

Estate Tax Update

Modified Carryover Basis Rules for 2010

Many of us have believed that the repeal of the estate and generation-skipping transfer (GST) taxes in 2010 would never happen, but Congress has not enacted legislation (as of this writing) that would end the repeal. For large estates of decedents dying in 2010, this may not be such a bad thing.

Unfortunately, along with the repeal of the federal estate and GST taxes for 2010, with reinstatement in 2011, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) changed the basis rules, for income tax purposes, of inherited property. A new modified carryover basis system will apply to property acquired from a decedent dying in 2010. Particularly heirs of smaller to mid-size estates would have been better off with the estate tax and former step-up-in-basis rules. They may owe significantly more in capital gains tax when they sell the inherited property.

Individuals who are (or are likely to be) impacted by these new rules should begin the necessary planning now.

Due to EGTRRA's sunset provisions, the modified carryover basis system will be replaced by the traditional date of death (or alternate valuation date) value rules in 2011. But heirs who continue to hold assets acquired from a decedent dying in 2010 will still be subject to the modified carryover basis rules until such property is sold or otherwise disposed of.

What Are the Modified Carryover Basis Rules?

General Rules - First, the bad news: Absent a retroactive law change, property acquired from a decedent dying in 2010 won't receive the traditional step-up in basis to date of death value. Instead, a modified carryover basis system applies so that property inherited from a decedent dying in 2010 will receive, as its income tax basis, the *lesser* of:

1. The decedent's adjusted basis (generally equal to cost), or
2. The fair market value (FMV) of the property at the date of the decedent's death.

Basis Increase - But, the news isn't all bad. Congress has allowed estates to increase the basis (but not above FMV at the date of the decedent's death) of up to \$1.3 million on certain appreciated assets. This is known as the *aggregate basis increase*. An additional \$3 million basis increase is available for outright transfers or Qualified Terminable Interest Property (QTIP) transferred to a surviving spouse, referred to as the *spousal property basis increase*. That means, property passing to surviving spouses outright or into

QTIP-type trusts can be allocated an increase in basis up to a total of \$4.3 million. (Because a QTIP election can't be made for decedents dying in 2010, we are calling this a "QTIP-type" trust.)

The executor can make the allocation on an asset-by-asset basis. For example, the basis increase can be allocated to a share of stock or a block of stock. The basis of an asset is never permitted to be adjusted above its FMV.

The \$1.3 million adjustment basis increase can be increased by the sum of any capital loss carryovers under IRC Sec. 1212(b) and Net Operating Loss (NOL) carryovers under IRC Sec. 172 that the decedent would have otherwise been able to carry over to a later year. It can also be increased by the sum of any losses that would have been allowable under IRC Sec. 165 (i.e., losses from a trade or business and worthless securities that have not been compensated by insurance) if the property acquired from the decedent had been sold at FMV immediately before the decedent's death.

Assets Eligible for Basis Increase - To be eligible for the basis increase under the modified carryover basis system, property must be both "acquired from a decedent" and "owned by the decedent at the time of death." Property acquired from a decedent includes the following:

- Half of property held jointly with decedent's spouse.
- Jointly held property with someone other than the spouse, to the extent of consideration provided by the decedent.
- Property transferred by the decedent to a qualified revocable trust.
- Surviving spouse's half of community property (if the deceased spouse owned at least half of the entire community property interest. In other words, the entire property interest is eligible for a basis increase.)
- Property received by gift from the decedent's spouse within three years of death unless the transferor spouse acquired the property by gift.
- Any other property passing from the decedent due to death to the extent the property passes without consideration.

Assets Ineligible for Basis Increase - Certain assets are not eligible for the allocation of the aggregate basis increase or the spousal property basis increase, including the following:

- Property that is considered income in respect of a decedent (IRD).
- Property that is acquired by the decedent by gift or by lifetime transfer for less than adequate and full consideration during the three-year period ending on the date of the decedent's death. However, property acquired by the decedent from the decedent's spouse is eligible for the basis increase unless, during the three-year period, the spouse acquired the property by gift or lifetime transfer for less than adequate and full consideration in money or money's worth.

