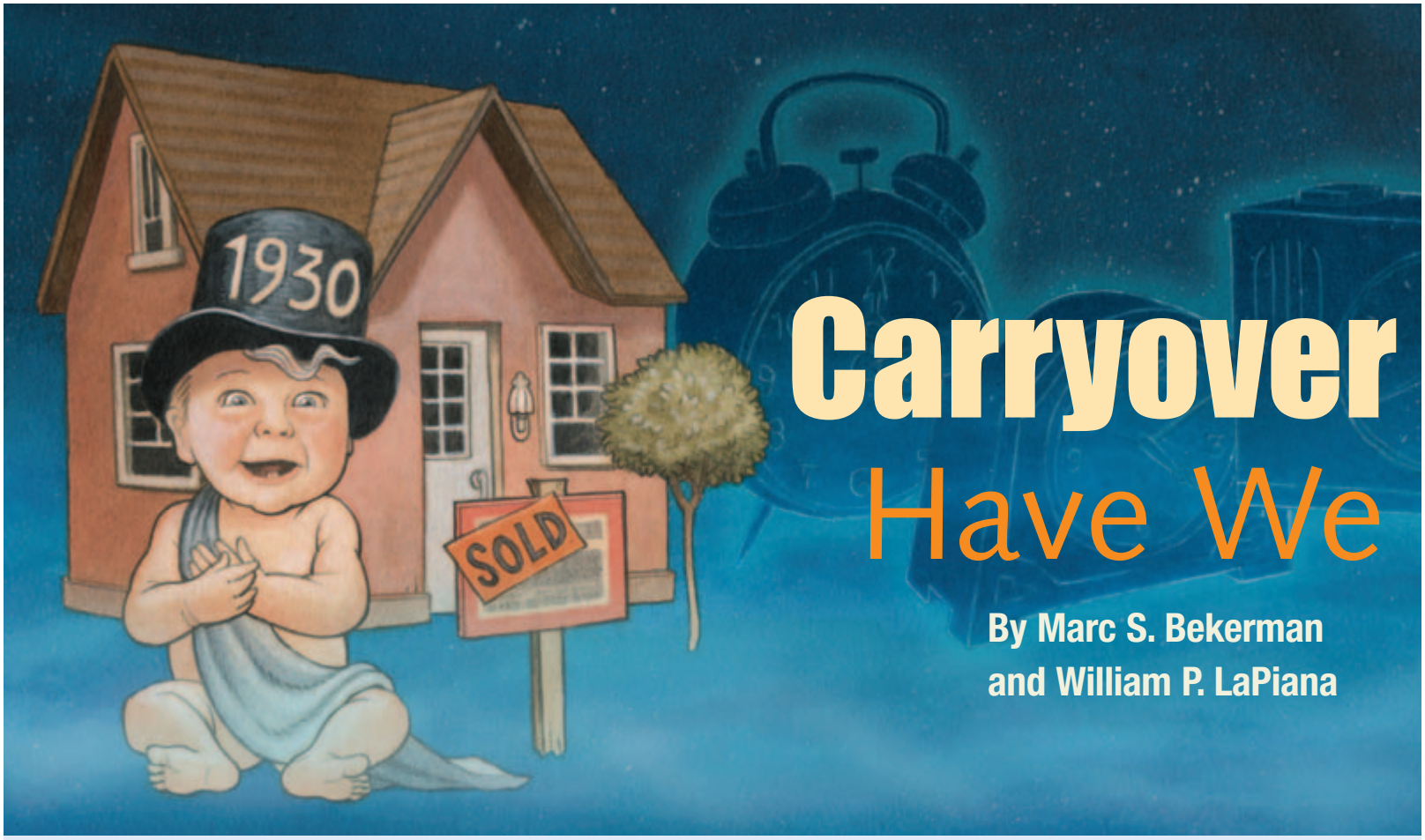

Carryover Have We

By Marc S. Bekerman and William P. LaPiana

"We learn from history that we do not learn from history."
Georg Friedrich Wilhelm Hegel (1770–1831)

Section 1014 of the Internal Revenue Code of 1986, as amended, allows in most cases for a beneficiary to take the fair market value of the property as of the date of the decedent's death as her basis of property that she acquired from a decedent. In 1976, Congress attempted to repeal this so-called "step-up" in basis with a system in which the beneficiary would receive a carryover basis from the decedent. This system was so unsuccessful that it was repealed retroactively shortly after passage.

