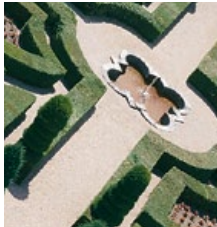


## DEALING WITH THE PREVIOUSLY UNTHINKABLE: MODIFIED CARRYOVER BASIS AND 2010 DECEDENTS

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As 2010 draws to a close, it appears that the most fervent wish of those professionals who handle decedent's estates may not be granted – Congress will not change the law applying to the estates of 2010 decedents to eliminate the carryover basis regime created under Section 1022 of the Internal Revenue Code. At best, Congress may provide an election between the modified carryover basis regime and the traditional estate tax regime. Even if Congress grants such a choice, it is likely that many larger estates will elect to apply 2010 law with its modified carryover basis rules. As such, practitioners need to carefully consider how to deal with the issues Section 1022 poses, including how to calculate the amount available for basis allocation, to which assets to allocate basis, who is able to make such allocations, and lastly, how to uphold a fiduciary's duties of fairness and impartiality in this brave new (and temporary) world.

### BACKGROUND

Under the terms of the Economic Growth and Tax Relief Reconciliation Act of 2001, no federal estate tax is imposed on the estates of decedents dying in 2010. However, this reprieve from the federal estate tax comes at a cost: a new modified carryover basis regime. Whereas in the past, every asset owned by a decedent received a step up to the date-of-death (or alternate valuation date) value for income tax purposes, the assets owned by a decedent who dies in 2010 are instead treated for income tax purposes as if they had been gifted to the recipient and maintain the basis that the assets had in the hands of the decedent. The basis in the hands of the recipient, meanwhile, will be the lower of the decedent's adjusted basis or the fair market value on the date of death.

The severity of this new regime is tempered by two basis allocation amounts that can be used to increase the basis of assets up to (but not in excess of) the fair market value on the date of death. The first general basis allocation amount, \$1.3 million, is available for allocation to assets deemed to have been "owned by the decedent" on the date of death. Such assets include those held in the decedent's individual name, in a qualified revocable trust (i.e., a trust that would be permitted to make a Section 645 election to be treated as an estate) or held as a joint tenant with right of survivorship. An allocation cannot be made to assets held in a marital trust created by a predeceased spouse, or to Income in Respect of a Decedent (such as qualified plan or IRA assets).

This general basis allocation amount may exceed \$1.3 million under some circumstances. For example, the allocation is increased by the amount of any unused capital loss carryovers or net operating loss carryovers reported on the decedent's final income tax return (Form 1040). Additionally, basis allocation is increased by the amount of any unrecognized losses that would have been recognized under Section 165 of the Internal Revenue Code if the property had been sold by the decedent immediately before death. Such losses include those relating to worthless securities, disasters, as well as losses incurred in a trade or business. Most commentators also would include any unrecognized capital losses, such as unrecognized losses on the sale of securities that have a fair market value lower than their basis. Because such assets would have resulted in a capital loss under Section 165 if they had been sold by the decedent prior to death, it appears that the amount of such unrecognized loss would be added to the \$1.3 million basis adjustment. We hope



that the IRS will issue guidance on this important matter in the near term.

An additional \$3 million spousal basis allocation is available for assets passing to a surviving spouse either outright or in a trust that would have qualified as a QTIP trust under 2009 law. It appears that such allocation also can apply to either the decedent's community property interest or the surviving spouse's community property interest; however, there is not a clear consensus on this issue, and IRS guidance is needed. In addition, a general power of appointment trust would qualify for this \$3 million spousal basis allocation as long as the power is testamentary. However, an inter vivos power of appointment would prevent such an allocation of the spousal basis increase to the trust.

What assets would fail to qualify for either the \$1.3 million general adjustment or the \$3 million spousal basis adjustment? Any assets acquired by the decedent by gift or by inter vivos transfer for less than full consideration within three years of the date of death would not qualify for either basis adjustment. There is an exception to this general rule: assets acquired by the decedent from his or her spouse. However, if the transferring spouse acquired the property by gift or by inter vivos transfer for less than full consideration within the three-year period, no basis adjustment is available with respect to these assets.

### THE EASY CASE

In many situations, the handling of a 2010 decedent's estate will be very straightforward because the total amount of unrealized gain on the decedent's assets will be less than the available allocation amounts. In these cases, basis allocation will allow most assets to be treated in the same way they would have been following a death in prior years – the assets will receive a step up in basis to the fair market value on the date of death. While the standards for reporting this new cost basis are not yet known (IRS guidance is currently being drafted), the decision-making process is relatively easy because the available allocation allows all beneficiaries to receive assets with a full step up in cost basis.

