

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

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Note: The Guide, Supplement Number 1, and this Supplement Number 2 are available through www.thompsonjones.com.

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WHAT'S HAPPENED SINCE SUPPLEMENT 1 WAS PUBLISHED

The IRS has released the following, of interest to executors of estates of decedents dying during 2010:

- ✓ Notice 2011-76, changing the due date of Form 8939 and the Section 1022 election due date to January 17, 2012
- ✓ Form 8939, entitled "Allocation of Increase in Basis for Property Acquired From a Decedent." Filing this form constitutes a Section 1022 Election that can't be revoked after January 17, 2012.
- ✓ Form 8939 instructions
- ✓ Publication 4895, Tax Treatment of Property Acquired From a Decedent Dying in 2010

Reminder: "Executor" means the executor or administrator of the decedent, or, if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent. See further *Guide*, p. 45.

IRS NOTICE 2011-76

Notice 2011-76 changed the due date of Form 8939 from November 15, 2011 to January 17, 2012. This change also means that estates of 2010 decedents have until January 17, 2012 to elect out of the estate tax and into modified carryover basis (the IRS calls this a "Section 1022 Election"). The same date applies to Schedules R and R-1 (generation-skipping transfer tax) that must be attached to Form 8939.

Executors will want to evaluate carefully whether to elect out of the automatic allocation of GST exemption. Since the GST tax rate for 2010 transfers is zero, automatic allocations of GST exemption could cause some of the exemption to be wasted in some cases. A direct skip in the most obvious case. The notice provides limited relief for direct skip gifts made during lifetime (GST exemption will not be allocated), but did not do so for transfers at death.

The Notice provides penalty relief for taxpayers who have sold property and underreported capital gains. The IRS understands and acknowledges that a taxpayer may not know whether a Section 1022 Election will be made and so might not know the basis of property sold or exchanged. The IRS said it won't assess tax understatement penalties, provided a good faith estimate is made of basis.

The Notice granted executors of estates of all 2010 decedents (not just those dying before December 17) an automatic extension of time to file estate tax and GST returns, as well as an automatic extension of time to pay tax, provided a timely request is filed on Form 4868. While the form has to be filed to get the automatic extensions, no reason for requesting either extension is required.

Other aspects of the Notice not directly relevant to Form 8939 are not covered here.

“MAILBOX RULE”

Changes to Treasury Regulations Section 301.7502-1, finalized in T.D. 9543, 76 F.R. 52561-52563 (8/23/11), provides methods for filing that, if followed, will provide the executor with *prima facie* evidence of the date filed. The methods include proper use of registered or certified mail, or use of a private delivery service designated under criteria established by the IRS. And here's a word to the wise: when using certified or registered mail, be sure to retain the mailing receipt, date-stamped by the postal service (not at the office postal meter) at the time the item is taken to the post office. (I recently heard a horror story about a certified mailing that was just dropped into a mailbox.)

FORM 8939 AND INSTRUCTIONS

This supplement will not detail the form and the instructions, but will comment on them.

Property Acquired From a Decedent

Errata

The following statement that appears on page 12 of Supplement 1 should read:

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 a tenant by the entirety, to the extent provided in IRC § 1022(d)(1)(B)(i).

General Power of Appointment

The instructions and Publication 4895 largely follow IRS Rev. Proc. 2011-66, with at least one notable exception. Whereas, in Rev. Proc. 2011-66, the IRS said that property acquired from a decedent includes property over which the decedent held a general power of appointment, the instructions did not include a similar statement. Nor did Publication 4895. While the IRS may or may not be rethinking its position on this subject, the Rev. Proc. 2011-66 optional safe harbor is available only if no reporting position is contrary to the Rev. Proc. Therefore, it would be best to report power of appointment property as property acquired from a decedent. If the IRS reverses its position, there should be an opportunity to amend the return within the six-month period allowed under Treas. Regs. section 301.9100-2.