- Stock of a foreign personal holding company, Domestic International Sales Corporation (DISC) or former DISC, foreign investment company, or passive foreign investment company (unless the company is a qualified electing fund with respect to the decedent).
- Property over which the decedent held a power of appointment.
- Property held in a Qualified Terminable Property (QTIP) trust created by a deceased spouse prior to 2010 of which the decedent (second-to-die spouse) is the income beneficiary. (This is because the property isn't considered an asset of the surviving spouse at his or her later death.)

Example 1: Carryover basis applies for property inherited in 2010.

Tim, a single taxpayer, died on 3/31/10, leaving his entire estate to his nephew, Steve. His estate includes the following assets:

Asset	Tim's Basis FMV on Date of Death	
Real estate	\$ 1,000,000	\$ 3,000,000
ABC Co. common stock	200,000	100,000
Individual Retirement Account (IRA)	—	2,000,000

Additionally, Tim had a capital loss carryover of \$68,000, which would otherwise be wasted upon his death (i.e., it doesn't carry over to the estate or other transferee). Because Tim died in 2010, Steve will inherit the property with no reduction for estate taxes (federal estate tax doesn't apply for 2010). However, unless the executor allocates any or all of the \$1.3 million "aggregate basis increase" plus the \$68,000 basis increase (Tim's unused capital loss carryover) to the assets, Steve will retain Tim's original basis on all assets except the common stock. Because the ABC Co. stock has declined in value, Steve's basis will be the lesser amount (\$100,000). The IRA is not eligible for the basis adjustment since it is considered IRD.

Example 2: Modified carryover basis applies if executor elects to allocate basis increase.

Assume the same facts as in Example 1, except that the executor of Tim's estate elects to adjust the basis of the real estate, which is the only asset eligible for the adjustment (since it has increased in value and is not IRD), to \$2,368,000 (\$1 million basis + \$1.3 million + \$68,000 basis increase for Tim's unused capital loss carryover). If the FMV of the real estate had been \$1.5 million, rather than \$3 million, the basis increase would have been limited to \$500,000, for a modified basis of \$1.5 million. This is because the basis increase can't cause the modified carryover basis to exceed the property's FMV upon Tim's death.

Holding Period Rules - The repeal of the Section 1014 estate tax value basis rules for 2010 also eliminates the automatic long-term holding period that would otherwise be available to assets received from a decedent's estate. A tacked holding period may be available, however, which allows the estate or other recipient to include the period held by the decedent, as well as the period that the estate (or other recipient) holds the asset. For the decedent's holding period to tack onto the recipient's holding period, the estate's or recipient's basis in property (for gain or loss) must be the same (in whole or in part) as the property would have in the decedent's hands.

Increase in FMV at Date of Death - If the executor allocates the decedent's aggregate or spousal property increase to the decedent's basis of the property, the tacked holding period should still be available regardless of whether the full \$1.3 million (and/or the \$3 million) basis increase is elected.

Decrease in FMV at Date of Death - If the decedent's basis in the property, as of the date of death, is lower than fair market value, IRC Sec. 1223(2) does not apply to tack the decedent's holding period onto the estate's (or other recipient's). In that situation, when the asset was sold or disposed of, the acquisition date to the estate (or other recipient) would typically be the decedent's date of death, rather than the decedent's original date of acquisition.

Liabilities in Excess of Basis - Although gain must normally be recognized when a transferor transfers property with a negative basis, liabilities in excess of basis will be disregarded in determining the adjusted basis of property that is acquired by a beneficiary (other than a tax-exempt beneficiary) from a decedent dying in 2010. This rule doesn't allow the debt to be added back to the decedent's basis in the asset or to protect the beneficiary from recognizing gain attributable to the liability when the property is later sold, though.

Example 3: No recognized gain on 2010 distribution of decedent's property with negative basis.

Betty died on 3/1/10, owning commercial property with an FMV of \$2 million (adjusted basis of \$600,000). The property is encumbered by a \$1 million mortgage. According to Betty's will, the property is to pass to her son, Raymond. The executor of Betty's estate does not allocate any of the aggregate basis increase to the commercial property.

No gain must be recognized upon Betty's death or the distribution of the commercial property to Raymond for the \$400,000 excess of debt over basis [\$1 million - \$600,000]. Raymond's basis will be Betty's adjusted carryover basis of \$600,000. He can't add the \$1 million mortgage to his basis.

What Planning Should Be Done Now?

