

Guide to Electing Out of the 2010 Estate Tax (And Into Modified Carryover Basis)

Supplement Number 1

Cross-references are made in this document to the **GUIDE TO THE ELECTION OUT OF THE 2010 ESTATE TAX (AND INTO MODIFIED CARRYOVER BASIS)** (which I'll refer to simply as "Guide").

Table of Contents

MODIFIED CARRYOVER BASIS GUIDANCE RELEASED BY IRS	2
A FREQUENTLY ASKED QUESTION	2
SELECTED IRS NOTICE 2011-66 HIGHLIGHTS	3
DUE DATE OF FORM 8939 (affects GUIDE, p. 10).....	3
GENERATION-SKIPPING TRANSFER TAX REPORTING: Schedule R of Form 8939 Announced; Get Out Your Calendars! (Not in the Guide)	6
<i>Can the time for making an allocation of the GSTT exemption be extended when the election out of the 2010 estate tax is made?</i>	8
<i>Due Date When the Section 1022 Election is Made</i>	8
<i>Keep these records forever</i>	9
REVENUE PROCEDURE 2011-41	9
Discussion of Selected Parts of Rev. Proc. 2011-41	10
<i>Rev. Proc. Section 4.01(3) Property Acquired From the Decedent (GUIDE, pp. 33-39)</i>	10
<i>Qualified Terminable Interest Property (QTIP) (GUIDE, p. 59)</i>	15
<i>Rev. Proc. Section 4.01(4) Property Owned by the Decedent - Section 1022(d) (GUIDE, pp. 48 – 49)</i>	15
<i>Rev. Proc. Section 4.02 Amount of Basis Increase; Consider Whether Fair Market Value at Death Has Declined As of the Date of Allocation (Guide, pp. 50 – 54)</i>	17
Rev. Proc. Section 4.04 Fair Market Value (Not in the GUIDE).....	18
Rev. Proc. Section 4.05 Special Rules for Community Property. (GUIDE, pp. 35, 46, 50, 63)	18

Rev. Proc. Section 4.06 Interaction of Section 1022 with Certain Other Income Tax Provisions (GUIDE, pp. 42 – 44).....	19
Rev. Proc. Section 4.06(4) Passive Activity Losses (Not in the GUIDE)	21
ALTERNATIVE MINIMUM TAX SYSTEM (Not in the GUIDE).....	22
A FORMULA ALLOCATION COULD AVOID WASTING BASIS INCREASE ALLOWANCES (GUIDE, Ch. 11)	23
FINALITY: IS IT OUT OF REACH? (Not in the GUIDE)	26

MODIFIED CARRYOVER BASIS GUIDANCE RELEASED BY IRS

On August 5, 2011, the IRS released importance guidance about making the election out of the 2010 estate tax, but still hasn't released Form 8939.

The IRS guidance came in two pronouncements:

- ✓ IRS Notice 2011-66, providing guidance on making the election out of the estate tax and into IRC § 1022's modified carryover basis rules (the IRS calls this the "Section 1022 Election") and various reporting requirements, and
- ✓ Revenue Procedure 2011-41 providing a safe harbor for interpreting IRC § 1022 in tax return reporting. Regulations are forthcoming, and comments are requested.

Notice 2011-66 is available online at: <http://www.irs.gov/pub/irs-drop/n-11-66.pdf>

Rev. Proc. 2011-41 is available online at: <http://www.irs.gov/pub/irs-drop/rp-11-41.pdf>

A FREQUENTLY ASKED QUESTION

Before discussing the IRS guidance, here's a question I have been asked several times: Will filing an extension of time to file Form 706 (the estate tax return) for a decedent who died in 2010 preclude the estate from electing out of the estate tax? The idea is to put the estate tax return on hold while the decision whether to elect out of the estate tax is being made. I believe that estates may elect out of the estate tax even though an extension of time to file Form 706 has been granted. As discussed further later, the IRS will consider filing the estate tax return and an election out of the estate tax as

inconsistent acts. But asking for an extension of time to file Form 706 is not the same thing as the act of filing a Form 706. Asking for an extension of time is not an act inconsistent with filing Form 8939. It may also be prudent to request an extension of time to pay the estate tax. Should the executor ultimately decide to elect out of the estate tax, it might be a good idea to let the IRS know that the Form 706 extension has been superseded by the Section 1022 Election.

SELECTED IRS NOTICE 2011-66 HIGHLIGHTS.

Notice 2011-66 sets forth details about how to go about making the election out of estate tax (the IRS calls this the “Section 1022 Election”) and allocating Basis Increase allowances. The election will be made by filing Form 8939 (not yet released). It also deals with Generation-Skipping Transfer Tax filing requirements, including when the Section 1022 Election is made.

DUE DATE OF FORM 8939 (affects GUIDE, p. 10)

The due date for making the Section 1022 election is November 15, 2011. The shocking news: the date for making the election generally may *not* be extended. There’s some wiggle room after that, but don’t count on making the election out of the estate tax any time after November 15.

The American Institute of Certified Public Accountants has asked IRS to extend the due date for both Form 8939 and Form 706 (the estate tax return). As of this writing, the IRS posted the final version of Form 706 on Saturday, September 3, but neither the instructions for Form 706 nor Form 8939 have been released yet. The AICPA has requested that the due dates be 90 days after both forms are issued in final form, including instructions. The Treasury said it would do this in [IR-2011-33](#) with respect to the Form 8939. The AICPA further requested that the IRS offer a 6-month extension for Form 8939.

The IRS said that “[p]rior filings purporting to make the Section 1022 Election must be replaced with a timely filed Form 8939.”

Once Form 8939 is filed, there’s another requirement soon after that. Within 30 days after Form 8939 is filed, the executor must “provide a statement to each recipient acquiring property reported on that form, setting forth the information required under section 6018(c).” Presumably the “recipient” is the person who ultimately receives property from a decedent. Except for specific bequests (“I leave Blackacre to X”), the specific properties that will be distributed to specific

beneficiaries may well not be known within 30 days. The IRS itself has acknowledged this in allowing allocation of the Spousal Property Basis Increase allowance after November 15th. But the IRS hasn't said how to comply with this 30-day requirement in such cases.

