

Fall August 2012

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Repository Citation

Gruer, Sharon Kovacs (2012) "Basis in Inheritance after EGTRRA," *Marquette Elder's Advisor*. Vol. 5: Iss. 1, Article 6.

Available at: <https://scholarship.law.marquette.edu/elders/vol5/iss1/6>

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INHERITANCE AND THE NEW CARRYOVER BASIS RULES

Sharon Kovacs Gruer*

New Modified Carryover Basis Rules under IRC § 1022

New IRC § 1014(f) Repeals IRC § 1014 for Decedents Dying After December 31, 2009

The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) changes the current rules regarding a step-up in basis for the beneficiaries at the decedent’s death. Under current law, § 1014 of the IRC provides an adjustment in basis for property that a taxpayer acquires from a decedent. Property included in the decedent’s gross estate for estate tax purposes is given an income tax basis, subject to certain exceptions, equal to its estate tax value, which is the fair market value (FMV) as of the decedent’s date of death or the alternate valuation date.¹

However, pursuant to current IRC § 1014(e), the IRS does not give this basis adjustment, or “step-up” for appreciated property, to property which a donor gifts to the decedent within one year of the decedent’s death, where such property passes back to the donor or the donor’s spouse. Instead, the basis of such property inherited by the original donor or her spouse is the same as the adjusted basis of the property in the hands of the decedent immediately before her death.

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1. I.R.C. §§ 1014, 2032. The alternative valuation date is the date six months after the decedent’s date of death, or, if the property was sold or disposed of within six months after the decedent’s death, then the date of such sale or distribution.

CURRENT LAW

Under current law, if a mother purchased a home for \$25,000 and then died years later when it was worth \$200,000, leaving it to her children, the children would receive a stepped-up basis of \$200,000. If the children sold the home for \$200,000, there would be no capital gain. Similarly, assets placed into a revocable trust in which the mother retained the right to the income for her life and the right to amend or revoke the trust are also includable in the mother's taxable estate upon her death under IRC § 2036. Pursuant to IRC § 1014(b)(2), her children would receive a step-up in basis at her death.

Also under the current rules, if the mother had transferred her home to her children but retained a life estate or the right to live in the home for her life, upon the mother's death IRC § 2036 would include the home in her taxable estate and her children would receive a step-up in basis.² Assets placed into an inter-vivos irrevocable trust by the mother, which provided the mother with the income for life but gave the remainder to her children would also receive a step-up in basis upon the mother's death under current law because IRC § 2036 would include the trust assets in her taxable estate.³

NEW LAW

New IRC § 1014(f) repeals the above IRC § 1014 for decedents dying after December 31, 2009 and replaces IRC § 1014 with a new IRC § 1022, which provides for a modified carryover basis rather than the stepped-up basis. Under new IRC § 1022, the basis of property inherited from a decedent will be equal to the *lower* of the asset's fair market value as of the date of the decedent's death or the decedent's adjusted basis at that time. If the fair market value of an asset on the decedent's date of death is lower than the decedent's basis, the basis is stepped-down and the beneficiaries receive the lower fair market value for their basis.⁴ The step-up in basis under the new law is not unlimited as it is under the old law. The new IRC § 1022 permits a step-up in basis only in the aggregate amount of \$1.3 million of appreciation, plus \$3 million of basis increase or appreciation for assets given to a spouse, as further described below.⁵

Although it may appear at first blush that the new basis rules may

2. I.R.C. §§ 1014(b)(9), 2036(a)(i).

3. *Id.*

4. I.R.C. § 1022(a)(2)(B).

5. I.R.C. § 1022(b)(2)(B), (c)(2)(1)(B).

not be relevant for Medicaid planning where estates are often valued at less than \$1.3 million or would not need more than that amount of basis increase, details in the new rules call into question the use of life estates and other techniques commonly employed by elder law attorneys. Even if the estate itself is under \$1.3 million, a transfer of a deed with the retention of a life estate does not appear to give the remainderperson a step-up in basis under the new rules.⁶ This issue is relevant to all elder law attorneys.