The one complicating factor to this “easy case” relates to the use of the spousal basis allocation. In some cases, the total amount of unrealized gain could be less than the \$4.3 million basis allocation available (\$1.3 million general and \$3 million spousal). However, the spousal basis allocation is only available for assets that pass in the appropriate manner – i.e., outright to the spouse or

in a trust that qualifies for the spousal basis allocation. Consequently, assets allocated to the spousal share need to be selected carefully in order to allow for full use of the spousal allocation. In practice, such selection may ultimately cause the spouse to receive a larger percentage of the low-basis, high-growth potential assets, while the children receive assets considered to have less growth potential. Although the goal was laudatory – to secure full use of the spousal allocation – such a deliberate selection may raise issues of fairness and impartiality.

Unfortunately, there is no easy solution to this spousal basis allocation challenge. On the one hand, there may not be an issue with such an allocation in a functional family where the spouse and children get along and the children know that the assets held in trust for the spouse ultimately will pass to them. Still, all parties should sign the appropriate consents and releases acknowledging such an allocation. However, where there is less harmony among the affected parties, such agreement may not be possible. In those circumstances, the fiduciary might choose to “waste” some of the available basis allocation to ensure that the division of assets is fair and equitable. This is a situation where the tax “dog” should not wag the planning “tail.”

### THE HARD CASE

Unfortunately, the available basis allocation amounts will not always be sufficient to cover all of the unrealized gain. Even if Congress changes the law applicable to 2010 decedents, many commentators believe that such legislation is likely to provide a choice for executors between the law as it was in 2009 (as modified by Congress) or the law as it stands for 2010. Most fiduciaries of very large estates will continue to opt for the 2010 law in order to avoid the estate tax. However, these very large estates are precisely the estates where the unrealized gain is likely to exceed the available basis allocations. As such, it seems unlikely these hard cases can be avoided, regardless of any action by Congress.

There are a myriad of issues that arise for fiduciaries and advisors alike with these hard cases. Should basis be allocated to sales implemented to raise cash for expenses, debts and taxes? Should basis be allocated to sales implemented to fund specific bequests? Should allocation be made to specific bequests of property? To tangible personal property? If allocation is made to the residue, how should it be divided? Are there assets to which allocation is not advisable?

**Raising Cash for Administration:** The first issue to confront is whether to allocate basis to sales made to raise cash required for the administration of the estate. Here, an argument exists for not allocating basis to such sales, because the tax will be paid “off the top” and at what may be a lower rate than what will be incurred in future years (when the capital gains tax is likely to be higher than the current 15% rate). However, engaging in such speculation is not advisable in most circumstances because capital gain rates on future asset sales may possibly be higher than current rates, and the future value of assets remains impossible to predict. As such, fiduciaries and advisors would be wise to focus their attention more on avoiding current taxes (based on the law in effect as of this writing) and less on minimizing potential future taxes that may or may not actually be incurred.

A similar approach is appropriate for sales made to raise cash for other purposes, including sales to fund relatively small specific bequests, to reduce asset concentrations, and/or to create a fund for the potential imposition of federal or state estate taxes. In some situations, the fiduciary may choose to treat these sales (which could have been deferred) differently, but the general logic behind the allocation decision remains the same.

**Specific Bequests:** A far more complex issue relates to whether to allocate any remaining basis allocation to specific bequests of property possessing significant unrealized gain. Examples of such property can include a bequest of the family residence or vacation home to a spouse or particular child, a bequest of the family owned business to a particular individual, or a bequest of a very valuable item of tangible personal property to a named individual. In many cases, the amount of the unrealized gain associated with the specific bequest will be minimal; however, some bequests may include assets (such as the interest in a closely held business) with a very significant unrealized gain. In the latter case, it is often difficult to glean what the grantor may have intended since most grantors never considered this issue, and consequently, did not provide any guidance in their estate plan. State law may assume that such specific bequests do not bear any burden for estate taxes, but analogizing capital gains tax (the timing of which is in the hands of the recipient) to estate tax seems to be a stretch. Ultimately, the fiduciary will have to decide on a case-by-case basis, considering all of the circumstances, as well as the family dynamics and specific document terms. In some situations, court direction may be needed,

especially if the value of the specific bequests (and their related unrealized gain) is sufficient to warrant such a proceeding.