As part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107–16, 115 Stat. 38, the estate tax is eliminated for one year (specifically 2010). Because much of the justification for the step-up in basis is tied to the imposition of an estate tax, EGTRRA also created a modified carryover basis system. Given that the likelihood of estate tax repeal before 2010 has increased, it is also more likely that such a modified carryover basis system also will take effect before 2010. Although many attorneys have modified their documents since the passage of EGTRRA to take into account larger applicable exemption amounts, and even possible repeal of the estate tax, very few attorneys have taken steps to plan for carryover basis.

This article will analyze the modified carryover basis system contained in Code § 1022, identify problems that may require legislative or administrative solutions, and present suggestions in planning for such a system.

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The Economic Growth and Tax Relief Reconciliation Act of 2001

Under the modified carryover basis system of EGTRRA that will take effect on the phase-out of the estate tax, the beneficiary's basis in property acquired from a decedent will be the lesser of the decedent's adjusted basis in the property or the fair market value of the property at the date of the decedent's death. Code § 1022(a)(2). The fiduciary of a decedent's estate can increase the basis in certain property from the decedent's adjusted basis to the fair market value of the property. Code § 1022(b). The aggregate basis increase under this section, however, is generally limited to $1.3 million. Code § 1022(b)(2)(B). In addition, the fiduciary may increase the basis of property acquired by the surviving spouse in the additional amount of $3 million as long as the property is qualified spousal property as defined in Code § 1022(c). Both of these limitations

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are indexed for inflation. Code § 1022(d)(4).

Several justifications allow for these basis adjustments. First, in smaller estates, it essentially gives the beneficiaries the same full step-up in basis currently allowed by Code § 1014. Further, such basis adjustment will reduce the capital gains taxes that might be assessed in situations in which no estate tax is currently due; however, as discussed later in this article, this reduction will not eliminate all such circumstances.

As is often the case, these modifications of a strict carryover basis system create a set of problems that Congress likely did not contemplate during the enactment of EGTRRA. This article will now discuss several of the more troubling issues created by the modified carryover basis system.

Issues Surrounding Allocation of the Step-Up in Basis

Presumably, the fiduciary will report the allocation of the basis adjustments by filing an informational return with the IRS. As no tax will be due with the filing of this return, it is unlikely that the IRS will examine many of these returns, and the beneficiaries will simply use the reported information for their personal planning and income tax purposes.

Acceptance by IRS of Information Contained in Informational Return

One important question is whether the IRS will consider the information contained in the informational return as binding on the government. The conclusive nature of information reported on the return will become an issue during an audit of a beneficiary's income tax return that reports either a sale of the property acquired from a decedent or the use of the adjusted basis in calculating income tax liability (for example, if the acquired property is depreciable by the beneficiary, such as commercial real estate). The information also will become relevant on the death of the beneficiary and reporting of basis by the fiduciary of the beneficiary's estate.

Worries about the IRS's treatment of the reported information are fed by experience with the IRS's approach to adjusted taxable gifts in an examination of an estate tax return. In these situations, the IRS often will take the position that it has the ability to make adjustments to prior gift tax returns, even when the statute of limitations has already run, because it affects calculation of the estate tax. The IRS could make a similar argument for reconsidering a reported basis allocation long after the fiduciary has filed the informational return.

The IRS may attack a basis adjustment by claiming that the decedent's basis was increased in excess of the property's fair market value at the time of the decedent's death. If the IRS's attack is successful, the result in the example given above will be increased capital gain or disallowed depreciation deductions. It is somewhat ironic that the IRS will be in the position of arguing that executors are overvaluing estate assets after arguing to the contrary for the duration of the estate tax. Therefore, cautious practitioners will continue to value assets at date of death and retain such appraisals indefinitely.

