MODIFIED CARRYOVER BASIS RULES OF I.R.C. §1022

CURRENT IMPLICATIONS

With the repeal of the federal estate tax and generation-skipping transfer tax comes the new "modified carryover basis". Prior to the repeal of the federal estate tax, beneficiaries of an estate received a "step-up" in the basis of the property they inherited from the decedent. New in 2010, beneficiaries will inherit property under the new "modified carryover basis rules".

What is the Basis of Property?

For income tax purposes, the basis of an asset means what was paid for the asset plus the value of certain improvements. In the case of stocks and bonds, the basis simply equals the purchase price, while with real estate the basis equals the purchase price plus the value of all capital improvements.

What is the Step Up in Basis?

Prior to the repeal of the federal estate tax on January 1, 2010, beneficiaries of an estate received a "step up" in the basis of the assets they inherited from the decedent. A "step up in basis" means that regardless of what the decedent paid for the asset, the heirs inherited the asset at the fair market value on the decedent's date of death. In other words, if a decedent paid $3,000,000 for a piece of real estate and did not make any capital improvements to it and the date of death fair market value of the real estate increased to $5,000,000, then the heirs inherited the property with a stepped up income tax basis of $5,000,000.

What is "Modified Carryover Basis?

With the repeal of the federal estate tax a new "modified carryover basis" is instituted. What this means for decedents who die on or after January 1, 2010, is that their heirs will inherit the decedent's original income tax basis in the decedent's property plus the value of certain improvements, not a full step up in basis. In other words, if a decedent paid $3,000,000 for a piece of real estate and did not make any capital improvements to it and the date of death fair market value in 2010 increased to $5,000,000, then the heirs will inherit the property with a carryover income tax basis of $3,000,000.

Even so, the carryover basis is subject to adjustment under the new "modified" carryover basis rules. Under these rules the basis of assets passing directly to a surviving spouse or into a qualified terminable interest property trust (or "QTIP" trust) for the benefit of the surviving spouse can be increased by $3,000,000, while the basis of assets passing to a non-spousal beneficiary can be increased by $1,300,000.

Using the new modified carryover basis rules, an asset with an original income tax basis of $3,000,000 and a date of death fair market value of $5,000,000, the executor of the decedent's estate can increase the original income tax basis by up to $3,000,000 so that the surviving spouse's modified carryover basis will be $5,000,000 (note that the basis cannot be increased above the fair market value), while a non-spouse beneficiary can increase the original basis by up to $1,300,000 so that the non-spouse's beneficiary's modified carryover basis will be $4,300,000 (i.e., the original $3,000,000 tax basis plus the $1,300,000 modified carryover basis).

Thus, if the non-spouse beneficiary sells the property with a modified carryover basis of $4,300,000 shortly after the decedent's death for $5,000,000, then the non-spouse beneficiary will owe capital gains tax on the net gain of $700,000, which is the difference between the sales price and the non-spouse beneficiary's modified carryover basis:

Contrast this with the sale of an asset under prior estate tax laws which provided for a full step up in basis to the beneficiary. Under prior estate tax laws, the basis of the property would be stepped up to the fair market value of $5,000,000 so that the sale would not generate any capital gains taxes to the beneficiary.

Under the new modified carryover basis rules, $700,000 net gain will now be subject to capital gains tax (currently 15% but soon to increase to probably 25% under Obama's regime) as well as state income tax on the capital gain.

In this example, $700,000 net gain X 15% = $105,000 in federal income taxes and add another 5% state income tax on the net gain (i.e., $35,000), the total income tax liability to the beneficiary is a staggering $140,000. Quite a contrast from the prior estate tax law.

Fiduciary's Dilemma

For small estates, the basis increase rules will permit the basis of eligible property to be increased to fair market value on the date of death. However, if the basis increase amount is less than the unrealized appreciation on the eligible property, the basis increase must be allocated among the eligible property. Under the rules, the executor has the discretion to allocate the basis increase to eligible property on an asset-by-asset basis. The only restriction on the executor's discretion is the ceiling rule which provides that the basis of an asset cannot be increased above its fair market value on the date of death. If there are multiple beneficiaries, then the executor's fiduciary obligation to all beneficiaries can present a couple of problems. In such cases, the act of allocating basis to property bequeathed to one beneficiary could be construed as a breach of the executor's fiduciary duty to the other beneficiaries. Guidance under the decedent's Will as to how the basis adjustment, if any, should be allocated may prevent such a dilemma. If no guidance exists under the decedent's Will, it would be prudent for the executor to obtain the consent of <u>all</u> beneficiaries to a basis allocation scheme prior to its implementation.

What Action Will Congress Take in 2010?

Since Congress has allowed the estate tax to disappear, there are three very different paths for Congress to take at this point:

1. The first option is to do absolutely nothing. Under this scenario the estate tax will return on January 1, 2011, with a $1,000,000 exemption and 55% tax rate. The generation-skipping transfer tax will also reappear with a $1,000,000 exemption that will be indexed for inflation in 2011 and beyond. This would be a disaster. Instead of paying no estate tax on a $3,500,000 estate, reverting back to old estate tax exemption of $1,000,000 the estate tax liability on a $3,500,000 estate will be $1,375,000. That is a significant difference which generates more revenue for "Uncle Sam".

2. The second option is Congress will act prior to the date that the first 2010 estate tax return is due, which is on or before September 1, 2010, to reinstate the estate tax retroactively back to January 1, 2010. The big issue with this option is that it is unclear whether applying the tax retroactively will be constitutional which, in turn, will lead to one or more lawsuits that could take years to unravel.

3. The third option is for Congress to act in 2010 to reinstate the estate tax but only apply it to the estates of decedents who die on or after the effective date of the new law. This option could potentially provide a windfall for wealthy decedents who die during the period while the estate tax is repealed, particularly if their estate passes to a surviving spouse and/or is comprised of assets with a high income tax basis.

As taxpayers, until Congress acts to resolve this mess, it would be in everyone's best interest (whether single or married) to revise your existing estate planning documents to include the necessary discretionary language to protect one's interests with regard to the new "modified carryover basis rules". For more information on these options, please contact John R. Lolio, Jr., Esquire, at (856) 661-2094 or e-mail him at jlolio@shermansilverstein.com.