



The Wealth Counselor

A monthly newsletter for wealth planning professionals

The 2010 Basis "Step-Up" Rules

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In the last issue of *The Wealth Counselor*, we examined the (for 2010 only) repeal of the estate tax and suspension of the generation-skipping transfer (GST) tax under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the resulting need to review existing estate plans to ensure that they continue to meet the client's goals and objectives.

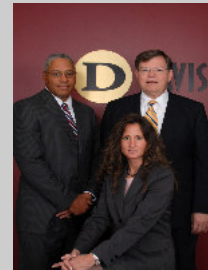
This issue of *The Wealth Counselor* looks at the other provisions of the Internal Revenue Code (IRC) that apply only to estates of people who die in 2010.¹ They impose radically different basis-adjustment rules and new reporting requirements for certain non-taxable estates.

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Estate Planning, Business
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The 2010-Only Law Changes

From January 1 through December 31, 2010, (barring Congressional action) Sections 1022 (basis adjustment) and 6018 (returns for certain non-taxable estates) will apply.

Section 1022 - Basis Adjustment Rules

Section 1022 substantially changes the rules for determining the basis for appreciated property passing at the death of the property owner. It completely replaces the prior rule, IRC Section 1014, which expired on December 31, 2009, along with the other estate tax provisions and will be reinstated on January 1, 2011. (Under the EGTRRA, the GST tax chapter is made inapplicable to transfers taking place in 2010, so that chapter, too, will come back next January 1, unless the Congress acts.)

Planning Tip: The text of Section 1022 is available online at http://www.law.cornell.edu/uscode/uscode26/usc_sec_26_00001022----000-.html.

Step Down in Basis for Loss Property

Section 1022 retains the prior law's step-down in basis at the death of the property owner for property that has fallen in value since its acquisition (basis greater than fair market value at death). However, it eliminates the automatic step-up in basis to fair market value, with which practically everyone is familiar.

\$1.3+ Million Allocable Basis Increase

Instead, Section 1022 permits the estate's executor or representative to assign up to \$1.3 Million in basis increase (not to exceed fair market value) to specific estate assets of U.S. citizen and U.S.-resident decedents. That amount is increased by unused built-in losses and loss carryovers. For decedents who are not U.S. citizens or residents, the allowable basis increase is \$60,000, not increased by unused built-in losses and loss carryovers.

Note that this is \$1.3 Million of *basis adjustment*, NOT increase to fair market value of \$1.3 Million in estate assets. Thus, if a decedent has an estate value of \$2 Million and estate assets with a basis of \$500,000, the estate assets' basis in the heirs' hands will be $\$500,000 + \$1,300,000 = \$1,800,000$, not $\$1,300,000 + (\$2,000,000 - \$1,300,000) = \$2,000,000$.

Case Study No. 1

Steven, a single person who owns appreciated property worth \$2.5 Million, dies in 2010. His basis in this property is \$200,000. Steven's estate plan leaves everything outright to his daughter, Mary. Under Section 1022, Mary will receive Steven's property with a basis of \$1.5 Million ($\$200,000 + \$1,300,000$), not \$2 Million. When Mary sells the property, she will pay capital gain tax on the difference between the selling price and \$1.5 Million. For 2010 liquidation, this will impose a \$75,000 tax burden ($\$500,000 \times 15\%$) on Mary. When the capital gains tax rate increases, so will the tax burden on Mary.

Planning Tip: Estimates are that this new rule will impact up to 60,000 decedents in 2010. Note, however, it will only affect property with low-cost basis, not cash or equivalent assets like CDs, checking accounts, and savings accounts.

\$3 Million Allocable Basis Increase for Surviving Spouse

Section 1022 also permits the estate's executor or representative to assign up to an additional \$3 Million (not to exceed fair market value) of basis increase to certain property going to or owned by the surviving spouse, regardless of whether the decedent is a U.S. citizen or resident. However, not all bequests to a surviving spouse qualify for application of the \$3 Million basis adjustment.

Applicable to Outright and QTIP Only

Section 1022 provides that only property left to a surviving spouse either outright or as "qualified terminal interest property" (QTIP) is eligible for the \$3 Million spousal property basis increase. The definition of QTIP is not different for 2010. Therefore, property left to a surviving spouse in either a power of appointment trust or in a survivor's trust will NOT qualify.

Planning Tip: It is critical that the planning team review how property is to be left to surviving spouses to make sure that it is eligible for the \$3 Million spousal property basis increase.

Planning Tip: Property placed by the decedent in a revocable trust is deemed owned by

the decedent for purposes of the \$1.3 and \$3 Million basis increase. However, property passing by the decedent's exercise of a power of appointment is not.

Impact on Community Property

Under the former Section 1014, property classified as community property under state law received a double basis adjustment at the death of the first spouse to die. In other words, the basis of both spouses' interest in community property was adjusted to date of death value, versus only the decedent's half of the property in separate property states. Thus, it was very advantageous from an income tax perspective to preserve community property, not only for clients in community property states, but also for those who move to separate property states owning community property.

The same sort of preference applies under the 2010 basis-adjustment regime because, for purposes of the \$1.3 Million property basis increase and the \$3 Million spousal property basis increase, all community property is deemed owned 100% by the decedent if the one-half transferred by the decedent otherwise qualifies for the basis increase.

