Tax Practitioner
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IRC Section 1022: Some Guidelines for Applying the 2010 Carryover Basis Rules

We have prepared this outline to provide general information about many of the issues arising under IRC Section 1022 for decedents who passed away in 2010. Our conclusions and suggestions set forth below are based upon our current analysis of these provisions. However, the Internal Revenue Service may issue guidance where they take a different view on one or more of the matters discussed.

1. Basic rules.

a) Basis of property acquired from a decedent is lesser of fair market value or decedent's basis. Section 1022(a)(2)

b) Certain increases to the basis are permitted.
  - i) $1,300,000 (inflation adjusted). Section 1022(b)(2).
  - ii) $3,000,000 for qualified spousal property (inflation adjusted). Section 1022(c)
  - iii) An amount equal to the sum of: a) decedent's unused capital loss carryover; b) net operating loss carryover; and, c) unrealized losses that would have been deductible under Section 165 if the decedent had sold the property.

c) The basis increase is allocated among the decedent's assets by the executor on a return filed under Section 6018. Note that this is the section that requires the filing of an estate tax return but a special version of the section applicable for 2010 prescribes a return containing the basis information and information about the allocation of the basis increase. A draft of the return form has been circulated but subsequently rescinded by the IRS. They have indicated that they are "starting over" to draft the form. There is concern that it may not even be available by its April 15, 2011, due date

d) The basis step-up allocated to any particular asset cannot increase the basis of that asset to more than its fair market value. Section 1022(d)(2).

2. Property acquired from a decedent. Section 1022(e).

a) Property acquired from the decedent by bequest, devise or inheritance or by the decedent's estate from the decedent.

b) Property transferred by the decedent during his lifetime to a revocable trust (as defined in Section 645(b)(1) (676 power to revoke).

c) Property transferred by the decedent to any other trust where the decedent had reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust.

d) Any other property passing from the decedent by reason of death to the extent that the property passed without consideration.

3. Qualified spousal property. Section 1022(c)(3).

a) Outright transfer property. Section 1022(c)(4)
  - i) Excludes terminable interest property where interest of spouse may fail on lapse of time or occurrence or non-occurrence of a contingency and an interest in the property has passed from the decedent to a person other than the spouse.

ii) A condition of survival of up to six months is permitted.

b) Qualified terminable interest property. Section 1022(c)(5).

i) Spouse must have qualified income interest for life, meaning the spouse is entitled to all income from the property paid at least annually and no person has a power to appoint any part of the property to any person other than the spouse.

ii) A power for someone to appoint the property after the spouse's death is permitted.

4. Requirement that property be owned by the decedent.

a) The $1,300,000 and $3,000,000 basis increases can only be applied to property that was owned by the decedent at the time of his death.

b) The decedent is treated as the owner of any property he transferred to a revocable trust as defined in Section 645(b)(1) (treated as owned by decedent under Section 676—power to revoke).

c) The decedent is treated as owning the spouse's half of community property for this purpose, so the increases can be applied to both halves of the community property.

d) The decedent is not considered for this purpose to own property over which he holds a power of appointment.

e) The decedent is not considered to own property he acquired by gift within three years of his death, except for gifts from his spouse.

f) Basis increase cannot be allocated to stock of a foreign personal holding company, a DISC or former DISC, or a foreign investment company unless it has made a QEF election.

g) Basis step-up cannot be allocated to IRD items. Section 1022(f).

h) Property held in a QTIP trust set up by a pre-deceased spouse is probably not considered to be owned by the decedent if the spouse that is the beneficiary of the QTIP trust dies in 2010. Section 1014(b)(10) has historically afforded a basis step-up for QTIP assets by providing that assets included in the decedent's estate under Section 2044 are deemed to have passed from the decedent. Section 2044 includes QTIP assets in the estate of the spouse who was the beneficiary of the QTIP trust. Section 2044(c) provides that assets included in the decedent's estate under Section 2044 are treated as passing from the decedent. Since neither 1014(b)(10) nor 2044 is applicable to the estates of decedents dying in 2010, there is no clear applicable provision that deems QTIP assets to have passed from the decedent.

5. Property with liabilities in excess of basis.

a) Debt in excess of basis will not cause the decedent or his estate to realize gain unless the property is left to a tax exempt beneficiary. Section 1022(g).

b) A tax exempt beneficiary is the United States, a state or political subdivision, an organization exempt from tax, and any foreign person or entity.

c) This provision authorizes regulations to cover transfers of such property where the principal purpose of such transfer is tax avoidance.

