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Note: for the purpose of this discussion I am assuming that in a married situation the husband will die first and the wife is the surviving spouse.

Modified Carry-Over Basis Under EGTRRA

1. The Rules.

Commencing 1/1/2010 §1014 will be repealed and a new §1022 goes into effect. §1022(a) provides: TREATMENT OF PROPERTY ACQUIRED FROM A DECEDENT DYING AFTER DECEMBER 31, 2009.

- (a) IN GENERAL--Except as otherwise provided in this section--
 - (1) property acquired from a decedent dying after December 31, 2009, shall be treated for purposes of this subtitle as transferred by gift, and
 - (2) the basis of the person acquiring property from such a decedent shall be the lesser of--
 - (A) the adjusted basis of the decedent, or
 - (B) the fair market value of the property at the date of the decedent's death.

This is different from §1015 (pertaining to the basis of property acquired by gift) which states the basis to a donee will be the same as it would be in the hands of the donor, except that if such basis is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss (*but not gain*) the basis shall be such fair market value. Thus under §1015 there is only a downward adjustment for determining loss but under §1022 there is the possibility of a downward adjustment which can affect both gain and loss.

If the basis of the property received by the heirs is adjusted, either upward or downward, in order to get long term capital gain treatment it must be held by the heirs for longer than a year, but if basis is not adjusted then the decedent's holding period is tacked onto the

heirs holding period. §1223(11) which presently provides for long term capital gain treatment for property acquired from a decedent is inapplicable in 2010. §1223(2), which remains applicable after 2010 provides: (2) In determining the period for which the taxpayer has held property (however acquired) there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

The aforementioned basis determination is subject to 2 possible upward adjustments.

A. \$1,300,000 plus unused capital loss carry-overs and net operating losses, plus unrealized losses under §165

Property owned by the decedent can be adjusted upward by \$1,300,000, limited to a particular asset's fair market value at the date of death, see §§1022(b)(2)(B) and 1022(d)(2). Note the \$1,300,000 basis adjustment is a limitation on the maximum adjustment in basis that can be taken and not a limitation on the fair market value of the property which can be adjusted. In other words property worth \$5,000,000 but with a basis of \$3,700,000 could be upwardly adjusted to \$5,000,000. In addition there can be an additional upward basis adjustment for unused capital loss carry-overs under §1212(b) and any net operating losses carry-overs under §172 plus any unrealized losses *that would have been allowable under §165* to the decedent if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death, §1022(b)(2)(C)(i) and (ii).

Query: It appears there is still an open question whether unrealized capital losses are included within those losses *that would have been allowable under §165*. This is what §165(f) says: Capital losses- Losses from sales or exchanges of capital assets *shall be allowed only to the extent allowed in §§ 1211 and 1212*, §165(f) says: Capital losses- Losses from sales or exchanges of capital assets *shall be allowed only to the extent allowed in §§ 1211 and 1212*.. Which is the controlling provision in determining unrealized losses for purpose of interpreting §1022(b)(2)(C) (ii), §165 or §§ 1211 and 1212? It seems reasonable to believe that if the intent was to provide the same basis to the heirs as it was in the hands of the decedent then unrealized capital losses must be taken into account otherwise the government would get a windfall. Ex. Decedent's basis = \$500,000, fair market value at date of death= \$300,000. Heirs get \$300,000 basis under 1022(a). If property sold, subsequent gain is determined by new basis of \$300,000 and not the basis in the hands of the decedent and thus \$200,000 has been subject to tax twice if it were not for the basis adjustment which allowed unrealized loss of \$200,000 to be counted.

B. \$3,000,000 spousal basis adjustment.

There can be an additional basis adjustment of up to \$3,000,000 for property passing to a surviving spouse either as an outright transfer or in which a spouse has a qualifying income interest for life, §1022(c)(2) and (3) . Again any spousal basis increase is limited to a property's fair market value.

To qualify for the basis adjustment the property must have been owned by the decedent, §1022(d)(1). Property subject to a decedent's general power of appointment doesn't qualify, §1022(d)(1)(B)(iii).

