Family Tax Planning Forum

By Robert S. Keebler

Choosing Between Code Sec. 1022 Modified Basis Step-up and Applying the 2009 Estate Tax Rules for Decedents Dying in 2010

Although the tax treatment for estates of decedents dying in 2010 is still uncertain, one possibility is that trustees and personal representatives will have a choice between applying the modified basis rules in Code Sec. 1022 and using the estate tax rules that applied in 2009 (45-percent tax rate and $3.5 million exemption). In this column, I will first provide background information on the workings of Code Sec. 1022 and then offer a somewhat simplified mathematical model for making the election.

Background

Historically, Code Sec. 1014 provided that the basis of property acquired from a decedent was the fair market value of the property on the date of the decedent's death.[1] Because the value of property ordinarily increased over time, this rule was generally referred to as stepped-up basis, although it was also possible for basis to be stepped down to date of death value. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) added Code Sec. 1014(f), however, providing that the basis of property in the hands of persons acquiring such property from a decedent dying in 2010 would instead be determined under newly created Code Sec. 1022.

Code Sec. 1022 generally provides that for decedents dying after December 31, 2009, heirs take a basis equal to the lesser of (1) the adjusted basis of the property in the hands of the decedent, or (2) the fair market value of the property on the

Robert S. Keebler, CPA, M.S.T., is a Partner with Baker Tilly Virchow, Krause & Company, LLP, in Appleton, Wisconsin.

decedent's date of death.[2] Thus, under the general rule of Code Sec. 1022(a), heirs take a carryover basis like the basis provided for the recipients of gifts under Code Sec. 1015 instead of a stepped-up basis under Code Sec. 1014(a) (unless the value of the property has dropped).

Permitted Basis Increases

Basis increases are allowed for certain property, however. Code Sec. 1022(b) allows a basis increase of up to $1.3 million for any property acquired from the decedent ($60,000 for nonresident, noncitizens).[3] An estate executor or personal representative can allocate this amount among the estate assets in any manner, provided that no asset receives a basis in excess of fair market value.[4] The $1.3 million amount is increased by the sum of the following:

- Capital loss carryovers under Code Sec. 1212(b) and NOLs under Code Sec. 172, that (but for the decedent's death) would have been carried forward from the decedent's last tax year to a later tax year of the decedent
- The sum of the amount of any losses that would have been allowable under Code Sec. 165 if the property acquired from the decedent had been sold for fair market value immediately before the decedent's death[5]

Code Sec. 1022(c) creates an additional basis increase of up to $3 million for qualified spousal property, which includes only property transferred outright to the spouse and qualified terminable interest property.[6] Outright transfer property is any interest in property acquired from the decedent by the surviving spouse unless the interest will terminate or fail on the occurrence of some event or contingency.[7] Qualified terminable interest property is property in which the surviving spouse has a qualified income interest for life.[8] Thus, it is property transferred to a QTIP trust.

Property Owned by the Decedent

Code Sec. 1022(d) states that the basis of property received from a decedent may be increased under the $1.3 million and $3 million rules only if the property was owned by the decedent at the time of death and provides the following rules relating to ownership.

- **Revocable trusts.** The decedent is treated as owning property transferred by the decedent to a qualified revocable trust (as defined in Code Sec. 645(b)).[9]
- **Powers of appointment.** The decedent is not treated as holding property by reason of holding a power of appointment over the property.[10]
- **Community property.** If at least one-half of a community property interest would be treated as owned by and acquired by the decedent without regard to Code Sec. 1022, then 100 percent of the property interest is treated as owned by and acquired from the decedent for purposes of Code Sec. 1022.[11]
- **Property held in joint tenancy with right of survivorship or in tenancy by the entirety.** There are three different rules for such property depending on the facts of the case. If the only other tenant is the surviving spouse, the decedent is treated as the owner of one-half of the property. If the other tenant is someone other than the surviving spouse, the decedent is treated as owning a percentage of the property proportionate to the consideration the decedent furnished. If property was acquired by gift, bequest, devise or inheritance by the decedent and a person other than the surviving spouse, and the parties' interests are not otherwise fixed by law, the decedent is treated as the owner of a fractional part of the value of the property equal to one over the number of tenants.[12]

Additional Provisions

A number of other rules should be noted. First, the Code Sec. 1022(b) and (c) basis increases do not apply 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 three-year period ending on the date of the decedent's death.[13] Second, the $1.3 million, $60,000 and $3 million amounts will be adjusted for inflation.[14] Third, basis increases are allocated on the information return required by Code Sec. 6018[15] and may be changed only with the consent of the IRS.[16] Finally, Code Sec. 1022 does not apply to items of IRD.[17]

Possible Election Option and Planning Implications

Earlier this summer, Senators Jon Kyl (R-AZ) and Blanche Lincoln (D-AR) introduced a bill that would

provide a $3.5 million exemption and 45-percent estate tax rate for estates of decedents dying in 2010. Over a 10-year period, the rate would decrease to 35 percent and the exemption amount would grow to $5 million. The bill would also give the estates of decedents dying in 2010 a choice between the Code Sec. 1022 modified basis adjustment regime outlined above and applying the rules in effect for 2009 (45-percent tax rate and $3.5 million exemption amount).