It is difficult to plan and draft for changes that will not take effect for another eight years and then may only be in effect for one year. EGTRRA will expire on December 31, 2010 and the new basis rules in IRC § 1022 may be in effect only for the year 2010 if Congress does not change the law.⁷

\$1.3 MILLION OF BASIS INCREASE

New IRC § 1022 does not provide an unlimited step-up in basis, as did previous IRC § 1014. Instead, IRC §1022 permits a basis step-up only in the aggregate amount of \$1.3 million of basis increase or appreciation plus an amount equal to certain unused built-in losses and loss carryovers. In addition, IRC § 1022(c) allows a surviving spouse an additional \$3 million basis increase. These amounts are subject to cost of living increases.⁸ The \$1.3 million and \$3 million limits apply to the appreciation of the property in excess of the decedent's basis. These figures do not refer to the amount of assets, but rather to the amount of the adjustment. In other words, the limits of \$1.3 million or \$3 million are not applied to the amount of property; they are applied to the *increase in appreciation* in excess of basis. Thus, property that has a basis of \$2 million in the hands of an unmarried decedent, but is worth \$3.3 million at the decedent's death could receive an increase in basis of \$1.3 million for a new basis in the hands of the beneficiaries of \$3.3 million.⁹

A taxpayer may further increase the aggregate basis increase of \$1.3 million under IRC § 1022(a) with unused built-in losses and loss carryovers. IRC § 1022(b)(2)(C) permits an adjustment for the following types of losses.

6. I.R.C. § 1022(d)(1)(A).

7. P.L. 107-16, see § 901(1)(b). The sunset provisions made by EGTRRA provided that the amendments made by EGTRRA shall not apply to decedents dying after December 31, 2010.

8. I.R.C. § 1022(d)(4).

9. I.R.C. § 1022(b)(2)(B).

INCREASED BASIS DUE TO NET OPERATING LOSS CARRYOVER

Section 1022(b)(2)(C)(i) permits an increase in the \$1.3 million of basis increase by the amount of any capital loss carryover under IRC § 1212(b) and the amount of any net operating loss carryover under IRC § 172 which the IRS would carry, but for the decedent's death, "from the decedent's last taxable year to a later taxable year of the decedent."¹⁰

INCREASED BASIS DUE TO UNUSED BUILT-IN LOSSES

Section 1022(b)(2)(C)(ii) also permits an increase in the \$1.3 million of basis increase for the amount of any losses that would have been allowable under IRC § 165 if the property acquired from the decedent "had been sold at fair market value immediately before the decedent's death."¹¹

A decedent's estate may then use her unrealized losses to increase the basis of assets with built-in gain. If the unrealized losses equal or are greater than unrealized gains, the appreciated assets may even receive a full step-up in basis. The beneficiaries can then avoid capital gain on the sale of assets after the decedent's death without matching the sale of appreciated and depreciated assets. This benefit does not apply to nonresidents who are noncitizens under IRC § 1022(b)(2).

The Full Basis Increase Does Not Apply to Beneficiaries of Nonresidents Who Are Not Citizens

Pursuant to IRC § 1022(b)(3), the basis increase for beneficiaries of unmarried decedents who are nonresidents and noncitizens is limited to \$60,000.00 rather than \$1.3 million, and the adjustment for losses is not applicable.¹²

The Basis Increase Does Not Apply to Income in Respect of a Decedent (IRD)

Under both prior and current law, the basis increase does not apply to income in respect of a decedent (IRD) under IRC § 691.¹³ IRD is the amount that the IRS entitled to the decedent as gross income, but only if income is receivable after death. IRD is generally

10. I.R.C. § 1022(b)(2)(C)(i).

11. I.R.C. § 1022(b)(2)(C)(ii).

12. I.R.C. §§ 1022(b)(3)(A), (B).

13. I.R.C. § 1022(f).

taxed to the decedent's estate or to the beneficiary receiving the income. IRC § 691 prevents a removal of taxable income from the income tax because of a taxpayer's death. For example, if the decedent had entered into an installment agreement selling property to a buyer prior to her death, the IRS would use the decedent's basis for purposes of determining any gain and there would be no step-up in basis.

