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Income Tax Basis for Decedents Dying in 2010

-by Neil E. Harl*

When the legislation was enacted in 2001 repealing the federal estate tax after 2009 and implementing a carryover basis regime starting in 2010,[1] with the federal estate tax and new basis at death returning after December 31, 2010,[2] few apparently thought that the one-year gap would actually become operative with a carryover basis for one year.[3] Among other factors was the bizarre situation of a new income tax basis before 2010 and after 2010 with a carryover basis for one year. Actually, the probabilities appear to be good for the Congress to enact and the President to sign legislation yet this year making the federal estate tax effective, retroactive for deaths after December 31, 2009[4] which would repeal carryover basis and set the applicable exclusion amount at $3.5 million with a 45 percent tax rate, the same as was in effect for deaths in 2009.

However, there is no assurance that such legislation will be passed and signed into law. For that reason, planners are well advised to consider the effects of the carryover basis regime being in effect for deaths in 2010 (and, possibly, beyond 2010).

Effects of carryover basis

Through 2009, property held until death received a new income tax basis at death equal to the value used for federal estate tax purposes or the fair market value at the date of death.[5] The Internal Revenue Code specifically refers to the value used for special use valuation,[6] the value under alternate valuation, up to six months after death[7] and the value stemming from a qualified conservation easement[8] as exceptions to fair market value at death which is the test where a federal estate tax return is required.[9]

For deaths after December 31, 2009, property acquired from a decedent dying after that date is treated as transferred by gift[10] with the basis for the person acquiring the property from the decedent being the lesser of the adjusted income tax basis of the decedent at the time of death[11] or the fair market value of the property at the date of the decedent's death.[12] That is the basic formula for property passing by gift during life[13] except for the adjustment to income tax basis for any gift tax paid[14] and the handling of gifts between spouses.[15]

The 2001 legislation provided, for deaths after 2009, a basis increase for all estates of $1,300,000[16] to be allocated among the assets owned by the decedent at death plus the sum of any capital loss carryover,[17] any net operating loss carryover (which would have been, but for the decedent's death, carried over to a later taxable year of the decedent)[18] and any losses that would have been allowable under I.R.C. § 165 had the property acquired from the decedent been sold at fair market value immediately before the decedent's death.[19] The statute does not require equal allocation among all eligible assets. Rather, the statute

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simply specifies that the executor (or personal representative, presumably) is to allocate the adjustments on the special return required.[20] However, the allocation cannot increase the income tax basis of any asset above its fair market value at the date of the decedent's death.[21]

The statute provides for an inflation adjustment to the amounts available for allocation for decedent's dying *after December 31, 2010*.[22]

For a decedent who is a non-resident who is not a citizen of the United States, the amount available for allocation after death is $60,000[23] without the loss adjustments.[24] That amount is, however, eligible for the inflation adjustment beginning with deaths after 2010.[25]

For surviving spouses, a basis increase of $3,000,000 is authorized[26] for "qualified spousal property."[27] That includes property transferred to the surviving spouse outright and qualified terminable interest property.[28] The spousal basis increase is conditioned on survival of the spouse for a period not exceeding six months (or on a common disaster resulting in the death of the surviving spouse and the decedent) for purposes of whether an interest passing to the surviving spouse will terminate or fail and such termination or failure does not occur.[29]

Property eligible for a basis increase

To be eligible for a basis increase, the property must have been owned, or treated as owned, by the decedent at the time of death.[30] For property held in joint tenancy or tenancy by the entirety with the surviving spouse, one-half of the property is treated as having been owned by the decedent (the so-called "fractional share" rule)[31] and is, therefore, eligible for an increase in basis.[32] For property held jointly with a person other than the surviving spouse, the portion of the property attributable to the decedent's consideration furnished (the so-called "consideration furnished" rule)[33] is treated as having been owned by the decedent and eligible for a basis increase.[34]

The 2001 Act does not acknowledge the so-called "Gallenstein" rule which allows the consideration furnished rule to be applied to joint interests created after 1954 and before 1977 between a husband and wife.[35] Note that the "Gallenstein" rule has been held by the Tax Court to be mandatory for joint tenancy property acquired after 1954 and before 1977.[36]