6. Some preliminary thoughts regarding planning.

a) **Allocate step-up amount to higher taxed assets.** There is nothing that requires step-up to be allocated to capital assets first so it may be advantageous to first use the step-up amount to increase the basis of assets that would produce ordinary income, such as property subject to recapture or inventory. Step-up cannot be allocated to IRD items. IRC Section 1022(f).

b) **Allocate the full spousal step-up.** In order to use the full $3,000,000 spousal step-up, you will need to be sure to leave the spouse assets having unrealized appreciation of at least $3,000,000, which of course, could be an asset worth $3,000,000 with basis to the decedent of zero or an asset worth $100,000,000 with basis to the decedent of $97,000,000. Remember that the survivor's half of community property is treated as having been acquired from the decedent under IRC Section 1022(d)(1)(B)(iv) so that half can be stepped up as well, subject to overall availability of the spousal step-up amount.

c) **Allocate to assets that will be sold soon.** Allocating basis to appreciated assets likely to be sold soon will increase the present value of the benefit of the basis increase as compared to allocating the step-up to assets likely to be held for extended periods. This is important as assets are often sold during the administration of an estate or administration trust.

d) **Do not allocate step-up to passive loss assets.** Step-up should generally ***not*** be allocated to assets with respect to which the decedent had suspended passive losses. The reason for this is that death is treated as a disposition of the passive activity asset that frees up the suspended passive loss. IRC Section 469(g)(2). However, the passive loss is disallowed to the extent of any basis increase which the property receives at the decedent's death. Before the carryover basis regime, this latter rule normally eliminated most or all of the decedent's suspended passive losses. Under carryover basis, if the step-up is allocated to other assets, the decedent will be able to deduct his suspended passive losses on his final income tax return. If the passive losses exceed taxable income on the decedent's final return, this would presumably create an NOL that could be carried back to generate refunds in prior years. The flip side to this is that the beneficiary who receives this asset will take a carryover basis and may have gain on his ultimate disposition of that asset.

e) **Fairness to beneficiaries.** Thought needs to be given as to whether an executor will have to be fair to beneficiaries by making sure that one does not receive a greater proportion of the increase than others. Is this something that the will/trust should specifically say that the executor does not have to take into account?

f) **Consider beneficiary tax status.** If some beneficiaries are known to be in lower tax brackets or to have loss carryovers, it could make sense to allocate greater portions of unrealized gain to them. Of course, it may not be possible to know this at the time wills/trusts are being prepared unless the client's death is expected soon.

g) **Foreign beneficiaries.** If one or more beneficiaries is neither a citizen or resident of the United States, you could consider distributing cash or assets with a basis close to fair market value to them. If assets with a low basis, such as appreciated securities, are distributed to a nonresident alien, the transfer will be treated as a sale for fair market value and the estate will recognize, and be liable for tax on, any gain under IRC Section 684(a). This provision, like IRC 1022 itself, is scheduled to sunset on January 1, 2011, although it is likely that transfers in 2011 and beyond from the estate of a 2010 decedent to a nonresident alien of assets with a fair market value in excess of basis still will be caught by this provision. Leaving foreign beneficiaries property with debt in excess of basis will also cause gain recognition under IRC Section 1022(g)(2)(C).

h) **Assets with liabilities in excess of basis and value.** One of the most vexing problems will be how to handle assets where the debt encumbering the asset exceeds its basis and value, so called "toxic assets." IRC Section 1022(g) provides that neither the decedent nor his estate recognizes any gain upon the transfer of these assets, but the provision does not prevent the beneficiary who receives the asset from recognizing gain upon his disposition of that asset. The section prevents a decedent from leaving these toxic assets to a government, to a charity, or to a foreign person. The decedent will recognize gain if he makes any of these dispositions. IRC Section 1022(g)(2).

When we briefly had carryover basis following the 1976 Act, the suggestion was to leave these assets to your ex-spouse or someone you really do not like. IRC Section 2518 only applies for purposes of Subtitle B, Estate and Gift Taxes, so it is not totally clear that someone who disclaims such a gift would not be required to recognize gain as a result of such disclaimer. A disclaimer may be a recognized transfer for income tax purposes. There is also a general tax avoidance provision contained in IRC Section 1022(g)(2)(D) which could be applicable if one tried to leave this type of property to a stranger. Note that GCM 39858 applied the Section 2518 disclaimer rules for income tax purposes with respect to the disclaimer of retirement benefits.