Qualified Spousal Property – Additional \$3 Million Increase in Basis

To be eligible for the additional \$3 million of basis increase for property bequeathed to a spouse under IRC § 1022(c), the property must be "qualified spousal property" under IRC § 1022(c)(3). The IRS defines this as either property transferred outright to the spouse under IRC § 1022(c)(4), or qualified terminable interest property ("QTIP") under § 1022(c)(5).¹⁴ The definition of QTIP is similar to that encompassed by the current rules of IRC § 2056. Under the new rules, the IRC defines QTIP as property that passes from the decedent and in which the surviving spouse has a qualifying income interest for life. That is, the IRS entitles the surviving spouse to all of the income from the property, payable at least annually, or has a usufruct interest for life, and no person has a power to appoint any part of the property to any person other than the surviving spouse during that spouse's life.¹⁵

PROPERTY ACQUIRED FROM A DECEDENT

The category of assets whose basis may be stepped-up under new IRC § 1022 is narrower than the category covered by current IRC § 1014. The new rules permit the stepped-up basis only for property acquired by bequest, devise, or inheritance by the decedent's estate from the decedent; for property transferred by the decedent during her lifetime to a qualified revocable trust or another trust in which the decedent retained the right to make certain changes; and for property passing from the decedent by reason of death without consideration.¹⁶

Property Acquired From a Decedent by Bequest, Devise, or Inheritance

Section 1022(e) limits the step-up in basis to property acquired from the decedent by bequest, devise or inheritance, or by decedent's estate from the decedent and only certain property transferred by the

14. I.R.C. §§ 1022(c)(4), (5).

15. I.R.C. §§ 1022(c)(5)(A), (B).

16. I.R.C. § 1022(e).

decedent during her lifetime.¹⁷

Property Transferred by Decedent During Her Lifetime

With regard to lifetime transfers, IRC § 1022(e) provides that only the following transfers qualify for stepped-up basis:

1. To a qualified revocable trust as defined in IRC § 645(b)(i), or

2. To any other trust with respect to which the decedent reserved the right to make any change in the enjoyment through the exercise of a power to alter, amend or terminate the trust.¹⁸

Property Passing From Decedent by Reason of Death

Section 1022 also applies to any other property passing from the decedent by reason of death to the extent that such property passed without consideration, such as, jointly held property or certain community property.

Property jointly owned by the decedent and her spouse is treated as one-half ownership by the decedent.¹⁹ Joint property owned by the decedent and someone other than her spouse is treated as owned by the decedent to the extent of the percentage of consideration furnished by the decedent²⁰ or, if the decedent obtained the property and any others as joint tenants by gift, bequest or inheritance, the decedent shall be treated as an owner in accordance with her proportionate interest.²¹ Community property, on the other hand, may be eligible to treatment as entire ownership by the decedent.²²

NEW IRC § 1022 DOES NOT INCLUDE SOME ASSETS THAT PREVIOUS LAW STEPPED UP

The new modified basis carryover rules deny a stepped-up basis for certain property that previous law had stepped-up. Previous IRC § 1014(b)(9) provided a step-up in basis for property included in the decedent's taxable estate for estate tax purposes. New IRC § 1022 on the other hand, does not provide a basis adjustment for all of the property that previously received a step-up. For example, new IRC § 1022 does not provide a stepped-up basis at death for property over

17. I.R.C. §§ 1022(e)(1), (3).

18. I.R.C. §§ 1022(e)(Z)(A), (B).

19. I.R.C. § 1022(d)(1)(B)(i)(I).

20. I.R.C. § 1022(d)(1)(B)(i)(II).

21. I.R.C. § 1022(d)(1)(B)(i)(III).

22. I.R.C. § 1022(d)(1)(B)(iv).

which the decedent held a general power of appointment if none of the other categories apply.²³

Section 1022 also does not appear to include property such as a remainder interest in real estate where the decedent had reserved a life estate. Furthermore, property in irrevocable trusts in which the decedent retained the income for life but gave the remainder to her children, which would currently receive a stepped-up basis under IRC §§ 2036 and 1014(b)(9), would not be treated as owned by the decedent under the new law for purposes of the stepped-up basis. This is also the case for irrevocable trusts such as Grantor Retained Annuity Trusts ("GRATS") and Qualified Personal Residence Trusts ("QPRTS") where the settlor dies during the income or annuity term. Moreover, the new rule does not permit a step-up for property that was subject to a QTIP election under IRC § 2056(b)(7) in the estate of the decedent's predeceased spouse.²⁴ QTIP property would not be eligible for any IRC § 1022 step-up upon the surviving spouse's death because the surviving spouse will not own it and the remainderpeople will not be inheriting it from the surviving spouse.

