

# Financial and Estate Planning: Practitioner's Strategies, Practical Guidance on 2010 Carryover Basis by: Martin M. Shenkman and Bruce D. Steiner, Esq., (Dec. 21, 2011)

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By: Martin M. Shenkman, CPA, MBA, PFS, AEP, JD<sup>1</sup> and Bruce D. Steiner, Esq<sup>2</sup>.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) made substantial changes to the transfer tax system. Among those changes were the additions of [Code Secs. 2210](#) and [2664](#), which made Chapter 11 (the estate tax) inapplicable to the estate of any decedent who died in 2010 and Chapter 13 (the generation-skipping transfer (GST) tax) inapplicable to GSTs made in 2010. Furthermore, for decedents dying in 2010, the stepped-up basis rules were replaced with a carryover basis regime.

In December 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) (hereinafter referred to as TRA). TRA Section 301(a) retroactively reinstated the estate tax for all of 2010 with a 35 percent tax rate and a \$5 million applicable exclusion amount. TRA Section 301(c) gives the personal representatives of estates of decedents dying in 2010 the option to elect the carryover basis rules of [Code Sec. 1022](#) and no estate tax or the estate tax regime as amended. In addition, TRA reinstated the GST tax for all of 2010, but with a zero percent GST tax rate and a \$5 million exemption.

To make and effectuate the carryover basis election, an executor of a 2010 estate must file Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent. Estates making the carryover basis election must follow the rules set forth in the form, instructions, and related guidance to allocate GST exemption.

## Carryover Basis Rules

Property acquired from the decedent within the meaning of [Code Sec. 1022\(e\)](#) is treated as having been transferred by gift. If the decedent's adjusted basis is less than or equal to the property's fair market value at the decedent's date of death, the recipient's basis is the adjusted basis of the decedent ([Code Sec. 1022\(a\)\(2\)\(A\)](#)). If the decedent's adjusted basis is greater than that fair market value, the recipient's basis is limited to that fair market value ([Code Sec. 1022\(a\)\(2\)\(B\)](#)).

If the executor makes the [Code Sec. 1022](#) election, then the carryover basis rules apply to determine a recipient's basis in all property acquired from that decedent, regardless of the year in which the property is sold or distributed. The stepped-up basis rules of [Code Sec. 1014](#).

Under [Code Sec. 1022](#), the executor can allocate additional basis to certain assets that are both "acquired from the decedent" and "owned by the decedent" within the meaning of [Code Sec. 1022\(d\)](#) at death. The total basis may not exceed the property's fair market value on the date of death.

Property acquired from the decedent includes: (1) property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent; (2) property in a "qualified revocable trust" as defined in [Code Sec. 645\(b\)\(1\)](#), regardless of whether the [Code Sec. 645](#) election is made for that trust; (3) assets of any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust; and (4) property held by the decedent and another person as joint tenants with right of survivorship or as tenants by the entirety.

On the other hand, property not acquired from the decedent includes: (1) income in respect of a decedent (IRD); and (2) a decedent's interest in a qualified terminable interest property (QTIP) trust or similar arrangement described in [Code Sec. 1022\(c\)\(5\)](#) funded for the benefit of the decedent by the decedent's predeceased spouse. Consider the ramification if the property is held in an inter vivos QTIP trust created by a spouse who is still living. Whether the QTIP trust was created during life or at death or if the creating spouse is still living should not matter.

Property owned by the decedent includes: (1) property legally titled in the name of the decedent at death (and not held by the decedent solely in a legal or representative capacity); (2) jointly owned property, whether owned as tenants in common or with rights of survivorship; (3) property transferred by the decedent during life to a qualified revocable trust as defined in [Code Sec. 645\(b\)\(1\)](#), regardless of whether the [Code Sec. 645](#) election is made for that trust; (4) certain community property; and (5) trust property that reverts to the decedent upon death pursuant to the terms of the trust.

The term "property owned by the decedent" excludes: (1) property over which the decedent holds any power of appointment; (2) property transferred to a trust by the decedent during life in which the decedent retained a power to alter, amend, or terminate the trust; (3) property transferred to a trust by the decedent during life in which the decedent retained an income interest is not considered owned by the decedent at death solely by reason of that retained income interest; or (4) interest in a QTIP trust or similar arrangement described in [Code Sec. 1022\(c\)\(5\)](#) funded for the benefit of the decedent by a predeceased spouse of the decedent.