The dates specified for compliance will place executors and practitioners under enormous pressure in the coming months. Getting appraisals takes months (valuation standards will be the same as for estate tax reporting), and that's just the start of the decision-making process. It would be very helpful if Congress stepped in to provide relief if the IRS won't.

After saying the election due date is iron-clad, the IRS went on to say there are some things that can be done after Nov. 15.

Where distributions of property qualifying for the Spousal Property Basis Increase will occur after that date and the form was timely filed, late allocations may be made, up to 90 days after the date of distribution. This acknowledges that spousal bequests may be funded later than the due date of Form 8939. But it's half a loaf, because allocations of the basic \$1.3 million General Basis Increase can't be similarly deferred. The asset selection process for making distributions to the surviving spouse versus to other beneficiaries is interrelated; assets are allocated to the spouse to the exclusion of all other beneficiaries and vice-versa. Accordingly, 90 days after distribution is the timing standard the IRS should adopt for allocation of Basis Increase for all distributions, not just those made to the surviving spouse.

While the election can't be reversed after Nov. 15, Form 8939 can be amended for any purpose (other than for electing out of the estate tax or *vice-versa*) through May 15, 2012 under Treas. Regs. § 301.9100-2.

A supplemental return may be filed under Treas. Regs. § 301.9100-3, but only to obtain extension of time to allocate any Basis Increase that has not previously been validly allocated. In this regards, the IRS said:

[S]uch relief, if appropriate, will be granted only if:

- (1) after filing the Form 8939, the executor discovers additional property to which remaining Basis Increase could be allocated; and/or

(2) the FMV of property reported on the Form 8939 is adjusted as the result of an IRS examination or inquiry. Relief will not be granted to reduce an allocation of Basis Increase made on a timely filed Form 8939.

The time for election *might* be able to be extended under Treas. Regs. § 301.9100-3, but only in rare cases.

Treas. Regs. § 301.9100-3 relief is an expensive process that requires a private letter ruling from the IRS. An IRS user fee applies, and the requirements for filing a private letter ruling must be met. Generally, Treas. Regs. § 301.9100-3 authorizes relief, provided the taxpayer demonstrates to the IRS' satisfaction that he acted reasonably and in good faith and that granting relief won't prejudice the government's interests. But the Notice warns:

[I]n this context, the amount of time that has elapsed since the decedent's death may constitute a lack of reasonableness and good faith and/or prejudice to the interests of the government (for example, the use of hindsight to achieve a more favorable tax result and/or the lack of records available to establish what property was or was not owned by the decedent at death), which would prevent the grant of the requested relief.

The IRS has taken the position that no "conditional" elections may be made based on, say, an increase in estate taxes upon audit. The IRS avoided using the term "protective election." It will be interesting to see whether this will be litigated. For example, a protective election into the estate tax's alternate valuation method was established neither by statute nor by administrative fiat, but rather by the Tax Court. See *Estate of Mapes v. Commissioner*, 99 T.C. 511 (1992). Estates that wish to make protective elections risk a refusal by the IRS, but may still be able to litigate to obtain relief. The flip side is uncertainty about the income tax basis of assets under a protective election. When assets are sold, it may be necessary to file a protective claim for refund pending whether the § 1022 protective election becomes effective.

The Rev. Proc. confirmed multiple "executors" could exist. Could one person cause an entire estate to elect out of estate tax? Apparently so, especially if no estate tax return is filed (the IRS will consider filing both Forms 8939 and 706 inconsistent acts, discussed below). Here's how the IRS will address differences if several "executors" file several Forms 8939: "executors" will get a letter granting 90 days to fix problems (mediation, anyone?). If no action is taken, the IRS will decide –

possibly prorating Basis Increase allocations across all properties having built-in gains. The IRS hasn't said how long this will take or how the required reporting to recipients of property will be handled if the IRS fixes Basis Increase allocations.

Solution: get an executor appointed. Then there's only one person with the power to act.

Another administrative conflict can arise when the executor files both Forms 706 and 8939. Obviously, these are inconsistent acts. Again, this could involve multiple "executors." In response, the IRS will send a notice to each "executor." If the election in or out isn't cleared up within 90 days, government help is on the way: the IRS will decide for you, as best as they can. And while taxpayers have deadlines, the IRS doesn't. The IRS hasn't said how long that might take. If the estate tax is chosen, interest will no doubt be charged. If the Section 1022 Election is chosen, the IRS will take care of basis allocations, too – possibly prorating them across all properties having built-in gains. But it hasn't said how or when required information must be provided to recipients of property.

If Basis Increase allocations of multiple "executors" add up to more than the Basis Increase allowances, the IRS will send out a notice to all of the "executors." If they don't fix this, the IRS will, as best they can. Again, the IRS hasn't said how long that might take.

GENERATION-SKIPPING TRANSFER TAX REPORTING: Schedule R of Form 8939 Announced; Get Out Your Calendars! (Not in the Guide)

Notice 2011-66 also addresses Generation-Skipping Transfer Tax reporting, and announces that Form 8939 will have its own Schedule R for allocating GST exemption and electing out of automatic allocations, to be used when the Section 1022 Election is made. If the Section 1022 Election is made, the Form 8939 Schedule R is due by November 15, 2011.

The time for filing GSTT returns, according to the Notice, may be summarized as follows:

DURING LIFETIME

	Before 12/17/2010	On or After 12/17/2010	Extension available?
Taxable Transfers (direct skips) and any election required to be made on such return	9/19/11	4/18/11	Yes
No GST transfer reported	4/18/11*	4/18/11	Yes

* The 4/18/11 date could apply to:

- ✓ Indirect skips (see IRC sec. 2632(c)(3))
- ✓ Election to treat a trust as a GST trust
- ✓ Election out of the automatic allocation of GST exemption

UPON DEATH

	Before 12/17/2010	On or After 12/17/2010	Extension Available?
NO SECTION 1022 ELECTION			
Taxable Transfers (direct skip, taxable distribution, taxable termination) and any election required to be made on such return	9/19/11	Nine months after date of death	Yes
No GST transfer reported	9/19/11	Nine months after date of death	Yes
SECTION 1022 ELECTION MADE	11/15/11	11/15/11	No

Can the time for making an allocation of the GSTT exemption be extended when the election out of the 2010 estate tax is made?