Special caution also should be given to an allocation to real estate. Because real estate values in some places are still declining, an allocation up to the date-of-death value, followed by a sale for less than the date-of-death value, may result in wasted allocation. In addition, Section 121 allows an estate to utilize the \$250,000 gain exclusion upon sale of a primary residence, which may minimize the need for any additional basis allocation.

**Allocation to Residue:** Once these initial allocation decisions have been reached, any remaining allocation will then need to be made to the residuary shares. As a general principal, the fiduciary should decide how the assets will be divided among the beneficiaries prior to the allocation decision to be sure that any unrealized gain is fairly apportioned among the beneficial shares. Particularly in these situations, the fiduciary may consider fractionalizing assets and distributing them pro rata among the shares to ensure that unrealized gain is equally distributed. One exception to this rule might be the allocation of assets with a large amount of unrealized gain to a charitable share. However, similar to the issue previously discussed regarding allocating low basis assets to a spousal share to allow full use of the spousal basis allocation, such a non-pro rata allocation to a charitable share may raise issues of fairness and impartiality. Discussion with the beneficiaries should occur, and obtaining their consent should be considered and may be appropriate wherever such a non-pro rata allocation is implemented. If obtaining such consents is not feasible, a more prudent approach might simply be to utilize a pro rata division, notwithstanding the potential lost opportunity to avoid future capital gains tax.

After the assets are divided pro rata, the fiduciary then should divide the remaining basis allocation pro rata based on the percentage of the residue allocated to a given share (other than a charitable share). This approach will ensure all the beneficiaries are treated fairly and impartially. However, it also may result in a surviving spouse, or the share held for the surviving spouse’s benefit, receiving the lion’s share of the basis allocation. In these cases, the fiduciary, with the help of his or her advisors, should be prepared to address the issues likely to be raised by non-spousal beneficiaries regarding such an allocation.

In some circumstances, the beneficiaries may have strong views regarding the proper method of allocating the basis increase. The fiduciary should review the allocation proposed by the beneficiaries carefully and in the event an acceptable agreement is reached, all of the parties should sign the appropriate consents and releases. It also may be necessary to ask a court to appoint a guardian ad litem to represent unborn(s) impacted by the allocation.

### WHO MAKES THE ALLOCATION?

Under the Internal Revenue Code, the executor is granted the authority to allocate the basis adjustments. In the event no executor is appointed, the statutory executor (generally the trustee) should be able to make the allocations. However, where an executor is appointed, it appears that the executor has the authority to determine allocation, even if most or all of the assets are held in a trust of which the executor is not the trustee.

Guidance from the IRS clarifying this issue is expected in the near future because in many cases, the roles of executor and trustee are held by different parties. Often, the bulk of the assets are held in a trust, but an estate is opened to run the necessary claims periods, even though the assets subject to probate are minimal or nonexistent. A fiduciary who is acting as the trustee – but not as executor – should request information and draft spreadsheets detailing the executor's proposed basis allocation as soon as such information is available. If the proposed allocation does not appear to meet the duties of fairness, impartiality and loyalty, this trustee, together with his or her advisors, needs to determine the proper way to proceed. Possible responses may include correspondence to all impacted parties, requests for consent from all parties, and/or court proceedings.

In those situations where no executor has been appointed and the fiduciary is the statutory executor for some but not all of the assets, there may be multiple parties with authority to allocate basis but with competing interests. Such situations

will require detailed analysis by the fiduciary and his or her advisors to determine how to proceed. Again, IRS guidance hopefully will assist in resolving this open issue of who must or may file the appropriate tax forms.

### A FEW REPORTING ODDS AND ENDS

Many decedents will lack basis information for some portion of their assets. Individuals may have retained assets for the sole purpose of obtaining a step up in cost basis at death because either the basis was so low or the cost basis information was unknown. In these circumstances, the fiduciary has a duty to use all reasonable due diligence to obtain the cost basis information. In the event no such information can be located, cost basis should be assumed to be zero.

Similarly, because the decedent's holding period carries over to the recipient, the fiduciary has a duty to try to obtain the holding period information as well. In the event the fiduciary cannot verify the asset was held more than one year prior to the decedent's death (i.e., a period sufficient to qualify for long term capital gain treatment), the default position would be to treat the asset as if it was purchased on the date of death. This approach will avoid treating a sale as long term where there is no proof that such treatment is appropriate.

Ultimately, 2010 presents complex fiduciary and administrative issues for everyone involved in settling the estates of such decedents. A detailed understanding of the applicable law, a careful consideration of the issues involved and a consistent approach to handling such issues should help fiduciaries and their advisors navigate these uncharted waters effectively and efficiently.

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