When planning for the modified carryover basis rules, either for clients who have died in 2010 or those who aren't likely to survive until 2011, a number of issues should be considered. Some of the most important planning issues are highlighted here. For more detailed coverage of other planning issues to consider, contact a Contryman Associates professional.

Recordkeeping - Because individuals have relied on the traditional step-up in basis at death rules for a number of years, most haven't worried about keeping track of basis on all of the assets they own. Clients should be encouraged to record the cost basis and acquisition date of all assets because this substantiation may help protect their estates and beneficiaries from a future IRS challenge of asset basis issues.

Recommend Authorization of Basis Increase Allocation by Executors or Trustees - Clients with noncash assets that have (or are likely to have) appreciation of \$1.3 million or more should consider adding provisions to existing estate planning documents that give the executor or trustee the power to allocate the decedent's aggregate basis increase among all assets includable in the gross estate (i.e., both probate and non-probate assets). Executors and trustees should be compensated for any losses and held harmless for making this allocation. Alternatively, the client should consider including specific directions as to how the carryover basis modifications should be made.

Delay Post-death Funding and Sales - For individuals who have died in 2010, consider delaying distributions of assets with carryover basis and sales of assets until the uncertainty over the federal estate tax (whether it remains repealed or is retroactively reinstated) is resolved. Consider obtaining loans if funds are needed immediately. Sales of assets should also be delayed until the asset bases can be determined with reasonable certainty. Heirs may need to be informed that there could be significant income tax consequences to selling property with a carryover basis that is less than the current FMV. Having said that, remember that the potential benefit of delaying the sales of assets until 2011 should be weighed against the increase in capital gain tax rate from 15% in 2010 to 20% in 2011.

Carefully Select Assets for Basis Increase - Which assets, and in what amount, the increase in basis should be allocated should be given careful consideration. The aggregate basis increase and spousal property basis increase should ideally be first allocated to assets that, if sold, would generate ordinary, rather than long-term capital gains. (Remember that inherited assets don't automatically qualify for long-term holding periods, as discussed previously.)

It may also be wise to increase the basis for property that is likely to be sold in the near future or according to the ability of the various beneficiaries to handle additional income tax liability if they were to sell the acquired property. Assets that would be eligible for various gain exclusions (e.g., the

Section 121 gain exclusion on the sale of a personal residence) and, thus, wouldn't be likely to generate taxable gain when sold are not recommended for the allocation of basis increase. Assets passing to charity should not be allocated any of the basis increase since charities aren't taxed on gains from the sale or disposition of assets. When there is a significant amount of appreciated assets or a number of beneficiaries, the process of allocating the basis increase can be daunting.

Example 4: Allocating the basis increase for appreciated assets.

Sheri, who was married at the time of her death in 2010, has a gross estate of \$9 million, consisting of:

Asset	Sheri's Basis	FMV on Date of Death
Mutual funds	\$ 1,000,000	\$ 4,000,000
Personal residence	250,000	700,000
Jewelry (family heirlooms)	50,000	300,000
ABC stock	700,000	4,000,000
Total	\$ 2,000,000	\$ 9,000,000

For simplicity, assume that Sheri's will directs that the house is to pass to her husband, Sam, and the jewelry to her daughter, Mindy. All other assets are to pass equally between Sam and Mindy.

The mutual funds and ABC stock are distributed equally to Sam and Mindy. The executor can allocate up to \$1.3 million of the aggregate basis increase to the assets that pass to Mindy and the \$3 million spousal property increase for property distributed to Sam. Because the jewelry will be kept in the family for many years, and the personal residence is not likely to be sold in the near future (and when it is, Sam should qualify for the \$250,000 gain exclusion on the sale of his principal residence), the executor does not allocate any of the basis increase to them. Instead, he must decide between allocating to the mutual funds or the ABC stock. After discussing the issue with Sam and Mindy, the executor learned that the ABC stock is not likely to be sold soon. Neither the mutual funds nor the ABC stock will trigger ordinary income upon sale. The executor chooses to allocate the basis increase as follows:

Property Distributed	Sam's Basis Before Allocation of Increase	Spousal Basis Increase	Sam's Modified Carryover Basis	Mindy's Basis Before Allocation of Increase	Mindy's Aggregate Basis Increase	Mindy's Modified Carryover Basis
Mutual funds	\$ 500,000	\$ 1,500,000	\$ 2,000,000	\$ 500,000	\$ 1,300,000	\$ 1,800,000
Personal residence	250,000	0	250,000	N/A	N/A	N/A
Jewelry	N/A	N/A	N/A	50,000	0	50,000
ABC stock	350,000	1,500,000	1,850,000	350,000	0	350,000
Total	\$ 1,100,000	\$ 3,000,000	\$ 4,100,000	\$ 900,000	\$ 1,300,000	\$ 2,200,000

Consider Form of Asset Ownership - To maximize the basis increased under the modified carryover basis rules, it's important to evaluate the appropriate form of ownership of the client's assets. Only those assets that are both "acquired from a decedent" and "owned by the decedent at the time of death" are eligible for the basis increase. If the assets are held in trust, you'll need to determine whether they will be eligible for the basis increases. For example, property in a qualified revocable trust would be treated as owned by the decedent at the time of his or her death, whereas property for which the decedent held a power of appointment is not considered as owned by the decedent, even though it would be included in the decedent's estate under IRC Sec. 2041. Be sure to keep in mind the client's asset protection objectives when evaluating the form of ownership to maximize the basis increases.

What Reporting Will Be Required?

"Large Death Transfers" - For estates created in 2010, the executor is required to file a tax return providing information on all assets (other than cash) owned by and acquired from the decedent when the fair market value of such property exceeds the aggregate basis increase amount (without regard to built-in losses and loss carryovers). In other words, filing is required when the decedent's assets, other than cash, are worth more than \$1.3 million (\$60,000 for estates of nonresidents who are not U.S. citizens). Unfortunately, the IRS hadn't designed the form for this as of this writing, so we don't know what the return will look like. What we *do* know is that the return must include the following information:

1. The name and tax ID number of the person who acquired the property from the decedent.
2. An accurate description of such property.
3. The adjusted basis of such property in the hands of the decedent and its FMV at the time of the decedent's death.
4. The decedent's holding period for such property.
5. Enough information to determine whether any gain on the sale of the property would be treated as ordinary income.
6. The amount of the basis increase allocated to each asset.
7. Any other information required by regulations.

The return must also report any appreciated property acquired by the decedent by gift (other than from his or her spouse) that was subject to gift tax filing, regardless of whether the \$1.3 million threshold (or \$60,000 for

estates of nonresidents who are not U.S. citizens) is met. (This property isn't eligible for the basis increase, as discussed previously.)

Beneficiaries should be given a copy of this information so they're notified of the basis of any assets distributed to them. Once made, the allocation can only be changed as provided by the IRS.

Filing Due Date - The information return is due when the decedent's final income tax return is due, including extensions. This means that for estates of decedents dying in 2010, the return could be filed as late as 10/17/11 (or later if the filing deadline is extended by regulations).

Penalties for Not Filing - The penalties for not filing are pretty steep and should not be taken lightly. Unless there is a reasonable cause, a penalty of \$10,000 applies for each failure to report to the IRS transfers at death of noncash assets valued over \$1.3 million by the due date of the informational return, and a penalty of \$500 for each failure to report to the IRS the decedent's receipt of appreciated property valued over \$25,000 within three years of death. Each failure to provide the required information to a beneficiary results in a \$50 penalty.

Smaller Estates - Executors of estates with noncash assets of \$1.3 million or less aren't required to file an information return regarding the decedent's basis and the allocation of any basis increase. Although there is no authoritative provision for automatic allocation of the basis increase, presumably the bases of assets are automatically increased up to their FMV. It may be wise to file the information return, even when not required, in order to document the value. Hopefully, the IRS will clarify this issue when it releases the required form and related instructions. Although filing is not required by estates with noncash assets valued at \$1.3 million or less on the decedent's date of death, beneficiaries should be notified of the basis and holding period of any asset distributed to them.

Conclusion

It is becoming increasingly likely that the modified carryover basis rules, as onerous as they may be, are not going away. Practitioners should familiarize themselves with the new rules as soon as possible, educate executors and clients on compiling the necessary basis information, and watch for new developments. Even if the modified carryover basis rules disappear in 2011, as scheduled, they will leave a lasting "legacy" for practitioners and clients. Anyone who has inherited assets from a decedent dying in 2010 will need to keep detailed records for these assets until they're sold or disposed of, which could be many years.