The IRS appears to have shortened the time when the GST return must be filed when the election out of the estate tax is made, compared to when the estate tax will apply and an extension of time to file the estate tax return (and thus the time for making a GSTT exemption allocation) is granted.

The “normal” due date, when the estate tax applies

In the case of generation-skipping transfers occurring at death, IRC § 2632(a) provides that allocation of the decedent’s GSTT exemption “may be made at any time on or before the date prescribed for filing the estate tax return for such individual’s estate (determined with regard to extensions), *regardless of whether such a return is required to be filed.*” (Emphasis added.)

If the 2010 estate tax applies, Form 706 must be filed and the allocation of GSTT exemption is made on Schedule R of Form 706. For example, if the due date of Form 706 is September 19, 2011 and if the executor is granted a six-month extension of time to file Form 706, the time for making the GSTT exemption allocation on Schedule R will also be extended by six months to March 19, 2012 (March 17 falls on a Saturday).

Due Date When the Section 1022 Election is Made

If the Section 1022 Election is made, Form 8939 must be filed. IRS Notice 2011-66 provides, in relevant part:

Form 8939 is due November 15, 2011. ... The IRS will not grant extensions of time to file a Form 8939 and will not accept a Form 8939 or an amended Form 8939 filed after the due date, except as provided in section I.A or B (in the event of conflicting filings) or in section I.D.2 (regarding relief provisions) of this notice.

Regarding allocation of GSTT exemption, Notice 2011-66 provides:

If the executor of a decedent who died in 2010 makes the Section 1022 Election, the executor allocates that decedent’s available GST exemption by attaching the Schedule R of Form 8939 to the Form 8939 for that decedent’s estate. If the Form 8939 is timely filed, this allocation will be considered a timely allocation of the decedent’s GST exemption under section 2632.

Thus far, it appears that the IRS has said the time for allocating GSTT exemption cannot be extended past November 15, 2011, the due date of Form 8939. The IRS could conceivably say (it has not done so) that a Schedule R extension can be obtained as long as Form 8939 is timely filed. For example, Schedule R could be filed with a supplemental Form 8939 filed after November 15, 2011. The IRS has decided to set this due date, even though contrary to IRC § 2632(a). Furthermore, relief is available under IRC § 2642(g)(1)(A)(i) for extending the time to make exemption allocations. So, why the rush, IRS?

Keep these records forever ...

“Books or records relating to collections of information must be retained as long as their contents may become material in the administration of any internal revenue law.”

No executor is likely to know when all property reported on Form 8939 has been placed beyond the reach of taxation. Furthermore, as discussed below (Finality: Is it Out of Reach?), Revenue Procedure 2011-41 says the IRS can question what’s in Form 8939 in an examination of the return of any taxpayer whose tax liability depends on Form 8939 reporting, even if that’s decades into the future.

REVENUE PROCEDURE 2011-41

In this Rev. Proc., the IRS interprets the provisions of modified carryover basis, and says if its interpretation is followed, meaning the taxpayer takes no return position contrary to what’s in the Rev. Proc., the IRS won’t present a challenge. The implication is that a taxpayer who takes even one contrary return position isn’t protected by the safe harbor.

What if the taxpayer disagrees with the Rev. Proc. but wants to come within the safe harbor? A protective claim for refund can’t be filed, since there’s no tax to pay.

The heart of the Rev. Proc. is Section 4. I’m only going to cover some parts of that, but here’s an outline of that:

.01 Application of Section 1022

- (1) In General.
- (2) Property Not Subject to Section 1022.
- (3) Property Acquired From the Decedent - Section 1022(e).
- (4) Property Owned by the Decedent - Section 1022(d).

- (5) Property Owned By and Acquired From the Decedent But Not Eligible for the Allocation of Basis Increase.
- .02 Amount of Basis Increase.
 - (1) Basis Increase.
 - (2) General Basis Increase.
 - (3) Spousal Property Basis Increase.
 - (4) Nonresident Decedents who are not citizens of the United States.
- .03 General Rules for Allocating Basis Increase.
- .04 Determination of Fair Market Value.
 - (1) In General.
 - (2) Aggregation Rule.
- .05 Special Rules for Community Property.
- .06 Interaction of Section 1022 with Certain Other Income Tax Provisions.
 - (1) Holding Period of Inherited Property.
 - (2) Tax Character of Inherited Property.
 - (3) Depreciation of Property Acquired from the Decedent.
 - (4) Passive Activity Loss Provisions.
 - (5) Recognition of Gain on Satisfaction of Pecuniary Bequest with Appreciated Property.
- .07 Testamentary Charitable Remainder Trusts

Discussion of Selected Parts of Rev. Proc. 2011-41

This discussion describes and comments on the parts of the Rev. Proc. that appear not to overlap and/or harmonize with the Guide.

Rev. Proc. Section 4.01(3) Property Acquired From the Decedent (GUIDE, pp. 33-39)

When the election out of the estate tax is made, the income tax basis rules of IRC § 1014 for property acquired from a decedent don't apply. Instead, IRC § 1022(a) provides that the modified carryover basis rules apply to "property acquired from a decedent." Not all property that changes hands when a decedent dies will be subject to the modified carryover basis rules because not all such property is "property acquired from a decedent."

IRC § 1014 was designed to afford basis adjustments on death as a quid pro quo for being subjected to estate tax (even if no estate tax was actually due). Because the reach of the estate tax extends to

things the taxpayer didn't, strictly speaking, own, § 1014's definition of "property acquired from a decedent" was crafted to follow the estate tax's extended reach.

The modified carryover basis statute defines "property acquired from a decedent" in IRC § 1022(e) by listing several categories. All of the categories were drawn from IRC § 1014, but not all of § 1014's categories were adopted. Some were drawn verbatim, others were modified, and some were entirely excluded. In reading IRC § 1022(e)'s definition of "property acquired from a decedent," the concept of including in that definition some property not actually owned clearly was imported from § 1014, but not to the same extent.

The modified carryover basis categories of property acquired from a decedent are interpreted in Section 4 (3) of Rev. Proc. 2011-41.