**Example 1:** Gary Quigley died prior to the end of the term of a qualified personal residence trust (QPRT) which provided that, if he died prior to the end of the QPRT term, the trust terminates and the property is to be distributed to Quigley's estate. Because the trust property becomes the property of Quigley's estate on his death, the trust property is considered to have been acquired from Quigley. For the same reason, the property is also considered owned by Quigley. Therefore, the basis increase may be allocated to the trust property.

**Example 2:** Same facts as Example 1 above, except that the QPRT provided that if Quigley died before the term ended, the trust property was transferred to his son, Robert. In this situation, the property is not owned by the decedent and the basis increase cannot be allocated to it.

### **Should the Estate Elect Carryover Basis?**

If the decedent does not have a surviving spouse and the gross estate is valued at less than \$5 million, the executor should not make the election. The estate will be subject to the default system (estate tax rules as amended by the TRA). Thus, the estate will owe no federal estate tax and the assets will get a step-up in basis.

In situations where the estate is valued at greater than \$5 million and there is no surviving spouse, the executor can elect to pay the estate tax and have a step-up in basis on estate assets. Or, the executor can elect to apply the carryover basis rules and receive a \$1.3 million basis adjustment. Some factors to consider in making the decision are: (1) the amount of estate tax owed; (2) the amount of unrealized appreciation after the basis increase; (3) whether the appreciated assets will be sold; and (4) the applicable income tax rate.

The carryover basis election should not be made when there is a surviving spouse and any amount over \$5 million will be includible in the surviving spouse's gross estate. Attention should be given as to how much estate tax will be payable on the spouse's estate.

If the election is made to apply the carryover basis rules, the executor should consider how the estate assets will be distributed. The executor must examine the formula provision in the will and whether the entire estate is distributed to a credit shelter or nonmarital trust. The will may also provide a cap on the credit shelter trust or nonmarital share.

Even if the will does not cap the trust, a state statute may apply that limits the credit shelter trust or nonmarital share to \$5 million. Consideration should be given as to whether the state statute allows for a construction proceeding based upon the facts of the case. If there is a cap on the credit shelter or nonmarital share, does the excess go to the spouse outright or in a QTIP-type trust? If the excess goes to the spouse outright, it would be included in the spouse's estate. If the excess goes to the spouse in a QTIP-type trust, the income (but not the principal) would be included in the spouse's estate.

Before making the election, the executor must consider the ramifications of the carryover basis election benefiting some beneficiaries at the expense of other beneficiaries. In those scenarios, should there be an equitable adjustment?

### **Code Sec. 1022 Election and Filing Requirements**

In August 2011, the IRS issued [Notice 2011-66](#), I.R.B. 2011-35, 184, which addresses the time and manner of making a carryover basis election under [Code Sec. 1022](#). The Notice identifies those who may make the election. In addition, amending returns, extensions of the filing deadline, and GST tax issues are discussed. [Notice 2011-66](#) is applicable to the executors of the estates of decedents who died in 2010 and persons acquiring property from such a decedent whose executor made the carryover basis election. [Notice 2011-66](#) is also applicable to donors who made GSTs during 2010.

If an executor of a decedent who died in 2010 makes the carryover basis election, the estate will need to file Form 8939 "Allocation of Increase in Basis for Property Acquired From a Decedent." Originally due on November 15, 2011, the due date for the form has been extended to January 17, 2012 ([Notice 2011-76](#), I.R.B. 2011-40, 479). Except as provided in [Notice 2011-66](#), the election is irrevocable. Any prior filing purporting to make a [Code Sec. 1022](#) election must be replaced with a timely filed Form 8939.

If both a Form 8939 and a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, were filed the IRS will issue a letter to each person who filed such forms including the name and address of each person who filed a Form 706 (or Form 706-NA) or a Form 8939 with respect to the decedent. The letter will explain that each of those persons must collectively sign and file either a restated Form 706 (or Form 706-NA) or Form 8939. The re-filing must be completed within 90 days from the date the IRS mails such letters. If no restated Form 706 (or Form 706-NA) or Form 8939, signed by each person who previously filed any such form, is filed within that 90-day period, the IRS will determine whether the executor has made a [Code Sec. 1022](#) election. Having the IRS make the election might be enticing if the election decision puts different beneficiaries at odds. However, consideration must be given to what liability exposure this action, or inaction, creates for the executor.