Any attorney representing an estate must be concerned about the IRS questioning basis allocation. For example, if it is later determined that the basis of a particular asset of the decedent was adjusted above fair market value, it may be that the disallowed basis adjustment cannot be allocated elsewhere and is, therefore, forever lost.

Timing of Filing

The IRS can do little to compel a fiduciary to file an informational return on a timely basis when little or no penalty is involved because no tax is assessed. As a result, a fiduciary might consider filing the informational return as late as possible to determine how to allocate the allowed step-up in basis (for example, to wait until the beneficiaries begin to dispose of assets). Such an approach will allow a fiduciary to use hindsight and foresight to determine how best to allocate the permissible basis adjustments. Two factors may influence the allocation of the basis adjustments: first, which assets are to be sold first because the capital gains tax will be due on these assets sooner; and, second, the relative performance of each asset because the fiduciary may decide not to allocate basis adjustment to an asset whose value decreases after the decedent's death.

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Payment of Tax in Situations Currently Nontaxable

The repeal of the estate tax combined with a modified carryover basis will result in the imposition of tax in certain situations when there is currently no tax. For example, a surviving spouse currently will pay no estate tax if the spouse inherits a sufficient portion of the estate to reduce the estate tax to zero and receives a step-up in basis on all property for income tax purposes. Code § 1014. Under this scenario, no estate tax or capital gains tax is involved on the death of the first spouse. Under Code § 1022, however, a surviving spouse who inherits property with significant built-in capital gains will face capital gains tax on the disposition of such property (to the extent that the permissible basis adjustments do not eliminate the built-in gains).

Fiduciary Issues

Under current law, a fiduciary must obtain values for all assets in a decedent's estate. If the estate is large enough, the fiduciary then must arrange for the preparation and filing of the necessary estate tax returns. This area of the law rarely causes disputes between a fiduciary and the beneficiaries.

Under Code § 1022, the fiduciary still must obtain valuations of all of the decedent's property because that may be the beneficiary's basis if the fair market value on the decedent's date of death is less than the decedent's adjusted basis in the property. Further, this fair market value is also the upper limit of the basis that the beneficiary can take in the property after permitted adjustments. Code § 1022(b). Using the appraisal information, the fiduciary will now have to determine how to allocate the basis adjustments permitted by Code § 1022(b).

A prudent fiduciary will look to the decedent's testamentary instruments to determine whether any guidance is contained in the documents regarding basis adjustment allocation. Unfortunately, at this time, very few instruments would be helpful to a fiduciary looking for such assistance. The absence of any direction or suggestion evidencing intent will create a situation in which a fiduciary may have to choose how to distribute this benefit among the beneficiaries of the estate. Most prudent fiduciaries would prefer not to find themselves in this situation, but, if they must decide, some of the appropriate considerations will include the following:

1. Residuary vs. Pre-residuary Gifts. A fiduciary could, by analogy, look to how estate taxes are apportioned, typically either against each beneficiary proportionately or against the residuary estate. Many estate planners will often ask their clients for guidance on whether a pre-residuary gift is intended to pay its "fair share" of estate tax; however, experienced practitioners know that this subject can be a minefield depending on a number of factors, including the value of gifts made outside of the residuary (including nontestamentary assets), the type of the pre-residuary bequest (specific bequest vs. general legacy), and the possible effect on an estate tax deduction of a possible tax apportionment (for example, having a spousal or charitable residue pay the estate tax for the pre-residuary gifts). In the absence of a specific tax apportionment under the will, local law will direct a statutory method of estate tax apportionment. As a result, there is no discretion—and therefore, no risk—for the fiduciary in apportioning estate taxes.

Now imagine attempting to apportion estate taxes without either a tax apportionment clause in the will or local law providing a default rule. Many fiduciaries will face this situation in allocating the basis adjustments because it is unlikely that local law will provide a default rule in the absence of guidance in the testamentary instrument (unless one views the benefit conveyed by the step-up as part of the residuary estate in the absence of a contrary provision). In this case, the fiduciary has complete discretion and, as such, may have significant risk in exercising that discretion to the detriment of one or more beneficiaries.