The first category is property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent. IRC § 1022(e)(1). The Rev. Proc. recites this statutory category without comment. The language of IRC § 1022(e)(1) is identical in all respects to IRC § 1014(1).

The second category of "property passing from a decedent" is property transferred by the decedent during the decedent's lifetime to a qualified revocable trust as defined in IRC § 645(b)(1). IRC § 1022(e)(2)(A). The Rev. Proc. confirms that the presence or absence of an IRC § 645 election to treat such a trust as part of an estate for income tax purposes has no effect on this definition. The statutory language of IRC § 1022(e)(2) is similar to, but not precisely identical to, IRC § 1014(2). I speculate it could have been identical, but wasn't because IRC § 645 and its definition of "qualified revocable trust" was yet not in effect when § 1014 was introduced into the IRC.

A qualified revocable trust as defined in IRC § 645(b)(1) is any trust (or portion thereof) which was treated under IRC § 676(a) owned by the decedent of the estate because the decedent transferred property in trust subject to a power to revest the property in himself. The power can be held by the grantor or by a non-adverse party. In practice, in a revocable living trust, commonly used as a will substitute while continuing to exercise full control over assets transferred to such a trust, the power to revest is held by the grantor. But here, for purposes of defining "property acquired from a decedent," the power in the grantor is determined without regard to IRC § 672(e), meaning that a power held by a spouse is not attributed to the grantor of a trust for purposes of determining whether a trust is an IRC § 645(b)(1) qualified revocable trust.

Treas. Regs. § 1.676(a)-1 interprets the power to revest to include a power of appointment, making no distinction between a power of appointment that can be exercised to revest title during lifetime versus a power to appoint to one's estate at death.

The third category of “property passing from a decedent” described in the Rev. Proc. is property transferred by the decedent during the decedent's lifetime to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust. This is a recitation of the statute. IRC § 1022(e)(2)(B). The corresponding version in IRC § 1014(3) is “property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.” The two provisions differ only as to the reference to a retained income right in IRC § 1014(3) not present in its IRC § 1022(e)(2)(B) counterpart.

The Rev. Proc. goes further, saying, for this purpose, the exercise of a power to alter, amend, or terminate the trust “is deemed to include a retained reversionary interest in the trust on death and trust property subject to any retained power of appointment.”

What's enumerated in the statute as the right to make any change in the enjoyment of trust property is limited to a power to alter, amend, or terminate the trust. The IRS has read in two things: (1) a retained reversionary interest in the trust on death and (2) trust property subject to any retained power of appointment. The IRS has not explained how these two additional things amount to one or more of: “a power to alter, amend, or terminate the trust.” While these items are not in the statute, they seem to square better with the second category, rather than the third.

The fourth category of “property passing from a decedent” is any other property passing from the decedent by reason of death to the extent that such property passed without consideration. IRC § 1022(e)(3). The IRS affirms that this category includes the decedent's interest in property as a joint tenant with right of survivorship or as one of several tenants by the entirety, to the extent provided in IRC § 1022(d)(1)(B)(i).

This provision is similar, but not identical to, the first sentence of IRC § 1014(9): “property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the

property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939.” IRC § 1022(e)(3) includes “to the extent that such property passed without consideration” to its definition, apparently as a substitute for IRC § 1014(9)’s reference to inclusion in the decedent’s taxable estate. What’s conspicuously missing from IRC § 1022(e)(3) that’s in IRC § 1014(9) is the phrase: “including property acquired through the exercise or non-exercise of a power of appointment.”

The IRS nevertheless reads the statute to include “any property transferred at the decedent’s death by reason of the decedent’s holding and/or exercising a general power of appointment (as defined in section 2041) with respect to such property if that power was not created by the decedent.”

This part of the Rev. Proc. is a departure from how a power of appointment is interpreted in the second and third categories, where the decedent transferred property to a trust during lifetime but retained a power of appointment. The power of appointment as interpreted in the second and third categories involves property owned by the decedent that the decedent transferred. In contrast, the Rev. Proc. is saying the fourth category (i.e., § IRC § 1022(e)(3)) includes property subject to such a power that never was the decedent’s property. In other words, someone other than the decedent created a power to appoint in his own property that the decedent could exercise. As a result, the IRS is saying that property that the decedent never owned and over which he did not create the power of appointment will constitute “property acquired from a decedent” if the decedent was granted such a power by another. The consequence of this is to cause a possible downward adjustment to basis without any possibility of allocating any part of the Basis Increase allowance.

With regard to the IRS’s reference to a power of appointment “as defined in section 2041,” It should be remembered that, when IRC § 1022 was framed, it was in the context of repeal of all of the estate tax provisions, including IRC § 2041’s definition of a general power of appointment. The election out of the estate tax regime was specifically designed to mean none of the estate tax provisions could apply. It seems highly inappropriate to mix the inapplicable estate tax rules, including IRC § 2041’s definitions, with the modified carryover basis rules.

In addition, and more to the point, IRC § 1014 specifically does not apply when IRC § 1022 does. IRC § 1014 provided the rules for income tax basis of property acquired from a decedent under the estate tax regime. It was “repealed” under EGTRRA, effective January 1, 2010 and can’t apply under TRA 2010 if the election out of the estate tax is made.

Congress and the drafters of IRC § 1022 had IRC § 1014 in full view when crafting IRC § 1022's definition of "acquired from a decedent." In fact, much of IRC § 1022's definition of that term was lifted more or less directly from IRC § 1014. So it seems highly significant and entirely deliberate that Congress excluded from this fourth category both IRC § 1014(4), ("property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will"), and the reference to a power of appointment in IRC § 1014(9) (the likely source of IRC § 1022(e)(3)).

In short, exclusion of the phrase, "including property acquired through the exercise or non-exercise of a power of appointment" from the language of IRC § 1022(e)(3) seems to have been deliberate.

The IRS should not read into IRC § 1022(e)(3) what Congress intentionally left out. Accordingly, "property transferred at the decedent's death by reason of the decedent's holding and/or exercising a general power of appointment (as defined in section 2041) with respect to such property if that power was not created by the decedent" should not be considered property acquired by the decedent for purposes of IRC § 1022's modified carryover basis rules.