#### **Reporting Requirements**

The executor must report and value all property on Form 8939, excluding cash and property that constitutes the right to receive an item of IRD under [Code Sec. 691](#). All property that is acquired from the decedent should be reported on the form. The executor also must report all appreciated property acquired from the decedent, valued as of the decedent's date of death, that was required to be included on the donor's Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, if such property was 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 three-year period ending on the date of the decedent's death ([Code Sec. 6018\(b\)\(2\)](#)). In addition, the executor "... must include with the Form 8939 any other information and supporting documentation as identified in the instructions to the Form 8939 or in any Internal Revenue Bulletin ..." ([Notice 2011-66](#)).

#### **Requirements to Report to Beneficiaries**

Within 30 days after the executor files a timely filed Form 8939, the executor (or each executor filing such a form) must provide a statement to each recipient acquiring property reported on that form, setting forth the information required under [Code Sec. 6018\(c\)](#). The statement must be given regardless of whether the executor allocates the basis increase to such property ([Code Sec. 6018\(e\)](#)). If an adjustment is made to the basis of property reported on a Form 8939, the executor must provide updated statements to each recipient of property affected by that adjustment within 30 days after making the adjustment or receiving notice of the adjustment from the IRS.

#### **Time for Filing Form 8939**

The due date for Form 8939 is January 17, 2012, extended from November 15, 2011. Forms 8939 filed prior to that date may be amended or revoked, but only on a subsequent Form 8939 filed on or before the due date. According to [Notice 2011-66](#), the Form 8939 that is timely filed by an executor is the last Form 8939 filed by that executor on or before the due date. Further, an executor's Form 8939 will have no effect on any Form 8939 filed by a different executor.

No extensions of time to file Form 8939 will be granted. Only in very limited circumstances will a Form 8939 or amended Form 8939 be accepted after the due date (see Relief Provisions below).

#### **No Hedging**

The executor cannot file an estate tax return as well as a conditional Form 8939 that would take effect only if an estate tax audit results in an increase in the gross estate above the applicable exclusion amount.

### **Relief Provisions**

Form 8939 may be amended after the due date to allocate the spousal property basis increase (as defined in [Code Sec. 1022\(c\)\(2\)](#)). Form 8939 must have been timely filed and complete when filed except for the allocation of the full amount of the spousal property basis increase to the eligible property reported on that Form 8939. Each amended Form 8939 must be filed within 90 days after the date of the distribution of the qualified spousal property to which the spousal property basis increase is allocated on that amended Form 8939.

The executor may file an amended Form 8939 under the provisions of [Reg. §301.9100-2\(b\)](#) on or before May 15, 2012, for any purpose. The form cannot, however, be amended to make or revoke a [Code Sec. 1022](#) election. The executor must write "Filed Pursuant to [Section 301.9100-2](#)" on the top of the amended Form 8939.

An executor may apply for relief to supplement a timely filed Form 8939 under [Reg. §301.9100-3](#). Such relief is limited to an extension of time to allocate any basis increase that has not previously been validly allocated. If appropriate, relief will be granted only if: (1) after filing the Form 8939, the executor discovers additional property to which the remaining basis increase could be allocated; and/or (2) the fair market value of property reported on the Form 8939 is adjusted as the result of an IRS examination or inquiry. Relief will not be granted to reduce an allocation of basis increase made on a timely filed Form 8939.

An extension of the time to file Form 8939 (thus, making the [Code Sec. 1022](#) election and the allocation of basis increase) may be granted if the requirements of [Reg. §301.9100-3](#) are satisfied. The amount of time that has elapsed since the decedent's death may constitute a lack of reasonableness and good faith and/or prejudice to the interests of the government (for example, the use of hindsight to achieve a more favorable tax result and/or the lack of records available to establish what property was or was not owned by the decedent at death), which would prevent the grant of the requested relief.

### **Carryover Basis Safe Harbor Guidance**

[Code Sec. 1022](#) determines a recipient's basis in property acquired from the decedent who died in 2010 if the decedent's executor elects to have the carryover basis rules apply. [Rev. Proc. 2011-41](#), I.R.B. 2011-37, 235, provides optional "safe harbor" guidance under [Code Sec. 1022](#). Given the tremendous uncertainty and myriad of possible approaches to the issues raised by carryover basis, fiduciaries should be very wary of not adhering to the safe harbors provided by the IRS. Fiduciaries might even consider obtaining express written acknowledgement of a deviation from the safe harbors from beneficiaries including acknowledgement of the potential risks.

The Revenue Procedure provides that

"if the executor of the estate of the decedent who died in 2010 makes the [Section 1022](#) Election and follows the applicable provisions of section 4 of this revenue procedure and takes no return position contrary to any provisions of section 4, the Internal Revenue Service (IRS) **will not challenge** the taxpayer's ability to rely on the provisions of section 4 either on the Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, or any other return of tax (emphasis added)."