For community property, the decedent is treated as having owned the surviving spouse's one-half share of community property, which is eligible for a basis increase if at least one-half of the property is owned by, and acquired from, the decedent.[37]

Property *not* eligible for a basis increase

The statute refers specifically to assets that are not eligible for a basis increase under the 2001 legislation.[38] That includes property over which the decedent held a power of appointment with respect to the property (even if it is a general power of appointment).[39] Property acquired by the decedent by gift (other than from the spouse unless the spouse acquired the property by gift) during the three year period ending on the date of the decedent's death.[40] Also, property that constitutes a right to receive income-in-respect-of-decedent[41] is not eligible for a basis increase. However, such income has not been eligible for an adjustment in basis at death under the pre-2010 rules.[42]

Finally, stocks or securities of a foreign personal holding company are not eligible for a basis increase.[43] The same applies to stocks of a DISC (domestic international sales corporation) or former DISC,[44] stock of a foreign investment company[45] or the stock of a passive foreign investment company (except for which a decedent-shareholder had made a qualified fund election with respect to the decedent).[46]

Finally. . .

After 2009, gain is not recognized at the time of death for property that is subject to debt-in-excess-of- basis rules.[47] Effective for deaths after 2009, the income tax exclusion on sale fo the principal residence[48] has been extended to estates and heirs.[49] If an estate distributes property to satisfy a pecuniary bequest using date of distribution values, the estate after 2009 has to recognize gain on only the difference between the date of death value and the date of distribution value.[50] That has been the case for years but it takes on additional significance after 2009 *if the carryover basis regime comes into play.*

ENDNOTES

[1] EGTRRA of 2001, Pub. L. No. 107-16, § 542(a), 115 Stat. 38 (2001).

[2] *Id*.

[3] See generally, Harl, "Economic Growth and Tax Relief Reconciliation Act of 2001," 12 *Agric. L. Dig*.81 (2001).

[4] See, e.g., H.R. 4154, 111th Cong., 1st Sess. (2009).

[5] I.R.C. § 1014(a). See Connecticut Nat'l Bank v. United States, 937 F.2d 90 (2d Cir. 1991) (adjustment in basis at death of spouse; surviving spouse died before sale of property and before funding of trusts); Janis v. Comm'r, 461 F.3d 1080 (9th Cir. 2006) (could not value assets differently for income tax purposes and for estate tax purposes); Janis v. Comm'r, 469 F.3d 256 (2d Cir. 2007) (could not value inherited property differently for income tax purposes than for estate tax purposes).

[6] I.R.C. § 2032A.

[7] I.R.C. § 2032.

[8] I.R.C. § 2031(c).

[9] See I.R.C. § 2031(a) (value of gross estate). See also Malm v. United States, 420 F. Supp. 2d 1040 (D. N.C. 2005) (basis determined by date of death, not date of estate's sale of assets).

[10] I.R.C. § 1022(a)(1).

[11] I.R.C. § 1022(a)(2)(A).

[12] I.R.C. § 1022(a)(2)(B).

[13] I.R.C. § 1015.

[14] I.R.C. § 1015(d).

[15] I.R.C. § 1015(e).

[16] I.R.C. § 1022(b)(2)(B).

[17] I.R.C. § 1212(b).

[18] I.R.C. § 172.

[19] I.R.C. § 1022(b)(2)(C)(iii).

[20] I.R.C. § 1022(d)(3)(a). See I.R.C. § 6018.