The fifth category of "property passing from a decedent" is the surviving spouse's one-half interest in community property, as set forth in IRC § 1022(d)(1)(B)(iv). The Rev. Proc. mischaracterizes this category as "any other property that passes from the decedent by reason of death to the extent that such property passes without consideration." At least in my home state of California, the community property share of one spouse is not property of the other. A decedent cannot dispose of his spouse's share of community property. The surviving spouse owns her share of community property both before and after death. So it can't be property that passes by reason of the death of the decedent. But not to worry: there's no reason to so characterize community property in this way, as IRC § 1022(d)(1)(B)(iv) specifically provides that community property is treated as property acquired from and owned by a decedent, so that it may benefit from an allocation of Basis Increase allowance. But it must be remembered that such property can also suffer a basis decrease if its FMV is less than its basis at death.

The Rev. Proc. deals with community property further in Section 4.05, directing that the community property interest of the surviving spouse must be listed on Form 8939 as property passing from a decedent and confirming that these items will qualify for allocation of Basis Increase under both IRC § 1022(b) (\$1.3 million general Basis Increase allowance) and IRC § 1022(c) (\$3 million spousal Basis Increase allowance).

Qualified Terminable Interest Property (QTIP) (GUIDE, p. 59)

The Rev. Proc. says that a decedent's interest in a qualified terminable interest property (QTIP) trust or similar arrangement that qualifies for allocation of Basis Increase by satisfying the requirements of IRC § 1022(c)(5) is not "property acquired from a decedent" with respect to the surviving spouse when the surviving spouse subsequently dies. The IRS confirmed that a remainder beneficiary's basis in such property will not be determined under IRC § 1022's modified carryover basis rules. Of course, both spouses will have to have died during 2010 for the latter point to apply.

The Rev. Proc. is silent on the topic of whether a QTIP that qualified for the estate tax marital deduction in the taxable estate of the predeceased spouse is property acquired from a decedent for modified carryover basis purposes when the surviving spouse dies. However, the required terms of the estate tax marital deduction QTIP are nearly identical to the marital Basis Increase QTIP but for the estate tax election. Thus, just as a modified carryover basis QTIP isn't treated as property acquired from a decedent when the surviving spouse dies in 2010, neither should an estate or gift tax QTIP be treated as property acquired from a decedent where the income beneficiary of that QTIP died in 2010.

Rev. Proc. Section 4.01(4) Property Owned by the Decedent - Section 1022(d) (GUIDE, pp. 48 – 49)

The Rev. Proc states that a limited amount of Basis Increase is available (but not beyond fair market value) under IRC § 1022(b) and/or (c), but that to qualify for any allocation of Basis Increase allowance, the property has to have been "owned by the decedent" in addition to having been "acquired from the decedent." Property acquired from the decedent but that wasn't owned by the decedent has carryover basis, but can't receive any Basis Increase allocation. The Rev. Proc. enumerates the areas where the statute defines the extent to which "ownership" it deemed to exist. These include:

- ✓ Property legally titled in the name of the decedent at death (and not held by the decedent solely in a legal or representative capacity)
- ✓ Jointly owned property, whether owned as tenants in common or with rights of survivorship, to the extent provided IRC § 1022(d)(1)(B)(i)
- ✓ Property transferred by the decedent during life to a qualified revocable trust as defined in IRC § 645(b)(1), regardless of whether the election under § 645 is made for that trust; and

- ✓ Community property, to the extent provided IRC § 1022(d)(1)(B)(iv)).

The decedent is *not* treated as owning any property by reason of holding a power of appointment with respect to such property. IRC § 1022(d)(1)(B)(iii). Nevertheless, as discussed earlier, at least some types of property over which the decedent held a power of appointment will be treated as acquired from the decedent, and thus subject to the carryover basis rules, while, at the same time, not qualifying for an allocation of Basis Increase allowance.

The Rev. Proc. goes on to say, “although considered to have been acquired from the decedent, property transferred to a trust by the decedent during life in which the decedent retained a power to alter, amend, or terminate the trust is not considered owned by the decedent at death for this purpose.” This should not be interpreted to in any way negate treatment of a qualified revocable trust as defined in IRC § 645(b)(1) as property owned by a decedent. As discussed earlier, where the decedent made a lifetime transfer in trust but a retained power to revest title in the himself such a trust will satisfy the “owned by the decedent” test, regardless of whether the decedent also retained a power to alter, amend, or terminate the trust.

The Rev. Proc. then turns to U.S. grantors who transfer property to a foreign trust, saying:

[B]ecause of the different definitions of ownership in [IRC] sections 679 [relating to Foreign trusts having one or more United States beneficiaries] and 1022, although a transfer of property to a foreign trust by a United States grantor, for example, may be sufficient to cause that grantor to be treated as the owner of at least a portion of that trust for income tax purposes under section 679, such a transfer is not sufficient to result in the trust’s being considered to be owned by the United States grantor at that grantor’s death for purposes of section 1022(d).

Finally, the Rev. Proc reads the statute to say that, when the terms of a trust require the trust property to revert back to the decedent upon death, then such property is deemed to be owned by the decedent. The Rev. Proc holds out as an example of this a Qualified Personal Residence Trust under IRC § 2702 and Treas. Regs. § 25.2702-5(c) that reverts to the decedent’s estate upon death.

Rev. Proc. Section 4.02 Amount of Basis Increase; Consider Whether Fair Market Value at Death Has Declined As of the Date of Allocation (Guide, pp. 50 – 54)

This part of the Rev. Proc. discusses IRC § 1022(b)'s \$1.3 million General Basis Increase allowance, which may be increased by certain unused loss carryovers and built-in losses, as well as IRC § 1022(c)'s \$3 million Spousal Basis Increase allowance.

Basis Increase allocations may be made to an *interest* in property. The Rev. Proc. provides:

... Basis Increase may be allocated to some or all of the decedent's shares of stock in a particular company, or to a life or remainder interest owned by the decedent at death. However, if, by reason of the decedent's death, the decedent's property is divided into different interests that are not undivided portions or fractional interests of each and every interest or right in the property that was owned by the decedent, Basis Increase may not be allocated separately to the various interests in that property created by reason of the decedent's death. An example of such a division of property is the division of property owned outright by the decedent at death into a life interest and a remainder interest in that property. Basis Increase may be allocated to the property owned by the decedent at death, but may not be allocated separately to the life estate and/or remainder interest.