The instructions are careful to point out that income in respect of a decedent is not Section 1022 property and is not reported on Form 8939. Several practitioners have asked me about IRAs and other retirement plan accounts. These are income in respect of a decedent and so are not to be reported on Form 8939.

Property Sold by Executor; Property Not Selected for Distribution to Beneficiary

A separate Schedule A is required to be attached to Form 8939 for each person who acquired property from a decedent. The instructions do not specifically state how to report items that the executor has sold, other than when sales proceeds will be distributed to a surviving spouse. Nor do the instructions specifically state how to report items that may be, but have not yet been, selected by the executor for distribution to one or more beneficiaries specified by the decedent.

Based on an informal conversation I have had with one of the drafters of the form and the instructions, my understanding is that the executor should include such items on a Schedule A showing the executor as the recipient of the property. For property that was sold by the executor, list the property that was acquired from the decedent, not the sales proceeds. Such property, although sold, still qualifies for allocation of the basis increase allowance. It is my suggestion that an explanation also be included with the Schedule A, stating the reason why the executor is being treated as the person acquiring the property from the decedent.

It is also my understanding that the executor is not required to provide anyone with a copy of a written statement showing the information required by section 6018(e) with respect to such property within the required 30-day period. In support of this understanding, note the following statement from the Form 8939 instructions:

The executor filing Form 8939 must furnish to each person whose name is required to be set forth in such return (*other than the executor filing the return*) a written statement showing the information required by section 6018(e) with respect to property acquired from

the decedent to the person required to receive the statement. The executor must furnish this statement not later than 30 days after the date Form 8939 is filed. (Emphasis added.)

Publication 4895 contains a similar statement.

The executor is not technically required to provide the ultimate recipients with the IRC Section 6018(e) information about property listed on a Schedule A and showing the executor as the recipient. But as a practical matter, the executor should provide the ultimate recipients with the Section 6018(e) information, since they otherwise have no way to obtain that.

Allocation of Basis Increase

Should Basis Be Increased to 100 percent of FMV?

There's always a possibility the IRS will examine Form 8939 and reduce the fair market value of one or more assets, thus causing some waste of basis increase allocations. One way to hedge against this risk is to allocate basis increase so that the reported total basis (including basis increase allocation) of each asset is slightly less than fair market value. If the maximum amounts of the basis increase allowances will be fully utilized, consider allocating basis increases to a level below FMV for hard-to-value assets. That should reduce or avoid potential IRS adjustments, while, at the same time, not wasting the basis increase allowances.

Income and Remainder Interests, and Allocation of Basis Increase Allowance

The instructions contain an example where one individual acquires an income interest in property and another acquires a remainder interest.

It appears to me that the basis increase allocation is made to the property. For example, it's not possible to allocate basis increase to the remainder interest while allocating none to the remainder interest.

There should be no confusion over QTIPs or any other trust providing an income interest: Where such a trust exists, basis increase allocation is made to the property, not, for example, to the income interest only. In such cases, the entire property is listed on one Schedule A showing the trust as the recipient of the property.

But where an income interest in property (not in trust) passes to one person and the remainder interest in that same property passes to another, several steps must be taken. First, the amount of the allocation to the property must be decided upon. Second, based on standard actuarial factors, the allocation must be further divided between the income and remainder interests. Third, each interest is reported on a separate Schedule A for the recipient of each interest, so two Schedules A are required to report the two parts of the property.

Note that the allocation to the income interest will expire when the recipient of that interest dies. In addition, if the income interest is sold, IRC section 1001(e) may (but doesn't always) assign zero basis for purposes of determining gain or loss. But, under uniform basis rules, as time passes, the portion of basis allocated to the income interest decreases, while the basis allocated to the remainder interest increases. And after the income interest holder dies, the income interest basis at date of death is not "lost." Instead, the holder of the remainder interest "acquires" all of the basis.