THREE-YEAR CONTEMPLATION OF DEATH RULE

The new statute provides a three-year contemplation of death rule, excluding any property acquired from the decedent within three years of death by gift for less than full consideration from the basis increase.²⁵ This differs from current law, which has only a one-year period under IRC § 1014(e).²⁶

However, this new three-year contemplation of death rule does not disqualify property acquired by the decedent from the decedent's spouse unless that spouse had received the property by gift for less than full consideration within the past three years.²⁷ Thus, a healthy spouse may gift appreciated property to a dying spouse shortly before his death to later inherit it from the recipient spouse who was on his death bed – allowing for a stepped-up basis for the healthy spouse.

On the other hand, if a trustee of a trust distributes principal to a beneficiary in an attempt to enable that beneficiary's heirs to obtain a step-up in basis under IRC § 1022, and if the beneficiary dies within three years of that transfer, the IRS may not permit a stepped-up basis.

23. I.R.C. § 1022(d)(1)(B)(iii).

24. I.R.C. § 2056(b)(7). Under current law, these assets receive a stepped-up basis.

25. I.R.C. § 1022(d)(1)(C)(i).

26. I.R.C. §§ 1014(e)(1)(A), (B).

27. I.R.C. § 1022(d)(1)(C)(ii).

CAPITAL GAINS EXCLUSION

The new rules allow for “tacking” on the decedent’s holding period for purposes of the IRC § 121 capital gains exclusion. Section 121 provides that a taxpayer may exclude up to \$250,000, or up to \$500,000 for a married couple, of capital gain from the sale of a personal residence, provided that the taxpayer resided in the home as her personal residence for at least two of the preceding five years.²⁸

Under new IRC §§ 121(d)(8) and (9) (applicable to decedents dying after December 31, 2009), the capital gains exclusion is available to property sold by the estate of a decedent, to any individual who acquired such property from the decedent within the meaning of IRC § 1022, and to a trust which, immediately before the decedent’s death, was a qualified revocable trust established by the decedent.²⁹ The IRS will take the ownership and use by the decedent into account, that is, the ownership and use by the decedent will be “tacked on” to the time requirement.

SECTION 1040(A) –

USE OF APPRECIATED CARRYOVER BASIS TO SATISFY PECUNIARY BEQUEST

If the executor of an estate transfers appreciated property to a beneficiary in satisfaction of a pecuniary bequest, the estate shall recognize the gain on such an exchange “to the extent that, on the date of such transfer, the fair market value of the property exceeds [its] value” as of the date of the decedent’s death.³⁰ A similar rule applies for certain trusts.³¹

The basis of property acquired in such an exchange shall be “increased by the amount of the gain recognized by the trust or estate on the transfer.”³² If a mother’s will left a bequest of \$20,000 and the executor distributed stock to satisfy the bequest with a basis of \$8,000 and a date of death value of \$19,000, but a date of distribution value of \$20,000, the estate will recognize gain of \$1,000. The beneficiary’s basis in the stock will add that same amount of \$1,000.

28. I.R.C. §§ 121(a), (b).

29. I.R.C. §§ 121(d)(8), (9).

30. I.R.C. § 1040(a).

31. I.R.C. § 1040(b).

32. I.R.C. § 1040(c).

DESIRE TO HAVE PROPERTY "OWNED" FOR PURPOSES OF BASIS INCREASE BUT PROTECTED LIKED A TRUST

Clients will want to have property deemed "owned" for purposes of basis increase adjustments, but they will also want the protection found in trusts to preserve assets for the family against the claims of creditors or spouses or from future estate tax increases.