2. Can an Equitable Adjustment Be Made Between Beneficiaries? The threshold question on this issue is whether local law will mandate, or even permit, an equitable adjustment between beneficiaries to take into account one beneficiary's receipt of a tax benefit in the form of an upward basis adjustment to the detriment of

another beneficiary. This will obviously not be an issue in a jurisdiction where local law would not permit such an adjustment. Similarly, if a jurisdiction mandates an equitable adjustment under these circumstances, the fiduciary has little discretion and must simply compute the adjustment. As discussed subsequently, this calculation is not as simple as one might initially believe. Finally, a fiduciary in a jurisdiction that permits, but does not mandate, an equitable adjustment must determine whether such an adjustment is appropriate.

If a fiduciary determines that an equitable adjustment is appropriate, the major difficulty facing the fiduciary is how to compute the adjustment. Ideally, the beneficiary receiving the benefit of the basis adjustment will sell the property quickly and the capital gains tax saved can be easily computed. Unfortunately, several potential problems are present here:

- *What if the beneficiary does not sell immediately?* The deemed savings may not take into account the time value of money. Further, it is difficult to determine whether there will actually be a capital gain realized in the future because the sales price cannot be known until the time of the sale. Finally, the capital gains tax rate can change over time.
- *What if the beneficiary has certain tax attributes?* Should a fiduciary take into account whether the beneficiary has a tax benefit that may reduce, or eliminate, the capital gains tax? For example, should a fiduciary take into account whether a beneficiary has significant capital loss carryforwards or is currently in an income tax bracket lower than the capital gain rate?

3. Valuation Issues. The valuation of assets under Code § 1022 contains a great potential for trouble. As discussed previously, a fiduciary can only step up the decedent's basis to the fair market value at the time of the decedent's death. Code § 1022(b).

Certain assets are difficult to value and, as such, may lead to questions about the appropriate limit of basis adjustments. For example, assume that a decedent has artwork with a basis of $100,000 that is appraised for $300,000. The executor can adjust the basis in the hands of the beneficiary to $300,000, and, on the sale of the artwork, the beneficiary will use $300,000 to calculate gain or loss (in the event that the beneficiary dies before sale of the item, this value will be used for allocating basis adjustment in the beneficiary's estate). If the IRS later audits the income tax

return reporting the gain, however, it may attempt to argue that the fair market value was $200,000 and limit the basis adjustment accordingly. As suggested above, this could result in the loss of the disputed basis adjustment.

Recommendations for Drafters

It appears increasingly possible that the estate tax will be repealed and that some form of carryover basis will be enacted. Estate planners should consider providing guidance in their estate planning documents on how fiduciaries should allocate the basis adjustments permitted under Code § 1022. These recommendations might include the following:

- If the surviving spouse is not the sole executor, give the surviving spouse the power to direct the executor on the allocation of the $3 million basis adjustment designated solely for the surviving spouse.
- Much like current discussions regarding estate tax apportionment, determine whether the client wants a beneficiary to receive a pre-residuary bequest with a tax bill or without a tax bill (in this case the tax bill being an income tax bill for the built-in capital gain as opposed to an estate tax bill based on the value of the gift).
- Determine whether local law permits (or requires) an equitable adjustment between the beneficiaries as a result of the exercise of the fiduciary's discretion. If an adjustment is not mandated, but is permitted, consider whether it is appropriate to provide for such an adjustment, and, if so, give guidance on how the adjustment should be made.
- Recommend, but do not direct, that basis step-up be allocated to assets with a readily ascertainable fair market value.
- Consider whether it is appropriate based on local law to include language in instruments that will exculpate and indemnify a fiduciary who allocates basis adjustments in good faith, or if language currently used will already do so.

Conclusion

The step-up in basis on property acquired from a decedent under Code § 1014 is likely tied directly to the future of the estate tax. Because many forces are leading towards the repeal of the estate tax, one must anticipate that the step-up in basis currently permitted under Code § 1014 is also in jeopardy. Although a pure carryover basis has already been dismissed implicitly, both by the retroactive repeal of the previous attempt to impose such a system and the enactment of Code § 1022(b), which permits a modified system allowing a certain amount of basis adjustments, estate planners must begin to consider drafting for carryover basis.

"Nothing endures but change."
Heraclitus (540–480 B.C.) ■