### **Amount of the Basis Increase**

The general basis increase equals the aggregate basis increase plus the carryovers/unrealized losses increase plus the spousal property basis increase under [Code Sec. 1022\(c\)](#). The aggregate basis increase is \$1.3 million and the spousal property basis increase is \$3 million.

The aggregate basis increase is increased by (1) capital losses that, but for the decedent's death, would have been carried over to subsequent years; (2) net operating losses that, but for the decedent's death, would have been carried over to subsequent years; and (3) unrealized losses that would have been allowable if the decedent had sold the property immediately before death, without regard to the limitation on capital losses.

The carryovers/unrealized losses increase consists of the sum of: (1) capital loss carryovers under [Code Sec. 1212\(b\)](#) that would (but for the decedent's death) have been carried from the decedent's last taxable year to a later taxable year; (2) net operating loss carryovers under [Code Sec. 172](#) that would (but for the decedent's death) have been carried from the decedent's last taxable year to a later taxable year; and (3) unrealized losses that would have been allowable under [Code Sec. 165](#) if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death ([Code Sec. 1022\(b\)\(2\)\(C\)](#)). This amount is determined without the dollar limitations on capital losses under [Code Sec. 1211](#).

**Example 3:** Kim Dashing owned 100 shares of stock for profit within the meaning of [Code Sec. 165\(c\)\(2\)](#). The stock is a capital asset, and any gain or loss from the sale of the stock would be long-term capital gain or loss under [Code Secs. 1221](#) and [1222\(3\)](#). Dashing died in 2010, still owning the stock. Dashing's adjusted basis in the stock, pursuant to [Code Sec. 1011](#), was \$5,000, and the stock's fair market value on the date of death was \$1,000. Dashing did not sell the stock during life, and thus did not incur a loss under [Code Sec. 165\(c\)\(2\)](#) reportable on her final Form 1040. The stock is considered to be property owned by and acquired from Dashing. The executor of Dashing's estate made the [Code Sec. 1022](#) election. If Dashing had sold the stock immediately prior to her death, Dashing would have had a net long-term capital loss of \$4,000. Based on Dashing's 2010 taxable income, she would have been able to deduct \$3,000 of the loss and \$1,000 would have been carried over to future years. For purposes of [Code Sec. 1022](#), however, the full unrealized net long-term capital loss of \$4,000 that would have been available to Dashing if she had sold the stock before death is available as a carryovers/unrealized losses basis increase.

The executor may allocate an additional \$3 million spousal property basis increase to qualified spousal property. Qualified spousal property is property passing to the spouse outright or in a QTIP-type trust. No QTIP election is required. Spousal property basis increase may be allocated to property that has already been distributed to the spouse or to a QTIP-type trust.

Spousal property basis increase may be allocated to property that has been sold, but only if: (1) the executor certifies on Form 8939 that the proceeds will be distributed to or for the benefit of the spouse in a manner that would qualify such property as qualified spousal property, and (2) the executor attaches a copy of the will or other document providing the bequest or devise to the spouse or QTIP-type trust to Form 8939. Furthermore, spousal property basis increase may be allocated to property held by a testamentary charitable remainder trust (CRT) if the spouse is the sole noncharitable beneficiary, and the CRT would have qualified for the marital deduction under [Code Sec. 2056\(b\)\(8\)](#) if the executor had not made the carryover basis election

**Example 4:** John Wood died owning 20,000 shares of Big Electric Co. stock. The executor of Wood's estate made the [Code Sec. 1022](#) election. Wood's adjusted basis in the stock is \$600,000 (\$30/share), and fair market value is \$2 million (\$100/share), resulting in appreciation at death of \$1.4 million. Wood's will bequeaths one-half of his estate to his wife, Teresa, outright. Four months after Wood's death, the fair market value of the stock declined to \$1.8 million (\$90/share). The executor sells all 20,000 shares of stock for \$1,770,000 net (\$88.50/share). The executor intends to distribute all of the proceeds from the sale of the stock to Teresa, in partial satisfaction of the residuary bequest.

The executor may allocate up to \$1.4 million of spousal property basis increase (\$70/share) if the required certification and supporting documentation is included on a timely filed Form 8939. To the extent that more than \$58.50 per share is allocated to the stock, the sale will generate a loss.

If the decedent owned 100 shares of stock, can the executor allocate the basis increase to 50 of the shares? Does it matter if the shares were purchased at different times? There does not appear to be anything that says the executor cannot allocate basis increase to only a portion of the property owned (even if the stock was bought all at once).