MARITAL PLANNING

The taxpayer should consider basis issues and allocation of basis as well as estate tax issues in planning for the spouse and family. When drafting trusts, the taxpayer should consider allowing outright distributions of principal to enable the beneficiary to have her heirs be entitled to § 1022 basis adjustments. An outright bequest to one's spouse would permit the possibility of a basis step up at each spouse's death. However, if Congress re-imposes the estate tax, the property may be subject to an estate tax in the estate of the surviving spouse. The taxpayer could use a disclaimer to provide a surviving spouse with the flexibility both with regard to use of the estate tax exemption and with regard to basis.

Another technique may be to place the property into a QTIP trust to take advantage of the \$3 million of spousal step-up at the death of the first spouse. The surviving spouse would receive income for her life and no one may appoint the principal during her lifetime. The will could provide that, to the extent that the executor does not make a QTIP or similar contingent basis election under the new rules, the property for which the taxpayer made no such election would pass into a trust that would not qualify for the marital deduction or new QTIP definition, such as a discretionary family spray trust where income and principal would be paid to the spouse or children at the trustee's discretion. However, until IRS approval is obtained, it is not clear whether under the new rules the IRS would consider such a contingent election as not meeting the QTIP qualifications because it does not pass directly to the spouse pursuant to IRC § 1022(c)(5)(A)(i) or because it is subjected to someone else's power to appoint in contravention of IRC § 1022(c)(5)(B)(ii).

With a QTIP trust, there would be a step-up in basis at the death of the first spouse for up to the full \$3 million. However, there would be no step-up at the death of the surviving spouse. Of course, if the trust gives the trustee the discretion to distribute principal, the trustee may later make distributions to the surviving spouse to enable the use

of the IRC § 1022 step-up in the estate of the surviving spouse. However, if the invasion of the QTIP and distribution to the surviving spouse is made within three years of the death of the surviving spouse, the IRS may take the position that there is no step-up in the survivor's estate because of the interplay of IRC §§ 1022(d)(1)(C)(i), (ii), and 1022(a)(1).

The taxpayer should give serious consideration to the use of broad durable powers of attorney to provide for maximum flexibility with regard to disclaimer, gifts, amendments and the like. Consideration should also be given to the use of partnerships, limited liability corporations (LLC's) and buy-sell agreements to provide for stepped-up basis with some retention of control.

DRAFTING TO PROTECT THE EXECUTOR

The Executrix, under the new rules, determines which assets will obtain the increase in basis. Disgruntled heirs may sue the executrix if the basis allocation is not equal. The fiduciary owes a duty of loyalty to the estate beneficiaries. Therefore, the testatrix may want to include language authorizing unequal basis adjustments, exonerating the executrix and releasing her from personal liability. Moreover, since the executrix is a fiduciary of the estate but not a fiduciary for the recipients of assets that pass outside of probate, the testatrix should consider authorizing the executrix to allocate increase in basis to assets passing outside of probate, for example, by a revocable trust or jointly held property. In addition, the testatrix should consider language authorizing the executrix to allocate basis increase to assets passing to herself.

SECTION 6018: REQUIREMENT OF TAX RETURN WITH BASIS INFORMATION

If the transfers at death exceed \$1.3 million for a U.S. citizen, or \$60,000 of tangible U.S. property for a nonresident who is a noncitizen of the United States, the IRS requires the executrix to file a return reporting, *inter alia*, the name and taxpayer identification number of the recipient of the property, a description of the property, the adjusted basis of the property in the hands of the decedent and its fair market value at the time of the decedent's death, the decedent's holding period for the property, sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income, and the amount of basis increase allocated to such property under IRC §§

1022(b) or (c). The executrix must also give the beneficiaries similar information.

If the executrix cannot prepare a complete return, then she shall provide the IRS with information as to every person holding a legal or beneficial interest in such property, and upon notice from the Secretary such person shall make a return as to such property.

Attorneys should advise their clients to keep detailed records for basis purposes since not all assets will receive a stepped-up basis under the new rules if the basis increase exceeds the permitted amounts. Since the new changes will not take effect for another eight years, may only be in effect for one year, or Congress may change the law before the new rules ever take effect; flexibility is the key in any planning undertaken at this point in time.