Reporting is as of DOD, but uniform basis rules shift basis over time between the remainder and life estate holders, and determine who gets to claim tax benefits, such as depreciation. Discussion of these rules is beyond the scope of this article, but a good place to start is Treasury Regulations Section 1.1014-4(b), which provides:

Where more than one person has an interest in property acquired from a decedent, the basis of such property shall be determined and adjusted without regard to the multiple interests. The basis of computing gain or loss on the sale of any one of such multiple interests shall be determined under § 1.1014-5. Thus, the deductions for depreciation and for depletion allowed or allowable, under sections 167 and 611, to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property not only in the hands of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under sections 167 and 611, both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 262. Similarly, adjustments in respect of capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable are made without regard to which one of the persons to whom the same uniform basis is applicable makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable. See § 1.1014-6 for adjustments in respect of property acquired from a decedent prior to his death.

Basis Increase Allocation for Gifts to Decedent Within Three Years of Death

Beginning on page 64 of the Guide, I said:

Congress worries about what happens within three years of death. In this case, Congress was worried that gifts would be bestowed upon terminally ill individuals for the purpose of getting a basis increase by allocation after death. Accordingly, IRC § 1022(d)(1)(C) provides that no basis increase allocation may be made to "property acquired by the decedent by gift

or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the 3-year period ending on the date of the decedent's death." It doesn't even matter whether or not the property passes back to the donor after the donee dies.

However, Congress likes surviving spouses. And complexity. So, gifts to the decedent by the surviving spouse within the three years preceding the decedent's death may receive a basis increase allocation, unless the donor-spouse "acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth." (This seems unnecessarily harsh for property that the surviving spouse had received as a gift outside the three-year period.)

Form 8939 instructions have clarified that basis increase allocations will not be barred by the three-year rule for spousal gifts to the decedent that were received by the donor spouse outside the three-year period. (See page 4 of the instructions.)

Schedule A is not enough information for the recipient of property.

The executor must, within 30 days of filing Form 8939 (or any later changes) provide to the recipient of property acquired from a decedent information required by section 6018(e). The information includes:

- (1) the name, address, and phone number of the person required to make such return, and
- (2) the information specified in subsection (c) [of IRC section 6018] with respect to property acquired from, or passing from, the decedent to the person required to receive such statement.

IRC section 6018 provides:

The information specified in this subsection with respect to any property acquired from the decedent is—

- (1) the name and TIN of the recipient of such property,
- (2) an accurate description of such property,
- (3) the adjusted basis of such property in the hands of the decedent and its fair market value at the time of death,
- (4) the decedent's holding period for such property,
- (5) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income [for example, section 1245 recapture potential],
- (6) the amount of basis increase allocated to the property under subsection (b) or (c) of section 1022, and
- (7) such other information as the Secretary may by regulations prescribe.

Publication 4895 states that sending a copy of Schedule A to the recipient of property satisfies the requirement.

But if only a copy of Schedule A is provided, the recipient of property might not have enough information. In addition to the required information, consider providing depreciation schedules (regular and AMT), the amount of section 1250 depreciation recapture subject to the special 25 percent capital gains rate, and any other information that the recipient may need to claim tax benefits and/or comply with tax rules as they may apply by reason of acquiring property having a carryover basis. A close inspection of the decedent's final income tax returns and supporting workpapers should help identify that information. State income tax attributes should also be considered for supplemental reporting in states that follow modified carryover basis.

ALTERNATIVE MINIMUM TAX

The IRS is still determining whether AMT characteristics carry over and whether an allocation of basis increase is permitted. It seems highly likely that the IRS will provide a cure procedure if guidance is not available by the due date of the return. It would not be a surprise if Treas. Regs. section 301.9100-2 is used as a basis for allowing the cure.

To preserve AMT benefits, an alternative solution is to prepare a second set of Schedules A listing the same assets, but showing AMT basis and allocating basis increase allowance. I would write "ALTERNATIVE MINIMUM TAX" at the top of each page, just as is done, for example, on depreciation schedules attached to individual income tax returns. I would also be careful to follow, for AMT purposes, properties that are the subject of basis increase allocations made under the regular tax (taking into account that AMT basis may not be increased beyond FMV, just as for regular tax).

A Word of Thanks

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