**Example 5:** Mark Link died in 2010 owning personal property with an adjusted basis of \$200,000 and fair market value of \$500,000. The executor made the [Code Sec. 1022](#) election. Link's spouse, Janis, gets 50 percent of the estate outright. Four months after Mark's death, the executor of Mark's estate sells the personal property for \$600,000 (\$100,000 post-death appreciation). The executor applies \$150,000 of the net proceeds from the sale of the personal property to pay administrative expenses

and will distribute the remaining \$450,000 of net proceeds from the sale of the personal property to Janis. The executor may allocate no more than \$225,000 of spousal property basis increase to the personal property.

The maximum allocation is determined by multiplying the unrealized appreciation at death (\$300,000) by the ratio of net proceeds to be distributed to Janis over the total net proceeds of the sale. Therefore, the executor may allocate up to \$225,000 ( $\$300,000 \times (\$450,000 / \$600,000)$ ) of spousal property basis increase to the personal property, provided a certification and supporting documentation are included on a timely filed Form 8939.

## **Allocating the Basis Increase**

The executor may allocate the basis increase on a property-by-property basis. Basis increase may be allocated to property even after the executor has disposed of or distributed the property. However, the basis increase may not be allocated so as to increase the basis of property in excess of fair market value as of the date of death. The executor may not allocate any basis increase to increases in value occurring after the decedent's death.

The term "property" includes interests in the property. For example, the basis increase may be allocated to some or all of a decedent's shares of stock in a particular company, or to a life or remainder interest owned by the decedent at death.

If a decedent's death results in property being divided into different interests that are not undivided portions or fractional interests of each and every interest or right in the property that was owned by the decedent, then basis increase may not be allocated separately to the various interests in that property created by reason of the decedent's death. For example, the decedent owns property outright on the date of death. Under will or by deed, the property is divided into a life interest and a remainder interest. The basis increase may be allocated to the property owned by the decedent at death but may not be allocated separately to the life estate and/or remainder interest.

## **Other Considerations When Allocating the Basis Increase**

When deciding how to allocate the basis increase, the executor should consider making allocations under the following circumstances:

- assets that are more likely to be sold sooner;
- GST tax-exempt dispositions;
- assets passing to younger beneficiaries, since assets passing to older beneficiaries will receive a basis step-up sooner;
- depreciable property; and
- assets subject to income tax at higher rates, such as artwork.

The executor should also consider the following questions. If the basis increase is not allocated pro rata, should there be an equitable adjustment? If so, how should the equitable adjustment be determined?

## **Determination of Fair Market Value**

The fair market value of property acquired from a 2010 decedent is determined in the same manner for carryover basis as for the estate tax. Thus, regulations under [Code Sec. 2031](#) that require appraisals to determine the fair market value of certain property included in the gross estate also apply for purposes of determining the fair market value of property acquired from the decedent under [Code Sec. 1022](#) for carryover basis. The executor must attach any appraisals required under [Code Sec. 2031](#) to Form 8939.

The basis increase allocated to property acquired from the decedent by a recipient cannot increase the recipient's basis in that property or property interest above the fair market value. The fair market value of an undivided portion of the decedent's property that is acquired from the decedent at death is a fractional share of the fair market value of the decedent's property at death. For example, if each of two or more recipients acquires an undivided portion of a property from the decedent, the fair market value of each recipient's portion is the fair market value of the decedent's entire interest in the property at death multiplied by a fraction, where the numerator is the undivided portion of the decedent's property acquired by that recipient

and the denominator is the decedent's entire interest in that property at death. An undivided portion of the decedent's property refers to a fraction or percentage of each and every interest or right the decedent held in the property at death.

### **Who Allocates Basis Adjustment**

The executor must allocate the basis increase on a timely filed Form 8939. "Executor" is defined in accordance with [Code Sec. 2203](#), as if that section were applicable. If an executor has been appointed, has qualified, and is acting for a decedent's estate within the United States, the IRS generally will only accept Forms 8939 filed by such executor. If an executor has not been appointed, any person in actual or constructive possession of property acquired from the decedent may file a Form 8939 for the property he or she actually or constructively possesses.

If the IRS receives multiple Forms 8939 that collectively purport to allocate the basis increase in an amount greater than the amount of basis increase available to the estate, the IRS will issue a letter to each person who filed such a form. Each of those persons must collectively sign and file a single, restated Form 8939 allocating the available basis increase in order to make the [Code Sec. 1022](#) election. The restated Form 8939 must be filed within 90 days from the date the IRS mails such letters. If no restated Form 8939 is filed within that 90-day period, the IRS will allocate the available basis increase as the IRS, in its discretion, determines.