The Rev. Proc. clarifies that a decedent's unrealized losses available to increase the General Basis Increase allowance are not limited to the \$3,000 annual maximum capital loss deduction that might have applied in the decedent's final income tax year.

Property that has been sold before an allocation is made may be the subject of a Basis Increase allocation. Example 4 of the Rev. Proc. points out that, while a Basis Increase may be allocated up to the fair market value at date of death, it's possible that the value of the sold asset may have declined since death, causing a loss to be recognized upon sale. It may be better to allocate an amount of Basis Increase equal to only the difference between the actual net sales proceeds and the carryover basis, if the amount of net sales proceeds is less than the date of death fair market value.

Qualified Spousal Property that has already been distributed may be the subject of a Basis Increase allocation. If Qualified Spousal Property that has received a Spousal Basis Increase allocation has been sold, the Rev. Proc. provides that allocation may be made only to the extent that the executor (1) certifies on the Form 8939 that the net proceeds from the sale of that property will be distributed to or for the benefit of the decedent's surviving spouse in a manner that would qualify property as

Qualified Spousal Property, and (2) attaches to Form 8939 each document providing a bequest or devise to the surviving spouse.

If part of the sales proceeds is used for some purpose other than to satisfy the marital bequest, then only the portion used for the marital bequest can qualify for a Spousal Property Basis Increase allocation. The Rev. Proc. illustrates this in Example 5.

Spousal Property Basis Increase may be allocated to property held by a testamentary charitable remainder trust (CRT) as defined in section 664 (subject to the limit of section 1022(d)(2)), if the surviving spouse is the sole non-charitable beneficiary of the CRT and the CRT would have qualified for the marital deduction under section 2056(b)(8), had the executor of the decedent's estate not made the Section 1022 Election.

Given that CRTs can sell property without incurring current capital gains taxes, it seems allocation of Spousal Property Basis Increase to property that will be distributed to a CRT would typically only be used if there's nowhere else to lodge some of the \$3 million Spousal Property Basis Increase. But if capital gains realized inside the CRT likely will pass out to the noncharitable beneficiary during the term of the trust, it may make sense to make a Basis Increase allocation.

Rev. Proc. Section 4.04 Fair Market Value (Not in the GUIDE)

The Rev. Proc. frames Fair Market Value ("FMV") as having the same meaning and determination as under IRC §2031. Appraisals are required.

Where a decedent makes a bequest of undivided portions of property, the FMV of the entire property is apportioned according to the portions passing at death. The Rev. Proc. defines an undivided portion of property as a fraction or percentage of each and every interest or right the decedent held in the property at death. Where the decedent owned all interests in a property, this rule eliminates the effect of fractional interest discounts. But where the decedent owned a portion of property subject to, say, a valuation discount for lack of control, the discounted value will be the date of death FMV. However, bequests of undivided portions of the decedent's portion will not bear a discount that differs from the discount that applies to the decedent's entire portion.

Rev. Proc. Section 4.05 Special Rules for Community Property. (GUIDE, pp. 35, 46, 50, 63)

Much of what's in this section of the Rev. Proc. is statutory, but there are a few very helpful parts.

The IRS remained silent on non-pro rata divisions of community property where such divisions are authorized under state law or the estate planning documents.

The IRS did point out that when an interest in community property qualifies as property acquired from and owned by the decedent, not only can an allocation of Basis Increase be made, but also both the surviving spouse's community property share and the decedent's community property share of unrealized losses on community property can be added to the general \$1.3 million General Basis Increase. Not so for *loss carryovers*: only the decedent's community property share of loss carryovers can increase the \$1.3 million amount.

Rev. Proc. Section 4.06 Interaction of Section 1022 with Certain Other Income Tax Provisions (GUIDE, pp. 42 – 44)

The Rev. Proc. confirms that the holding period, depreciation method, and potential depreciation recapture all carry over from the decedent. 2010 depreciation must be apportioned between the decedent and the recipient of the property from the decedent in the same manner as prescribed in Treas. Regs. § 1.168(d)-1(b)(7)(ii). Of course, the use of the property determines whether depreciation can be claimed after death, but in any event, potential depreciation recapture remains. Example 9 says that, when basis is determined under IRC § 1022 and property was IRC § 1245 property in the decedent's hands, the property remains IRC § 1245 property in the hands of the recipient and therefore will be subject to recapture under IRC § 1245 when subsequently sold, regardless of whether the property is depreciable property in the hands of recipient or whether the executor allocates any Basis Increase to that property. So, the Rev. Proc. is saying that the whole depreciation recapture potential carries over. But we shall see later in this discussion that allocation of Basis Increase has a potential effect on the extent to which potential recapture is actually recognized in a subsequent sale or exchange.

The holding period of the decedent is added to the holding period after the decedent's death, and, according to the Rev. Proc., is not affected by whether the executor allocates any Basis Increase to that property. In other words, the portion of property receiving an allocation of Basis Increase has the same holding period as the rest of that same property.

Depreciation with respect to the portion of property receiving an allocation of Basis Increase is treated as a newly acquired asset. Since the portion of the asset equal in value to its allocation of Basis Increase is depreciated as a newly acquired asset, it has the potential to create its own depreciation recapture potential. It would seem reasonable that the recapture potential of the other,

non-Basis Increase portion of the asset won't affect the recapture potential of the portion treated as newly acquired for depreciation purposes. But the potential for IRC § 1250 recapture, for example, can shift as a result.