A couple of things to consider might be, can the decedent form a shell C corporation when he does his estate planning and leave his toxic assets to the C corporation at this death? If the C corporation transfers the asset to the creditor, or the creditor forecloses, there will be a tax liability the C corporation will be unable to pay. There should be no transferee liability to anyone as long as nobody receives any distributions from the C corporation. This strategy would present the issue of whether IRC Section 1022(g) overrides IRC Section 357(c). I would argue it clearly does as Section 357(c) only creates gain where liabilities exceed basis and IRC Section 1022(g) says that for transfers from the decedent, "liabilities in excess of basis shall be disregarded." This approach could fall victim to the tax avoidance rule.

Another approach would be to leave the toxic asset to a separate trust that does not contain anything else. The trust would name an income beneficiary but provide that principal cannot be distributed for the perpetuity period. Maybe you even put the trust in one of the states that repealed or greatly extended its perpetuity period. The trust could just sit on the asset as long as it can, but if the creditor eventually forecloses, the gain would be allocated to principal and taxed to the trust, which would have no ability to pay it. I did not say it would be easy to find a trustee who would be willing to take such a trust! The asset could also be transferred to a revocable trust by the decedent during his life where the trust becomes irrevocable at his death

i) **Sell the asset in 2011?** Some have suggested that due to the way Section 901 of Economic Growth and Tax Relief Reconciliation Act of 2001 is worded, on January 1, 2011, an asset acquired from a decedent who died in 2010 will acquire a fair market value basis.

Section 901(b) provides: "The Internal Revenue Code of 1986 shall be applied and administered to years, estates, gifts and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted."

This approach is not for the faint of heart.

j) **Remember that holding period is not automatically long term.** Section 1223(9) will not apply to create long term holding period because Section 1014 does not apply to property where the decedent dies in 2010. Section 1014(f). The decedent's holding period can be tacked to the beneficiaries' where part or all of the basis is determined with reference to the decedent's basis. This would not be the case with respect to depreciated assets. They will start a new holding period in the hands of the beneficiary because they take a fair market value basis at the decedent's death.

Allocating basis increase in an amount that brings the basis of an asset all the way up to its fair market value will also cause the holding period to start over. Consider the following example. The decedent owned a stock position for which he had paid $25,000. At the time of his death during 2010, the position was worth $100,000. Eight months after the decedent's death, the position has appreciated to $125,000 and the executor sells it. How much of the decedent's basis increase amount should be allocated to this position? The executor cannot increase the basis to more than the fair market value on the date of the decedent's death. However, if he allocates $75,000 of basis increase to make the basis $100,000, the holding period starts over and the sale eight months later will produce a $25,000 short-term capital gain. The holding period starts over because no portion of the decedent's basis was used to determine the estate's basis in the stock. If the executor had instead allocated $74,000 of basis increase to this stock, then the estate's basis would have been determined with reference to the decedent's basis, taking the decedent's basis of $25,000 and increasing that by the allocated amount of $74,000, for a total basis of $99,000. The gain upon sale would be $26,000, but now it would be a long-term capital gain taxed at a much lower rate.

k) **Exercise powers of appointment.** Property over which the decedent holds a power of appointment does not qualify to be allocated any basis increase. Consider exercising general powers that can be exercised during lifetime. If a general power can only be exercised at death, consider having the person exercise it in his will and appoint the property to his estate.

l) **Be careful funding pecuniary bequests.** Gain may be recognized where appreciated assets are used; however, a special rule limits this gain. The gain recognized is limited to post-death appreciation, so the rule is like under prior law. Section 1040. This limitation on gain recognition also applies to distributions from trusts.

m) **Will copyrights resulting from the decedent's work remain ordinary income assets?** Section 1221(a)(3) treats as an ordinary asset any copyright held by the taxpayer whose personal efforts created it or anyone in whose hands the basis of the copyright is determined in whole or in part with reference to the basis of the creator. However, for 2010, a new version of this provision is in effect and contains a parenthetical which says ("other than by reason of section 1022"). It therefore appears that these assets will be capital assets in the hands of the decedent's beneficiaries.

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