### **No Basis Adjustment for Certain Gift Property**

Pursuant to [Code Sec. 1022\(d\)\(1\)\(C\)](#), the executor cannot allocate the basis increase to property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration during the three-year period ending on the date of the decedent's death. This prohibition does not apply, however, to property acquired from the decedent's spouse, provided the property had not been transferred to the spouse during such three-year period 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.

### **Generation-Skipping Transfer Tax in 2010**

The GST tax was retroactively reinstated by TRA and applies to the estates of all decedents who died after December 31, 2009, regardless of whether a [Code Sec. 1022](#) election is made. Section 302(c) of TRA provides that, for each GST occurring during 2010, the applicable rate under [Section 2641\(a\)](#) is zero.

If an executor makes the [Code Sec. 1022](#) election, the executor allocates the decedent's available GST exemption on Schedule R of Form 8939. If the Form 8939 is timely filed, the allocation will be considered a timely allocation of the decedent's available GST exemption under [Code Sec. 2632](#).

A donor who wishes to pay GST tax at the rate of zero percent and does not want any GST exemption allocated to that transfer may elect out of the automatic GST allocation rules to that direct skip. A donor could affirmatively elect out of the automatic allocation of GST exemption by describing, on a timely filed Form 709, both the transfer and the extent to which the automatic allocation is not to apply. A timely filed Form 709 accompanied by payment of the GST tax (as shown on the return with respect to the direct skip) is sufficient to prevent an automatic allocation of GST exemption with respect to the transferred property.

Under the automatic allocation of exemption rules, the default is automatic allocation of GST exemption to direct skips. Reporting a direct skip not in trust on a timely filed gift tax return is treated as an election out of automatic allocation. However, the automatic allocation of exemption will occur if the transfer in trust is a direct skip or occurs at the end of an estate tax inclusion period (ETIP).

### **GST Tax Return Filing Deadlines**

TRA extends the time for filing any return required under [Code Sec. 2662](#) (including any election required to be made on such return) to report a GST transfer made after December 31, 2009, and before December 17, 2010, to September 17, 2011. The due date for filing a return reporting a direct skip, a taxable distribution, or a taxable termination (including any election required to be made on such return) that occurred on or after January 1, 2010, through December 16, 2010, was September 19, 2011, including extensions. However,

Schedule R attached to Form 8939 is due on or before November 15, 2011, extended to January 17, 2012, by [Notice 2011-76](#).

The due date for gift and GST tax returns for 2010 reporting an indirect skip or a post-December 16, 2010 direct skip was not extended. The due date for filing a Form 709 that does not report a GST transfer or that reports a GST transfer (or any election pertaining to such transfer) that occurs on or after December 17, 2010, through December 31, 2010, was April 18, 2011, including extensions. The time for filing Form 709 could have been extended to October 15, 2011, if an extension of time was requested to file the donor's income tax return. The due date for filing a Form 709 to elect to treat a trust as a GST trust or to allocate GST exemption to a transfer occurring during 2010 under [Reg. §26.2632-1\(b\)\(3\)](#) or [\(4\)](#) was April 18, 2011, including extensions. If the donor timely filed Form 709 for 2010, but failed to allocate GST exemption to a transfer occurring during such year [Reg. §301.9100](#) relief may be possible.

### **Code Sec. 645 Election to Treat Trust as Part of Estate**

The executor and the trustee of a qualified revocable trust may elect to treat the trust as part of the estate for income tax purposes. This election permits the trust to obtain income tax benefits that, but for making this election, would only be available to the estate, such as: (1) choosing a fiscal year for income tax purposes; (2) avoiding estimated income tax requirements for the first two taxable years of the trust; (3) obtaining a current deduction for funds set aside for a charity that are not yet paid to the charity; (4) automatic eligibility, without making any election, as a qualified S corporation shareholder for the duration of the period of estate administration; (5) utilizing the \$25,000 active real estate exception to the passive loss limitation rules for two years post-death ([Code Sec. 469\(i\)\(4\)](#)); and (6) recognition of a loss on satisfaction of a pecuniary bequest ([Code Sec. 267\(b\)\(13\)](#)).