Basis Increase and Recapture Example: During his lifetime, Nigel purchased land for \$800,000 and developed rental real estate at a cost of \$1,200,000. Nigel died in 2010, when the land was worth \$1,100,000 and the building was worth \$1,400,000. Through the date of Nigel's death, accumulated depreciation with respect to the building of \$300,000 was allowed or allowable, making his adjusted cost basis in the building \$900,000. For purposes of the special 25 percent capital gains tax rate on IRC § 1250 recapture, the potential recapture amount is \$300,000. If the executor of Nigel's estate makes a timely Section 1022 Election but makes no allocation to increase the property's basis, the potential gains are:

	<u>Land</u>	<u>Building</u>	<u>Total</u>
FMV	\$1,100,000	\$1,400,000	\$2,500,000
Basis	<u>800,000</u>	<u>900,000</u>	<u>1,700,000</u>
Gain	<u>\$300,000</u>	<u>\$500,000</u>	<u>\$800,000</u>
Amount subject to 25% capital gains tax (IRC § 1250 recapture)		\$300,000	\$300,000
Amount subject to 15% capital gains tax	\$300,000	\$200,000	\$500,000

Now, assume the executor of Nigel's estate allocates \$500,000 of Basis Increase to the building. The property passes under Nigel's estate plan to his daughter Ellie. According to Rev. Proc. 2011-66, she has acquired the land and building having the carryover basis as shown above, and is treated as newly acquiring a depreciable building having a basis of \$500,000.

If Ellie immediately sells the land and building for \$2,500,000 (selling costs have been ignored for purposes of this example), her taxable gains are as follows:

	Carryover Portion		Newly Acquired Portion	
	<u>Land</u>	<u>Building</u>	<u>Building</u>	<u>Total</u>
FMV	\$1,100,000	\$900,000	\$500,000	\$2,500,000
Basis	<u>\$800,000</u>	<u>\$900,000</u>	<u>\$500,000</u>	<u>\$2,200,000</u>
Gain	<u>\$300,000</u>	<u>\$0</u>	<u>\$0</u>	<u>\$300,000</u>
Amount subject to 25% capital gains tax (IRC § 1250 recapture or gain, whichever is less)		<u>\$0</u>	<u>\$0</u>	<u>\$0</u>
Amount subject to 15% capital gains tax	<u>\$300,000</u>	<u>\$0</u>	<u>\$0</u>	<u>\$300,000</u>

It will take a large increase in the building's value to trigger all of the carryover IRC § 1250 recapture, when compared to the increase in the building's value needed to trigger all of the recapture had there been no Basis Increase allocation.

Rev. Proc. Section 4.06(4) Passive Activity Losses (Not in the GUIDE)

Here's a confession: this one escaped me when I wrote the Guide. Hats off to the IRS for some savvy sleuthing!

When the Section 1022 Election is made, the starting point for determining the income tax basis property acquired from a decedent is that such property is treated as acquired by gift. The passive activity rules have a special rule for this: the decedent's basis is increased by the amount of any passive activity losses allocable to the decedent's interest in the passive activity property that have not been allowed as deductions as a result of IRC § 469(a)'s limitation on the deductibility of passive activity losses.

There's more. That basis adjustment is deemed to occur before the decedent's death. If, after taking into account the basis adjustment, the decedent would have incurred a loss on sale deductible under IRC § 165, that loss may be added to the General Basis Increase of IRC § 1022(b).

Both spouses' community property interests in passive activities are treated as passing from the decedent under IRC § 1022(d)(1)(B)(iv). The passive activity implication of that is: the income tax basis of both spouses' interests in such property are increased under IRC § 469(j)(6) by the amount of any passive activity losses allocable to spouses' combined interests in the passive activity property that have not been allowed as deductions as a result of IRC § 469(a)'s limitation on the deductibility of passive activity losses. The Rev. Proc. goes on to say:

To the extent that losses attributable to the spouse's interest in the community property are used to increase basis and/or were included in Carryovers/Unrealized Losses Increase allocated by the decedent's executor, such losses may not thereafter be deducted by the spouse. However, to the extent that losses attributable to the spouse's interest in community property are not so used by the decedent's executor, they remain the spouse's suspended passive activity losses.

The Rev. Proc. then adopts a Basis Increase Allocation ordering convention that tends to preserve the surviving spouse's passive activity loss deductions:

For purposes of this computation, these losses will be deemed to be the last part of Basis Increase allocated, and the decedent's share of these losses will be deemed to be allocated before the surviving spouse's share of these losses.

Examples 10 and 11 in the Rev. Proc. illustrate application of the interaction between the passive activity and modified carryover basis rules.

ALTERNATIVE MINIMUM TAX SYSTEM (Not in the GUIDE)

Robert S. Keebler of Green Bay, Wisconsin's Keebler & Associates, LLP has pointed out that the Rev. Proc. addresses neither the basis of property acquired from a decedent under the alternative minimum tax (AMT) system, nor the possible effect of unused AMT losses on the AMT equivalent of the addition of unused losses in determining the General Basis Increase Allowance. Stay tuned on this issue. To begin with, the authority for applying AMT attributes with respect to property acquired from a decedent under IRC § 1022 would have to be rooted in the authority for carrying over these same attributes in the case of a lifetime gift.

A FORMULA ALLOCATION COULD AVOID WASTING BASIS INCREASE ALLOWANCES (GUIDE, Ch. 11)

Consider using a formula allocation to avoid wasting any part of the Basis Increase allowance. Basis Increase allowance allocations will be wasted to the extent the IRS successfully challenges and lowers the fair market value (FMV) of any asset that received an allocation of Basis Increase to FMV. The wasted portion of Basis Increase allocation is the difference between FMV as finally determined and FMV as reported on Form 8939.

A number of things can go wrong to cause Basis Increase allocations to be partly wasted. These include:

- ✓ Downward adjustments by the IRS to fair market value of property acquired from and owned by the decedent,
- ✓ Downward adjustments by the IRS to the unrealized losses and unused loss carryovers that increase the General Basis Allowance,
- ✓ Discovery by the executor of upward adjustments to the unrealized losses and unused loss carryovers that increase the General Basis Allowance,
- ✓ Sale by the executor for less than date of death FMV, taking into account selling expenses,
- ✓ Discovery by the executor of assets not known to the executor by the due date of the Basis Increase allocations, or
- ✓ Failure on the part of the executor to correctly identify property that qualifies as both acquired from the decedent and owned by the decedent.