1. Community Property.

With respect to community property the decedent is considered to own the surviving spouse's ½ interest in community property, §1022(d)(1)(B)(iv). Thus assume a decedent and spouse own community property worth \$5,000,000 dollars with a basis of \$700,000 and \$4,300,000 of appreciation. If the deceased spouse's interest is to be distributed to the surviving spouse either in an outright disposition or in a trust in which the surviving spouse is given a qualifying income interest, the property can be adjusted to the full extent of \$5,000,000 even though the decedent's interest in the community property is only \$2,500,000 having a basis of \$350,000. Under this new section the decedent is considered to own the entire \$5,000,000 for purposes of the basis adjustment, and there would be a \$1,300,000 adjustment under §1022(b)(2)(B) and another \$ 3,000,000 adjustment under §1022(c)(2)(B).

C. 3 year rule.

IN GENERAL—the \$1,300,000 basis adjustment and \$3,000,000 spousal basis adjustment shall not apply to property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the 3-year period ending on the date of the decedent's death, §1022(d)(1)(c)(i).

The general rule described above shall not apply to property acquired by the decedent from the decedent's spouse unless, during such 3-year period, such spouse acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth. Therefore, there could be still be a deathbed transfer by the surviving spouse to the dying spouse which would still be eligible for a basis increase provided the surviving spouse did not acquire the property by gift within the 3 year period ending on the decedent's death, §1022(d)(1)(c)(ii).

D. Compliance.

The \$1,300,000 and \$3,000,000 basis increase is allocated by the executor §1022(d)(2) and must be made by the due date of the decedent's last income tax return or a later date as specified in future regulations. Thus the executor must have accurate records from which to determine the decedent's carryover basis and the resulting amount of appreciation. The basis increase can be allocated on an asset by asset basis. Thus if carryover basis actually becomes a reality we will no doubt be paying more attention in our trust and will provisions as to the manner in which basis is to be allocated. In addition there will be more money spent on compliance and not less because not only must the fair market value of the property be known but also the basis in the hands of the decedent. A "basis" return will have to be filed by the due date if there are non-cash transfers from the decedent in excess of \$1,300,000 and for all appreciated property acquired by the decedent within 3 years of death for which a gift tax return was required to have been filed by the donor.

Query: I wonder how much more often resort will be had to Treas. Reg. 1.1015-1(a)(3) which states: If the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to the donee, the district director shall, if possible, obtain such facts from such donor.... . If the district director finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall **be the fair market value of such property** as found by the district director **as of the date** or approximate date at which, **according to the best information the district director is able to obtain, such property was acquired by such donor.**

II. Planning

- A. Accurate record keeping to keep track of basis is imperative.
- B. Providing for the \$1,300,000 basis adjustment **at the death of the surviving spouse.**

If estate tax repeal occurs then the emphasis for estate planners will change from saving transfer taxes to the avoidance of capital gains. **One area where estate planning is affected is in the typical AB plan that has already been implemented.** Assume a husband and wife and children with no children from a preexisting marriage. Husband dies in 2002 with \$2,000,000 of separately owned assets with a zero basis. \$1,000,000 is directed to the bypass trust and \$1,000,000 passes to a QTIP trust. At the surviving spouse's death in 2010 neither the amount in the bypass trust or the QTIP trust will be eligible for the \$1,300,000 basis adjustment. The remaindermen of these trusts are wondering why you failed

to advise their parents of this result. You explain this was a typical bypass plan to save estate tax but this falls on deaf ears in 2010 when there is no estate tax. What can you do now to avoid this argument later?

1. Provide an Independent Trustee who can make an outright distribution to the surviving spouse.

Regarding the bypass trust and the QTIP trust it might be wise to appoint an independent trustee who is neither “related or subordinate” to the surviving spouse as that term is understood within the meaning of 672(c) and give the independent trustee the ability to distribute the principal of the trust to the surviving spouse prior to the surviving spouse’s death. Aside from the easily recognizable problem of permitting a distribution to the surviving spouse if there are children from a pre-existing marriage and the loss of asset protection to the spouse should a distribution occur, there are 2 other problems with this approach.

1. A reading of the applicable statute suggests this distribution might have to occur at least 3 years prior to the date of the decedent’s death because the \$1,300,000 basis adjustment does not apply to property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the 3-year period ending on the date of the decedent's death, see §1022(d)(1)(c)(i).

2. An independent trustee might be reluctant to exercise this power unless they receive the prior consent of the remainder beneficiaries and are adequately protected in the trust document.

2. Better yet provide that a Special Trustee appointed by the Court can make an outright distribution.