Planning Tip: Generally, a married couple must live in a community property state to acquire community property. However, Alaska law permits non-Alaska residents to opt-in to Alaska's community property regime. Thus, community property is available to all clients, whether they currently live in a community property state or not.

Case Study No. 2

Ricky and Lucy are married and live in California, a community property state. They own their home as community property. The home cost \$500,000 years ago when they bought it, but it is now worth \$5 Million. Ricky dies in 2010 and his interest in the home goes by right of survivorship, outright bequest, or QTIP trust to Lucy. \$4.3 Million of basis increase can be allocated to the property so Lucy's new basis can be increased to \$4.8 Million (\$500,000 + \$1,300,000 + \$3,000,000). However, if Ricky had left his interest in the house to a trust of which Lucy and their children are beneficiaries, the \$3 Million spousal property basis increase could not be applied to the home.

Planning Tip: In 2010, absent proper planning, property passing at death may receive little or no step-up in basis, resulting in larger capital gain tax when the beneficiaries sell the property.

Uncertainty as to Irrevocable Trust Property

There is no clear answer as to the effect of Section 1022 on property held in an irrevocable grantor trust. Some experts believe that property held in an irrevocable grantor trust is not eligible for basis increase allocation at the grantor's death. Others believe the exact opposite. Because Section 1022 only became effective January 1, 2010, any court interpretations will not come until after 2010 is over, and Section 1022 only applies to the assets of people who die in 2010.

Planning Tip: The usefulness of irrevocable grantor trusts has not changed, even though

property held in an irrevocable grantor trust may not receive a step-up in basis if the grantor dies in 2010.

Life Estate Not Sufficient for Basis Step-Up

There is no support in Section 1022 for a life estate holder to be considered an owner for purposes of a step-up in basis. Therefore, it appears that property held subject to a life estate interest will not receive a step-up in basis at the death of the life estate holder during 2010 or while Section 1022 is in effect. This is completely different from the treatment of life estate property in the past under IRC Section 2036. Under IRC Section 2036, life estate property was included in the decedent's estate and got a full basis adjustment.

The Section 121 Exemption Remains

Section 121 provides for a \$250,000 exemption (\$500,000 for married couples) from capital gains from the sale of a primary residence. It appears that the Section 121 exemption will still be available for assets held individually, in a revocable trust, or in an irrevocable trust, assuming the appropriate rights to the home were retained in the trust. There were no changes to the grantor trust rules that would prevent application of the Section 121 exemption to property held in an irrevocable trust.

Planning Tip: Life estate property will not get a step-up in basis in 2010, but the Section 121 exemption for primary residences remains.

Section 6018 - Estate Tax Returns Required for Certain Non-Taxable Estates

Although under the EGTRRA there is no estate tax imposed on the estate of anyone who dies in 2010, the special executor-assignable basis increase rules for 2010 do mean that an estate tax return may have to be filed. Which 2010 estates have to have estate tax returns is specified in IRC Section 6018. An estate tax return must be filed for 2010 decedents who are:

1. U.S. citizens or residents whose gross estate exceeds \$1.3 Million plus the decedent's unused built-in losses and loss carryovers; or
2. Non-citizen, non-residents whose gross U.S. property exceeds \$60,000.

What's Next?

The Congress could enact federal estate tax legislation this year - retroactive to January 1, 2010, or effective upon enactment - likely repealing Section 1022 in the process. It is also possible that it could repeal Section 1022 even if it does not pass new estate tax legislation this year. It could also, as it has for the past 10 years, continue to do nothing about the Section 1022 basis adjustment problem. There is even a rumor from the office of Senator Blanche Lincoln (D-Arkansas, Member of the Senate Finance Committee) that the Congress may offer estates of 2010 decedents a choice between the 2010 rules (no estate tax, but Section 1022 carryover basis) and the 2009 rules (\$3.5 Million estate tax exemption and full basis adjustment).² What Congress will do, and whether whatever it

does will be retroactive, is anyone's guess!

Absent further action from Congress, Section 1022 will expire on December 31, 2010.

Conclusion

Our clients are well aware that we are living in times of uncertainty, including as to the estate and GST taxes. Being a knowledgeable advisor is particularly critical at times like these. We hope this issue of *The Wealth Counselor* will help in that regard.

Although Section 1022 makes it more difficult to obtain a step-up in basis for the estate of a 2010 decedent, proper planning will allow clients to take advantage of the \$1.3 Million and \$3 Million basis step-up in the event of a 2010 death while still meeting their overall planning objectives. All clients should be encouraged to review their estate plans to ensure a 2010 death would not result in unintended tax consequences and, if it occurs, they can take advantage of the basis increase rules of Section 1022.

¹ This issue of *The Wealth Counselor* deals with the estate tax law only as it now stands.

² Section 1022(d)(4) provides for inflation adjustments for "decedents dying in a calendar year after 2010," but all of the EGTRRA, including Section 1022, is repealed at the end of 2010 and treated, for post-2010 transfers, as if it had never been enacted. Oh, that Congress!

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax adviser based on the taxpayer's particular circumstances.

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