### **Revocable Trust as Part of Estate Under Carryover Basis**

The general rule is that if the executor and trustee of a qualified revocable trust elect, the trust will be treated as part of the estate (and not as a separate trust) for income tax purposes for all taxable years of the estate ending after the date of the decedent's death and before the "applicable date." The applicable date is either (1) the date which is two years after the date of the decedent's death if no estate tax return is required to be filed or (2) the date which is six months after the date of the final determination of the estate tax liability if a return is required to be filed ([Code Sec. 645\(b\)](#)). If an executor makes the [Code Sec. 1022](#) election, no estate tax return is required to be filed. Therefore, the "applicable date" is two years after the date of the decedent's death.

### **Impact of Code Sec. 1022 on Other Income Tax Provisions**

The carryover basis rules may have an income tax effect in addition to the estate tax ramifications.

#### ***Holding Period of Inherited Property***

To the extent the recipient's basis in property acquired from a decedent is determined under [Code Sec. 1022](#), the recipient's holding period includes periods during which the decedent held the property. The tacking of holding periods occurs whether or not the executor allocates any basis increase to that property.

#### ***Tax Character of Inherited Property***

The tax character of property acquired from a decedent by a recipient is determined in the same manner as the holding period. To the extent the recipient's basis in property is determined under [Code Sec. 1022](#), the tax character of the property is the same as it would have been in the hands of the decedent. This includes property described in [Code Sec. 1221](#) (capital assets); [Code Sec. 1231](#) (property used in a trade or business and involuntary conversion property); [Code Sec. 1245](#) (depreciation recapture property); and [Code Sec. 1250](#) (depreciation recapture upon disposition of certain depreciable real property). But, the tax character of property may be affected by a subsequent change in the recipient's use of the property.

#### ***Depreciation of Property Acquired from the Decedent - Decedent's Basis***



If [Code Sec. 1022](#) applies to property acquired from the decedent that is depreciable property in the hands of the recipient, the recipient is treated, for depreciation purposes, as the decedent for the portion of the recipient's basis in the property that equals the decedent's adjusted basis in that property. The recipient determines any allowable depreciation deductions for this carryover basis by using the decedent's depreciation method, recovery period, and convention applicable to the property. If the property is depreciable property in the hands of both the decedent and the recipient during 2010, the allowable depreciation deduction for 2010 for the decedent's adjusted basis in the property is computed by using the decedent's depreciation method, recovery period, and convention applicable to the property, and is allocated between the decedent and the recipient on a monthly basis. The allocation is made in accordance with the rules in [Reg. §1.168\(d\)-1\(b\)\(7\)\(ii\)](#) for allocating the depreciation deduction between the transferor and the transferee.

#### ***Depreciation of Property Acquired from the Decedent - Basis Increase***

The portion of the recipient's basis in the property that exceeds the decedent's adjusted basis in the property as of the decedent's date of death (e.g., the basis increase allocated to the property by the executor) is treated for depreciation purposes as applying to a separate asset that the recipient placed in service on the day after the date of the decedent's death. The recipient determines any allowable depreciation deductions for this excess basis by using the depreciation method, recovery period, and convention applicable to the property on its placed-in-service date or, if not held on that date as depreciable property by the recipient, on the date of the property's conversion to depreciable property. This requires that at least two separate "assets" be tracked.

#### **Passive Activity Losses**

Under [Code Sec. 469\(j\)\(6\)](#), if an interest in a passive activity is transferred by gift, the basis is increased by the unused passive activity losses. This increase is deemed to occur immediately before death. Thus, it reduces the hypothetical loss that would have been sustained on a sale, so that there is no double increase for the unused passive activity loss.

The passive loss rules disallow certain losses from passive activities although some disallowed losses may be suspended and carried forward under [Code Sec. 469\(b\)](#). If an interest in a passive activity is transferred by reason of the taxpayer's death, the taxpayer may treat suspended passive losses as losses that are not from a passive activity (and therefore may deduct the losses) to the extent such losses are greater than the excess (if any) of the basis of such property in the hands of the transferee, over the adjusted basis of such property immediately before the death of the taxpayer.

When an interest in a passive activity is transferred by gift (which is the carryover basis paradigm), the basis of such interest immediately before the transfer is increased by the amount of any passive activity losses allocable to such interest that have not been allowed as deductions as a result of [Code Sec. 469\(a\)](#) and [\(j\)\(6\)](#). Once used to increase the donor's basis, these formerly suspended losses may not be deducted for any taxable year.

