the property by the estate's executor
7. other information required by the Treasury (See Section 6018(c))

This tax return is to be filed with the decedent's income tax return for the year of the decedent's death or on a later date to be specified in the regulations.

In general, the estate executor can allocate $1.3 million (the aggregate tax basis increase) on a property-by-property basis among the decedent's eligible built-in gain assets.

This allocation by the executor cannot increase the tax basis of any property acquired from the decedent above the fair market value of that property as of the date of death. See Section 1022(d)(2).

The $1.3 million allocation amount is increased by the sum of:

1. the amount of any capital loss carryover,
2. the amount of any net operating loss carryover that would, but for the decedent's death, be carried from the decedent's last tax year to a later tax year, and
3. the amount of any losses that would have been allowable under Section 165 if the transferred property was sold at its fair market value immediately before the decedent's death. See Section 1022(b)(2)(C).

Therefore, this basis adjustment provision allows for the step-up in basis procedure to continue to apply to a decedent's estate with a built-in gain of $1.3 million or less. The basis of depreciated property is stepped down to the property's fair market value at the time of the decedent's death.

However, the ability to allocate the Section 165 built-in losses among the decedent's appreciated property allows the "lost basis" to be shifted to the decedent's other appreciated property.

If the decedent is survived by a spouse, then the estate executor may allocate an additional $3 million (i.e., the aggregate spousal property basis increase) to:

1. any property that the surviving spouse acquires from the decedent (i.e., outright transfer property), and
2. any qualified terminable interest property (QTIP). See Section 1022(c).

There is a net effect of (1) the aggregate basis increase and (2) the aggregate spousal property basis increase. That is, for estates with a surviving spouse receiving either outright or in a QTIP up to $3 million of built-in gain assets, the total basis adjustment the estate executor may allocate is $4.3 million.

The decedent's built-in gain would need to exceed $4.3 million before the modified carryover basis procedure has an impact.

Typically, attorneys draft wills or revocable living trusts for couples with formula provisions that, due to the estate tax repeal, cause the decedent's estate to be distributed entirely to a trust that will benefit the spouse and the decedent's children.

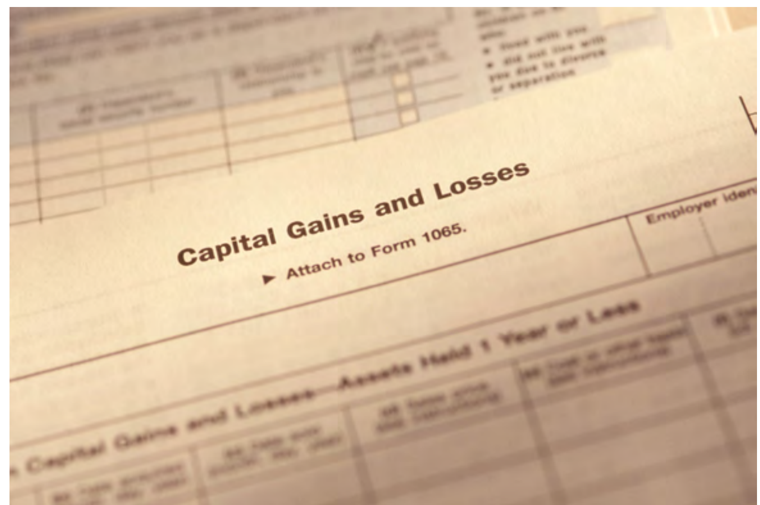
However, such a trust will not qualify as a QTIP. Therefore, the $3 million aggregate spousal property basis increase will be lost. This is because a QTIP must be solely for the benefit of the surviving spouse.

Couples with wills or revocable trusts with such formula provisions should consult with their attorney. The attorney may revise the formula provision so as to better account for the $3 million spousal property basis increase.

The attorney should note that the adjustment relates to the amount of the built-in gain of the property, not the fair market value of the property. For example, a property with an fair market value of $30 million may have a built-in gain of only $3 million.

The couple may not want the executor to have the power to allocate the $30 million to a QTIP just to allow for the allocation of the aggregate spousal property basis increase.

Similar to the step-up basis procedures for pre-2010 deaths, decedents residing in a community property state are at an advantage under the



modified carryover basis procedure. Spouses owning community property under state law are considered to own an undivided one-half interest in that property.

However, for purposes of the modified carryover basis procedure, the surviving spouse's one-half interest is deemed to be acquired from the deceased spouse. See Section 1022(d)(1)(B)(iv).

This community property procedure means that if the couple has community property with built-in gain of at least $6 million, then the estate executor should be able to take advantage of both:

1. the aggregate basis increase of $1.3 million and
2. the aggregate spousal property basis increase of $3 million.

This conclusion is true regardless of who receives the deceased spouse's property.

The Property Must Be Owned by the Decedent

In order for property to be eligible for the basis adjustments by the executor, it must be property that was owned by the decedent at the date of death. See Section 1022(d)(1)(A).

If the property is owned by the decedent and by another person as joint tenants with right of survivorship or tenants by the entirely and if the other person is the surviving spouse, then the decedent is treated as the owner of only 50 percent of the property.

If there are other tenants besides the surviving spouse and if the decedent has furnished consideration for the acquisition of the property, then the decedent is treated as the owner to the extent of the portion of the property that is proportionate to the consideration provided.

If there are other tenants besides the surviving spouse and if the property was acquired by gift, bequest, devise, or inheritance by the decedent and others, then the decedent will be treated as the owner to the extent of the fair market value of a fractional part to be determined by dividing the fair market value of the property by the number of joint tenants with right of survivorship. See Section 1022(d)(1)(B)(k).

