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Trusts & Estates/Elder Law/Health & Hospital Law Focus

The carry-over basis dilemma

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) repealed the estate tax for 2010. Along with the repeal, EGTRRA changed the way an estate's beneficiary computes his or her income tax basis for property that is inherited. Prior to 2010, the beneficiary's basis for property inherited from an estate was its "estate tax value." Estate tax value is, generally, the fair market value of the property on the date of the decedent's death.

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Section 1022 of the Internal Revenue Code of 1986 ("IRC") provides that the income tax basis for assets inherited from an individual who died in 2010 is the lesser of the decedent's adjusted basis for the property or its fair market value. One of the major problems with this change is the determination of the decedent's basis. For assets acquired many years prior to death the determination of cost basis requires records that may no longer be available. The Internal Revenue Code very clearly provides a zero adjusted income tax basis for property for which a taxpayer cannot establish his or her cost basis.

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However, the Code contains the following two increases to carry-over basis that can be made by the decedent's executor:

1. The basis of assets inherited by a spouse, either directly or through a Qualified Terminable Interest Property (QTIP) trust can be increased by up to $3 million.

2. The basis of assets inherited by anyone can be increased by up to $1.3 million.

It should be noted that these adjustments cannot increase an asset's basis above its fair market value.

Example: A child inherits property worth $2.5 million with an income tax basis of $1 million. The executor can increase the basis of the property to $2.3 million. However, if the basis of the property was $1.5 million the executor could only increase the basis of the property by $1 million to its fair market value of $2.5 million.

With the recent decline in values of real estate and marketable securities, the beneficiary may face a "step-down" in basis.

Example: Decedent purchased real estate for $3.6 million. On the date of the decedent's death the property was worth $3 million. The beneficiary's basis will be stepped down to $3 million, the lesser of the decedent's basis or the property's fair market value.

The executor that makes the basis increase election must notify the IRS of the increases on a form (presently being developed) by April 15, 2011. The form is to be attached to the decedent's final individual income tax return. Section 6018(c) of the IRC requires that the following information must be included with the form:

1. The name and the taxpayer identification number of the recipient of the property.

2. An accurate description of the property.

3. The decedent's adjusted basis for the property and its fair market value.

4. The decedent's holding period for the property.

5. Information to determine if the gain on the sale of the property or any portion thereof would be taxed as ordinary income.

6. The amount of the aggregate or spousal increase in the basis of the property.

7. Such other information as may be required by Treasury Regulations.

A $10,000 penalty is imposed on an executor who fails to file this form timely. In addition, the

executor is also required to furnish this information to the respective beneficiaries who are affected by this increase.

In addition to the issues set forth above, the carry-over basis regime is further complicated by the language contained in Section 901(b) of EGTRRA. Section 901(b), if read literally, says that in 2011 and later years the estate and gift tax rules shall be applied and administered as if the changes made by EGTRRA "had never been enacted."

Does this mean that if an individual died in 2010 and the beneficiary or the estate does not sell any of the assets of the estate until 2011, the basis of those assets are estate tax value (fair market value on date of death)?

Example: An individual died in 2010 owing real estate worth $3 million with an adjusted basis of $1 million. Assume that no basis adjustment was made to this asset and it was sold in 2010 by the executor for its value. The estate would have a taxable gain of $2 million. If the literal reading of Section 901(b) is correct and the executor held on to the asset and sold it in 2011, for its value, no taxable gain would be realized.

Is that what Congress intended? There has been no indication as to how this is ultimately going to be interpreted. In addition, if the executor interprets this provision literally and intentionally holds off selling assets to get the higher income tax basis, what if the asset's value drops considerably? Has the executor subjected himself/herself to a lawsuit from a beneficiary? Any executor would be well advised to discuss the issue with the beneficiary and get his or her approval before taking this delaying action.

Other Issues:

1. Some commentators have suggested that since there is no estate tax for 2010 there is no need to have the decedent's assets appraised. However, if the executor is going to elect to increase the basis of assets an appraisal is needed to show that the new increased basis is not in excess of the asset's fair market value. Even where no basis adjustment is to be made, Section 1022 of the IRC provides that the beneficiary's basis is the lower of the decedent's adjusted basis or the asset's fair market value. Additionally, as previously stated, where a basis adjustment is made the executor must file a form with the IRS. Until that form and instructions are issued it is unclear as to what additional attachments (*i.e.* appraisals) might be required. Finally,if the decedent is a New York State resident or a non-resident who has real or tangible personal property with a situs in New York (and meets other criteria), a New York State estate tax may be due and an appraisal of the assets would be a necessity.

2. Some estate planners anticipated a year in which there would be no estate tax and included in their wills provisions relating to the election to increase the basis. For example, where there were multiple executors the duty to assign the asset basis increase was given to one of them. Where there were family member executors and non-family member executors, the duty to assign the asset basis increase was given, generally, to the non-family member executor to avoid any potential conflicts. Unfortunately, few estate planners believed that Congress would allow for the one-year repeal of the estate tax. Therefore, many of the wills of 2010 decedents are silent in this regard. Therefore, there are potential conflicts that can arise in who will make the ultimate decision. If the decedent named one of the children to be an executor there are potential conflicts between the executor and his/her siblings over the basis increase allocations. Some commentators have suggested that there may be potential gift tax consequences arising from these allocations.

3. Prior to 2010 any inherited property was considered to be long-term for income tax purposes. Therefore, if a decedent acquired and asset on December 1, 2009 and died on December 15, 2009, the asset was considered a long-term asset in the hands of the beneficiary and qualified for long-term capital gain benefits when sold. For 2010, this rule no longer applies. The holding period of the assets will include the decedent's holding period if the beneficiary uses the decedent's adjusted basis.

Example: An individual dies on March 1, 2010. One of the assets owned by the decedent was a parcel of land acquired six months earlier for $1 million. On the date of the decedent's death the property was worth $1.2 million. Assuming no increase was elected for this property, the estate's income tax basis is $1 million with a 6-month holding period. If on the date of the decedent's death the property was worth $950,000, the estate's tax basis for the property would be $950,000 and the decedent's holding period would not be used.

The carry-over basis rules, while simple on their face, have created complications far greater than tracing the cost basis of the decedent's assets. Estate planners, estate administration attorneys, accountants preparing estate and income tax returns and executors must be cognizant of these rules and the dilemmas that have been created. They must take steps to closely follow future developments and interpretations.

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