In addition to adjusting for these uncertainties, use of a formula might also make it unnecessary to file a supplemental Form 8939, or might make it unnecessary to seek an extension of time to act under Treas. Regs. § 301.9100, as outlined in Notice 2011-66. But if the formula causes adjustments to Basis Increase Allocations after Form 8939 is filed, both IRS and the recipients of property that has been adjusted will need to be notified in some manner, even if the adjustment is determined more than six months after the due date for filing Form 8939.

Formula tax allocations are common in estates to maximize tax benefits authorized by congress, while dealing with uncertainties as to valuations and IRS examination adjustments. They should be appropriate here, too. Note that the Rev. Proc. provides a formula approach to the interaction between loss carryovers from passive activities, as discussed earlier.

The statute says that the Aggregate Basis Increase of § 1022(b) is “the portion of the aggregate Basis Increase which is allocated to the property pursuant to this section.” Similar language is used for the Spousal Property Basis Increase. Thus, there is nothing in the statutory language that appears to preclude use of a formula allocation.

However, IRC § 1022(d)(3)(B) provides that any Basis Increase allocation may be changed only as provided by the Secretary. If the IRS determines that using a formula causes a “change” to an allocation, it would be necessary for the IRS to approve the “change.” It could do this by affirming allocation by formula, which would be preferable to approving allocations made under a formula on a case-by-case (or item-by-item) basis. The IRS could also choose to recognize that, where allocations by formula turn only on facts that exist as of the date when the allocation is made, final determination of allocations under such a formula aren’t a “change” within the meaning of IRC § 1022(d)(3)(B).

Using the General Basis Increase Allowance of IRC § 1022(b), a formula allocation might say:

The Executor hereby elects to allocate the amount of the General Basis Increase Allowance as finally determined under IRC § 1022(b), up to the whole thereof, to the assets contained in the list following this election statement (hereinafter referred to as “IRC § 1022(b) Allocation List”). The allocation shall be made to each item shown in the IRC § 1022(b) Allocation List in the order listed, and the amount of each such allocation shall be the minimum amount necessary, if any, to increase the income tax basis of each such item such that it be equal to the lesser of:

(1) Its fair market value as finally determined for purposes of IRC § 1022 as of the date of the decedent’s death; or

(2) If transferred in any transaction treated for income tax purposes as a taxable sale or exchange occurring on or before the date of this Section 1022 Election (determined without regard to whether or not treated as an installment sale under IRC § 453), its selling price, net of selling costs deductible therefrom.

To the extent that the General Basis Increase Allowance remaining available to allocate to any item appearing on the IRC § 1022(b) Allocation List is insufficient to so increase the basis of such item because of allocation to one or more items that precede such item in the IRC § 1022(b) Allocation List, then the remaining amount of the General Basis Increase Allowance shall be allocated to such item.

Notwithstanding anything else herein to the contrary, to the extent that the General Basis Increase Allowance includes suspended passive activity losses (within the meaning of IRC § 469(a)) of the decedent or of the decedent's surviving spouse, such losses shall be deemed to be the last part of Basis Increase allocated, and the decedent's share of such losses will be deemed to be allocated before the surviving spouse's share of such losses.

The IRC § 1022(b) Election List would appear next. The amount of allocation to each property could be listed, with a note that the amounts listed are the amounts the executor believes to be the Basis Increase amounts pursuant to the formula adjustment. There could also be included a statement to the effect that, to the extent that the formula is finally determined not to constitute an effective allocation of Basis Increase, then (and only then), the Basis Increase allocation amounts contained in the list shall constitute the executor's allocations without regard to the formula. The list should be arranged to give priority to those assets for which Basis Increase allocations are most desired. For example, assets that actually have been or will be sold, could be listed first, while land, including land on which depreciable buildings sit, could be listed last. The final item entered on the list could refer to all property (including an interest in property) discovered by the executor, which allocation of General Basis Increase shall be prorated based on relative built-in gains as of date of death, as finally determined.

Alternatively, the election formula could refer to the assets as listed on Form 8939, in the order listed, with the Form 8939 list arranged to give priority to those assets for which Basis Increase allocations are most desired.

Instead of allocating the Basis Increase Allowance to only some assets, it may be desirable in some cases to allocate the Basis Increase Allowance in a way that all assets benefit, for example, on a pro rata basis. But pro rata based on what? One alternative might be to pro rate the General Basis Allowance based on relative fair market values. Another might be to equalize, to the extent possible, the ratio of built-in gains to fair market values as of a stated date (date of death; date of sale, if sold; or date of allocation). This last alternative could be the best way for fiduciaries to carry out the duty to treat all beneficiaries impartially. Another approach to satisfying that duty might be for the

fiduciary to engage a valuation consultant to ascertain the fair market value of property to be distributed, taking into account built-in gains.

The Spousal Property Basis Increase Allowance allocation formula could be crafted to also apply to property that will pass to the surviving spouse after the allocation date, as and to the extent permitted under Rev. Proc. 2011-41 and paragraph I.D.2 of Notice 2011-66 regarding relief for allocating Spousal Property Basis Increase to such property distributed after the due date of the Form 8939, or any further IRS guidance. Use of a formula can eliminate guesswork about whether net proceeds from property that will be sold will be distributed to the surviving spouse or to Spousal Property Basis Allowance QTIP.

FINALITY: IS IT OUT OF REACH? (Not in the GUIDE)

Finality of Form 8939 reporting could be an issue. In Notice 2011-66, the IRS said:

The recipient's basis in a particular property (including the amount of Basis Increase allocated to that property) is subject to adjustment upon the examination by the IRS of any tax return reporting a value dependent upon the property's basis (for example, the property's depreciation, sale, or other disposition that triggers gain or loss on the property, or otherwise).

Apparently, Congress has burdened taxpayers with carryover basis while providing no limit on when the IRS can question carryover basis or fair market value determinations. There's no telling how long the question of carryover basis and Basis Increase allocations could stay open. Use of formula allocations will at least provide some flexibility to taxpayers, even as the IRS has none of the usual limitations on its time to make challenges. But how does a taxpayer whose tax reporting depends on how Form 8939 was prepared defend that tax reporting? And by what mechanism, if any, will a taxpayer gain access to the records underlying Form 8939, such as records establishing the decedent's basis and evidence of fair market value appraisals? How will the executor know when those records can be disposed of? IRS guidance on these issues would be helpful.