[21] I.R.C. § 1022(d)(2).
[22] I.R.C. § 1022(b)(4).
[23] I.R.C. § 1022(b)(3)(A).
[24] I.R.C. § 1022(b)(3)(B).
[25] I.R.C. § 1022(d)(4)(A).
[26] I.R.C. § 1022(c)(2)(B).
[27] I.R.C. § 1022(c)(3).
[28] I.R.C. § 1022(c)(3)((A), (B).
[29] I.R.C. § 1022(c)(4)(C).
[30] I.R.C. § 1022(d)(1)(A).
[31] I.R.C. § 2040(b).
[32] I.R.C. § 1022(d)(1)(B)(i)(I).
[33] See I.R.C. § 2042(a).
[34] I.R.C. § 1022(d)(1)(B)(i)(II).
[35] E.g., Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992) (entire value entitled to new basis at death for husband-wife joint tenancy where husband provided consideration and preceded wife in death). See 5 Harl, *Agricultural Law* § 43.02[2][b][i] (2009); 1 Harl, *Farm Income Tax Manual* § 3.20[4][l][1][F][XIV][c] (2010 ed).
[36] Hahn v. Comm'r, 110 T.C. 140 (1998), *acq*. 2001-2 C.B. 319, AOD CC 2001-06.
[37] I.R.C. § 1022(d)(1)(B)(iv).
[38] I.R.C. § 1022(d)(1)(D).
[39] I.R.C. § 1022(d)(1)(B)(iii).
[40] I.R.C. § 1022(d)(1)(C).
[41] I.R.C. § 691(a).
[42] *Id*.
[43] I.R.C. § 1022(d)(1)(D)(i).
[44] I.R.C. § 1022(d)(1)(D)(ii).
[45] I.R.C. § 1022(d)(1)(D)(iii).
[46] I.R.C. § 1022(d)(1)(D)(iv).
[47] I.R.C. § 1022(g).
[48] I.R.C. § 121.
[49] I.R.C. § 121(d)(9).
[50] I.R.C. § 1040(a).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ADVERSE POSSESSION

FENCE. The rural properties of the parties were separated by a crooked fence which was built as much as 30 feet on to the plaintiff's property such that more than 19 acres of the plaintiff's titled land was on the defendant's side of the fence. The evidence did not show when or by whom the fence was constructed, but the evidence did show that the fence had existed for over 70 years and that all previous property owners used their land up to the fence. The plaintiff had the plaintiff's property surveyed six years after purchasing the property and discovered the error in placement of the fence. When the defendant refused to allow the fenced to be moved to the actual property line, the plaintiff sued for quiet of title. The defendant argued that title had passed by boundary by agreement from the conduct of the previous and current owners who used their land up to the fence for various farming activities. The court agreed with the defendant and quieted title with the defendant based on the conduct of the owners of both properties over 70 years. **Flying Elk Investment, LLC v. Cornwall, 2010 Ida. LEXIS 72 (Idaho 2010)**.

BANKRUPTCY

FEDERAL TAXATION

IRS DISCLOSURES. The IRS has issued a Chief Counsel Notice advising, in question and answer format, employees in the Office of Chief Counsel on the scope of disclosures, under I.R.C. § 6103(h), of returns and return information, collectively "tax information," that may be made to the Department of Justice in bankruptcy cases. **CC-2010-009, May 11, 2010**.

CHILD TAX CREDIT. The debtor, a single parent with one minor child, filed for Chapter 7 on January 4, 2010 and filed the 2009 income tax return on February 24, 2010, claiming a refund. The refund was estate property except to the extent of any exemptions and the debtor sought to exclude the portion of the refund attributable to the child tax credit, arguing that the credit was received in trust for the debtor's child. The court rejected the treatment of the credit as held in trust, noting that no provision of bankruptcy law treated the credit as a trust. In addition, the court noted that the credit was already received by the debtor in that it reduced the tax liability; therefore, to exempt the credit from the refund would result in a double benefit to the debtor. The court held that the amount of the credit was not allowed as an exemption from the refund. ***In re* Parisi, 2010-1 U.S. Tax Cas. (CCH) ¶ 50,403 (Bankr. E.D. New York 2010)**.

CONTRACTS

HEDGE-TO-ARRIVE CONTRACTS. The plaintiff was a grain farmer who entered into four hedge-to-arrive (HTA) contracts for the sale of grain. The contracts stated the price, type and quantity of grain to be sold but did not provide for a specific delivery date or fees for rolling over the contracts to subsequent crop years. The plaintiff did roll over the HTAs several times and paid a fee for each extension but eventually failed to deliver any grain. The plaintiff sought a ruling that the HTAs were invalid futures contracts because they were not traded through an exchange registered by the Commodity Futures Trading Commission. The court found that, because the plaintiff was assessed a fee for rolling over the contracts and that such a fee would eventually force delivery, the parties intended for the crop to be delivered; therefore, the HTAs were not invalid as futures contracts. **Farmers Elevator Co. of Oakville, Inc. v. Hamilton, 2010 Ind. App. LEXIS 701 (Ind. Ct.**