The decedent is treated as owning property transferred during his or her life to a qualified revocable trust as defined in Section 645(b)(1). See Section 1022(d)(1)(B)(ii).

Property that is the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under community property law is treated as owned by, and acquired from, the decedent. This conclusion is true if at least one-half of the whole of the community interest in the property is treated as owned by, and acquired from, the decedent.

The decedent is not treated as owning any property by reason of holding a power of appointment for such property. See Section 1022(d)(1)(B)(iii).

Property That Is Ineligible for the Basis Adjustment

Property acquired by the decedent by gift or by lifetime transfer for less than adequate consideration during the three-year period ending on the date of death is not eligible for the basis adjustment. See Section 1022(d)(1)(C)(i).

Similar to the pre-2010 step-up in basis procedures, the stock of certain entities does not qualify for the basis adjustment procedure:

1. stock or securities of a foreign personal holding company
2. stock of a domestic international sales corporation (DISC) or a former DISC
3. stock of a foreign investment company
4. stock of a passive foreign investment company, unless such company is a qualified electing fund (as defined in Section 1295) with respect to the decedent

The Section 1022 modified carryover basis procedures do not apply to property that constitutes a right to receive income in respect of the decedent under Section 691.

This exception is consistent with the procedures that previously applied to the step-up basis procedures prior to 2010.

Estate Liabilities in Excess of the Tax Basis

The estate should determine if a gain is recognized on the receipt of the decedent's property (either directly from the decedent or from the decedent's estate).

In this determination, liabilities in excess of basis are disregarded when the property is acquired by either:

1. the decedent's estate or
2. any beneficiary other than a tax-exempt beneficiary. See Section 1022(g)(1).

A tax-exempt beneficiary is defined as:

1. the United States, any state or political subdivision thereof, any possession of the United States, any Indian tribal government, or any agency or instrumentality of any of the foregoing;
2. an organization (other than a cooperative described in Section 521) that is exempt from tax imposed by Chapter 1 (i.e., normal income taxes and surtaxes);
3. any foreign person or entity (within the meaning of Section 168(h)(2)); and
4. to the extent provided in the regulations, any person to whom property is transferred for the principal purpose of tax avoidance.

For these reasons, when an estate executor is planning the distributions of the estate assets to charities or to foreign persons, he/she should select those assets that do not have liabilities in excess of their basis.

Sunset of the 2010 Modified Carryover Basis Procedures

For a decedent who dies after 2010, the tax law will be applied as if EGTRRA "had never been enacted." For this reason, the modified carryover basis procedures will cease to apply after 2010.

The implications of these sunset provisions are uncertain. One possible interpretation is that even if a decedent dies during 2010, the step-up basis procedures of Section 1014 apply for property sales or exchanges after 2010.

The Treasury (and perhaps the courts) will need to provide guidance on the ultimate interpretation of these sunset provisions.

Summary and Conclusion

The transferee property modified carryover basis procedures became effective on January 1, 2010, and they are effective only for 2010. Lawyers, accountants, and other estate advisers will have to become familiar with a complex set of procedures related to the administration of a 2010 decedent's estate.

The burden on estate executors and other estate advisers to gather the necessary information to comply with the carryover basis procedures, especially finding the decedent's basis in certain transferred property, may be quite significant.

However, this information will be necessary in order to determine the transferee's tax basis in the 2010 estate transferred property.

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Income Tax Traps

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13. Reg. § 1.754-1(b)(1).
14. Reg. § 1.754-1(c); Sufficient cause includes: A change in the nature of the partnership business; A substantial increase in partnership assets, or; An increased frequency or shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election.
15. See Service Notice 2005-32, 2005-1 C.B. 895.
16. § 743(d)(1).
17. In the case of a basis reduction to property distributed to the transferee partner in a non-liquidating distribution, Section 743(e)(5) provides that the amount of the transferor's recognized loss taken into account under Code § 743(e)(2) is reduced by the amount of the basis reduction under Section 732(a)(2).
18. See Rev. Rulings 89-45, 1989-1 CB 267, and 89-55, 1989-1 CB 268.
19. But see Rev. Ruling 93-31, 1993-1 CB 186, in which the Service ruled that a separate share of a trust does not meet the single beneficiary requirement if there is even a remote possibility that the trust corpus will be distributed to a person other than the current income beneficiary.
20. See Reg. § 1.1361-1(j)(1)(ii).
21. See PLR 9519036 and Reg. § 1.663(b)-1.
22. PLR 8508048.
23. See Reg. § 1.1361-1(m)(1)(ii).
24. See Section 1361(e)(1)(A)(i) and Reg. § 1.1361-1(m)(1).
25. See T.D. 9422, Fed. Reg. 47526 for amendment to Reg. § 1.1361-1(m)(4)(vi).
26. See Rev. Ruling 92-84, 1992-2 CB 216.
27. See Reg. § 1.1361-1(j)(8).
28. See Reg. § 1.1361-1(j)(8).
29. See Sections 651 and 661.
30. See Reg. § 1.641(c)-1.
31. See Section 1361(e)(1).
32. See Christopher J.C. Jones and Justin Steinschriber, "Income Tax Considerations in Structuring the Sale of S Corporation Stock to a Trust," *Probate and Property*, July 2010, p. 55.
33. Section 1368(c)(1).
34. 2008-30 IRB 160.
35. Reg. § 1.1366-1(a)(2)(viii).
36. Sections 1366(a)(1)(A) and 1367(a)(1)(A). See also, Reg. § 1.1367-1(d)(2).
37. PLR 200409010.
38. Sections 1368(e)(1)(B).
39. Section 72(e); See also, Rev. Ruling 2009-13, 2009-21 IRB 1029.

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