Because property owned by the decedent at death will be treated under [Code Sec. 1022](#) as having been transferred by gift, [Code Sec. 469\(j\)\(6\)](#), rather than [Code Sec. 469\(g\)\(2\)](#), applies to determine the decedent's adjusted basis in such property. The basis adjustment under [Code Sec. 469\(j\)\(6\)](#) is deemed to occur immediately prior to the decedent's death, and thus is applied to determine the decedent's adjusted basis in the property at death as described in [Code Sec. 1022\(a\)\(2\)\(A\)](#). Any loss that would have been sustained under [Code Sec. 165\(c\)\(1\)](#) or [\(c\)\(2\)](#) on a hypothetical sale of the property immediately prior to the decedent's death (equal to the excess of the decedent's adjusted basis (determined as described under [Code Sec. 469\(j\)\(6\)](#)) over the fair market value at death) may be included in the [Code Sec. 165](#) losses in the general basis increase.

**Example 6:** Tom Dooley owned a building that generated losses disallowed under [Code Sec. 469](#). Dooley died in 2010 and the executor of his estate made the [Code Sec. 1022](#) election. The building is property owned by and acquired from Dooley by his child, Chris. On Dooley's death, the fair market value of the building is \$100,000. Dooley's basis in the building is \$10,000, and the suspended passive activity losses allocable to the building equal \$50,000. The \$50,000 in suspended passive

activity losses are added to Dooley's basis of \$10,000, resulting in an adjusted basis of \$60,000. For purposes of [Code Sec. 1022\(b\)\(2\)\(C\)\(ii\)](#), a hypothetical sale of the property just before Dooley's death would have produced a gain of \$40,000 (\$100,000 fair market value less Dooley's adjusted basis of \$60,000), so there is no loss under [Code Sec. 165](#) from this property. Chris's basis in the building as of Dooley's date of death is \$60,000, plus any amount of the general basis increase allocated to this property.

### **Satisfaction of Pecuniary Bequest with Appreciated Property**

[Code Sec. 1040](#) provides that if the executor makes the carryover basis election and distributes appreciated property in satisfaction of a pecuniary bequest, the estate recognizes gain to the extent the fair market value on the date of distribution exceeds the fair market value on the date of death. The recipient's basis equals the estate's basis, plus the gain recognized by the estate.

#### ***Recognition of Gain on Satisfaction of Pecuniary Bequest with Appreciated Property***

The same rule will apply to distributions of appreciated trust property made in satisfaction of trust provisions that are the equivalent of a pecuniary bequest. However, this only applies to the extent so provided in regulations. A safe harbor provision will apply this rule to qualified revocable trusts as defined in [Code Sec. 645\(b\)\(1\)](#), as well as to trusts that would have been included in the decedent's gross estate for federal estate tax purposes under [Code Sec. 2036](#), [2037](#), or [2038](#) had the decedent's executor not made the carryover basis election. Provisions of [Code Sec. 1040](#), however, do not apply to the distribution of property that constitutes the right to receive an item of IRD in satisfaction of a pecuniary bequest.

### **Charitable Remainder Trusts**

TRA retroactively repealed [Code Sec. 2511\(c\)](#), which treated each transfer in trust during 2010 as a gift unless the trust was treated as wholly-owned by the donor or the donor's spouse. The provision had raised doubt as to the viability of charitable remainder trusts. However, the retroactive repeal made this issue moot, even when a [Code Sec. 1022](#) election is made.

Under [Reg. §1.664-1\(a\)\(1\)\(iii\)](#), a trust is a charitable remainder trust if a deduction is allowable under [Code Sec. 170](#), [2055](#), [2106](#), or [2522](#), and the trust is a charitable remainder annuity trust or a charitable remainder unitrust. If the executor makes the carryover basis election, there is no estate tax deduction. However, a testamentary trust that would otherwise qualify as a charitable remainder trust except that it fails to meet the requirement that an estate tax charitable deduction be allowable under [Code Sec. 2055](#) solely because the executor makes a [Code Sec. 1022](#) carryover basis election will still qualify as a charitable remainder trust.

### **Conclusion**

The decision whether to make the carryover basis election and how to implement the election is complicated and has the potential to be contested by beneficiaries. Fiduciaries should follow the safe harbor procedures and must be aware of all filing deadlines. When possible, address issues and differences among beneficiaries. Fiduciaries should consider the appropriate degree of disclosure to beneficiaries and the contents of receipts and releases.

#### **Footnotes**

- 1 Shenkman Law Office, Paramus, NJ.
- 2 Kleinberg, Kaplan, Wolff & Cohen, P.C., New York, NY. Mr. Steiner contributed an article on carryover basis, discussing the carryover provisions added by the Tax Reform Act of 1976, to CCH's TAXES—THE TAX MAGAZINE in 1978. See Logarithms, Exponents, and Carryover Basis, 56 TAXES 486 (1978).