

## Repeal of the Estate Tax, But Carryover Basis for 2010

The temporary repeal of the estate tax for 2010 brings with it the modified carryover of basis of property received by beneficiary from a 2010 decedent.

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**Written By:**  
Thomas R. Wechter

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) enacted a new regime of modified carryover basis, replacing the step-up in basis rules for assets owned by and acquired from a taxpayer who died in 2010. After phasing out the estate tax by raising the “applicable exclusion amount” or “exemption” and reducing the estate tax rate, the estate tax is repealed for 2010 only and reinstated beginning in 2011, with the same exemption, estate tax rate and step-up in basis rules as in effect during 2001.

### **Step up in Basis Prior to 2010**

Prior to 2010, assets acquired from a decedent by reason of death obtained a basis equal to the fair market value of the property at death or at six months after death, if the estate elected to value property under the alternative valuation date. In addition, the long term capital gains holding period automatically applied. The step-up in basis or the step-down if the fair market value of the property is less than the decedent’s basis in the property eliminated the recognition of gain or loss by the recipient on any appreciation or depreciation in the property that occurred prior to the decedent’s death.

### **Modified Carryover Basis Rules for 2010**

For deaths occurring in 2010 only, a modified carryover basis regime is substituted for the step-up basis rules that applied prior to 2010 and will apply after 2010. Under these rules, a recipient of property owned by and transferred from a 2010 decedent will receive a basis equal to the lesser of the decedent’s basis or the fair market value of the property on the decedent’s date of death. Under these rules, the carryover basis in property acquired from a decedent dying in 2010 will be stepped-up by an aggregate amount of \$1.3 million and property passing to the spouse of a 2010 decedent will be stepped-up by an aggregate amount of \$3 million, but in both cases no interest in property acquired from the decedent will be stepped up above its fair market value. There is also a carryover of the holding period, if the basis is determined in whole or in part from the decedent’s basis. In addition, the character of the gain on the sale of the property received from the decedent carries over to the recipient.

For example, real estate subject to depreciation recapture if sold by the decedent will be subject to depreciation recapture if sold by the recipient of the property. If the decedent’s basis is modified by the \$1.3 million or the \$3 million increases, there will be no tacking of the holding period.

### **Increased Basis for Each Decedent**

There are two basis increases provided for in the carryover basis rules for 2010. One is that the basis of property of a decedent can be stepped-up in aggregate by \$1.3 million, but the value of any interest in property received cannot be stepped up in excess of the fair market value of the property. In addition, the basis of a decedent’s property can be increased by the amount of unused capital losses, net operating losses (NOL) and certain built-in losses, but again the value of any interest in

property received cannot be stepped up in excess of its fair market value. The executor may allocate the basis increase of \$1.3 among the assets passing from the decedent in any way.

### **Increased Basis for Property Passing to a Spouse**

The other modification is the increase by an additional \$3 million in aggregate of the basis of property transferred to a surviving spouse. The spousal increase in basis only applies to "qualified spousal property," which is generally defined as QTIP property or an outright transfer property, but does not include any terminable interest. One-half of property jointly owned with a spouse with rights of survivorship is treated as qualified spousal property eligible for a basis adjustment. Both the \$1.3 million basis increase and the qualified spousal property basis increase can be allocated entirely to qualified spousal property thus increasing the basis of property transferred to a surviving spouse in aggregate by a total of \$4.3 million.

The practical effect of the basis increase is to provide smaller estates with step-up in basis treatment equal to the step-up in basis under prior law.

### **Property Eligible for Basis Increase**

The basis modification rules apply only to property owned by or considered as owned by the decedent and acquired from the decedent, which includes property in a revocable trust with respect to which there has been made an election to treat the revocable trust as part of the decedent's probate estate for post-death income tax purposes. Property over which a decedent held a power of appointment or the right to withdraw assets will not be considered basis adjustment property solely as a result of the power or right of withdraw and no part of the \$1.3 million basis adjustment can be allocated to such property. Further, property acquired by the decedent by gift or *intervivos* (a gift made when someone is alive) transfer for less than adequate and full consideration within three years of death is not considered basis adjustment property. There is an exception to the three year rule for property acquired from the decedent's spouse if such property was not acquired by the spouse as a gift.

### **Carryover Basis Reporting Requirements**

While the Treasury has yet to issue guidance or even publish a form, the executor of the estate of a 2010 decedent with property eligible for carryover basis modification (i.e., non-cash assets) in excess of the \$1.3 million must file a return with the Internal Revenue Service (IRS) with the decedent's income tax return for the year of death. If the fair market value of the property eligible for carryover basis modification does not exceed \$1.3 million then no return is required. If the executor is unable to make a complete carryover basis return, the executor is obligated to file a return that includes a description of the property and the name of every person holding a legal or beneficial interest therein.

There are seven items of information that must be included in each return, including the name of the recipient of the carryover basis property, accurate description of the property, adjusted basis in the hands of the decedent and fair market value of the property, the holding period of the decedent in the property, information to determine the character of the gain on the sale of the property, the

aggregate spousal basis increase allocated to the property and such other information as set forth in the regulations. In addition, the executor is required to furnish each person listed on the carryover basis return a written statement identifying the executor and information provided the IRS with respect to the property acquired from or passing from the decedent to such person.

A \$10,000 penalty is imposed on an executor who fails to file the carryover basis return on time. However, there is a reasonable cause exception. If the failure to file the carryover basis return with the IRS or to issue a written statement regarding the required information to the recipient of the carryover basis property is due to an intentional disregard of the requirements, a penalty is imposed of five percent of the fair market value of the property for which reporting was required.

### **Conclusion**

For property of a decedent who dies in 2010, the beneficiaries of the property take the same basis as the decedent, with an aggregate basis increase of \$1.3 million or in the case of a surviving spouse, an additional aggregate increase of \$3 million. However, the adjusted basis as modified may not exceed the fair market value of the property. The allocation of the aggregate increase in basis is made on an asset-by-asset basis by the executor of the estate.

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