Even if the 35-percent and $5 million provisions do not become law, the election idea could be attached to a different bill, creating a very interesting planning problem. Executors and personal representatives would have to choose between paying estate tax but receiving a full-basis step-up on the one hand, and paying no estate tax but receiving only a limited-basis step-up on the other.

Which Alternative Is Better?

We are now ready to look at a basic model. Although we would use a somewhat more sophisticated model for clients, the model presented here will show the general contours of the analysis.

For decedents who are single or the second spouse to die and have estates under $3.5 million, there will be no estate tax, and a full step-up in basis will always be more valuable. However, for such taxpayers with estates over $3.5 million, a quantitative analysis will be required to determine which alternative is more favorable. The relevant independent variables in the analysis will be amount of basis the heirs would receive under the carryover rules and the size of the estate.

Perhaps the most straightforward way to do the mathematical comparison is to calculate the break-even estate size given different amounts of carryover basis before the $1.3 million amount is added. Because the Code Sec. 1022 step-up alternative grows more favorable as estate size increases, any estate larger than the break-even point would be better off electing Code Sec. 1022, and any estate smaller than the break-even size would be better off electing year 2009 tax treatment. The measure of how favorable each alternative was would be based on the sum of the estate tax paid by the estate and the income tax paid by the heirs assuming they sold the assets immediately after they received them.

First assume that the decedent would have a carryover basis of $0 and that the value of the estate is $3.5 million. Under these assumptions, the $1.3 million basis addition permitted under Code Sec. 1022 would increase the total basis to $1.3 million. As a result, the amount of income tax payable under Code Sec. 1022 would be $440,000 [($3.5 million FMV – $1.3 million basis) x 0.20 = $440,000], and the amount of estate tax payable would be $0, making the total tax paid $440,000. The total tax payable under the 2009 rules would be $0. The tax consequences are illustrated in Chart 1.

Chart 1.

	Code Sec. 1022	2009 Rules
Estate Tax Payable	$0	$0
Income Tax Payable	$440,000	$0
Total	$440,000	$0

We know that, as the size of the estate increases above $3.5 million, each dollar will be taxed at 20 percent under the Code Sec. 1022 alternative and at 45 percent under the 2009 rules. Thus, the point at which the alternatives will break even is $3.5 million plus the amount represented by the formula shown in Chart 2.

Chart 2.

$440,000 + 0.2X = 0.45X

If we subtract 0.2X from both sides of the equation we get $440,000 = 0.25X

Solving for X, we get $440,000/0.25 = $1,760,000

If we then add this amount to $3.5 million we get a break-even point of $5,260,000

This result is easy to check. Let's look at the Code Sec. 1022 alternative first. If the value of the assets is $5.26 million, the gain recognized on a sale is $3.96 million ($5,260,000 – $1,300,000). Assuming a 20-percent capital gain rate, the income tax payable would be $792,000. There would be no estate tax. Turning then to the 2009 alternative, $1.76 million would be subject to estate tax ($5,260,000 – $3,500,000). The tax payable on this amount would be 0.45 x $1,760,000 = $792,000. Chart 3 summarizes these results.

Chart 3. Estate of $5.26 Million–Tax Payable

	Code Sec. 1022	2009 Rules
Estate Tax Payable	$0	$792,000
Income Tax Payable	$792,000	$0
Total	$792,000	$792,000

Thus, we see that the break-even point is simply the estate value at which the estate tax payable equals the income tax payable. Chart 4 shows the break-even points for other amounts of carryover basis.

Chart 4.

Carryover Basis	Break-even Estate Value
$0	$5,260,000
$500,000	$4,860,000
$1,000,000	$4,460,000
$1,500,000	$4,060,000
$2,000,000	$3,660,000
$2,200,000	$3,500,000
>$2,200,000	None

Note that where the carryover basis amount exceeds $2.2 million, the Code Sec. 1022 modified basis alternative is always superior regardless of how large the estate is. Thus, there is no break-even point.

Where the decedent is the first spouse to die, the situation is far more complex. I will address this analysis in my next column. In the meantime, tax advisors should begin to develop spreadsheets to gather basis information while waiting for new developments.

Endnotes

1 Code Sec. 1014(a).
2 Code Sec. 1022(a).
3 Code Sec. 1022(b)(1) and (e).
4 Code Sec. 1022(d)(2).
5 Code Sec. 1022(b)(2)(C).
6 Code Sec. 1022(c)(1), (2) and (3).
7 Code Sec. 1022(c)(4).
8 Code Sec. 1022(c)(5).
9 Code Sec. 1022(d)(1)(B)(ii).
10 Code Sec. 1022(d)(1)(B)(iii).
11 Code Sec. 1022(d)(1)(B)(iv).
12 Code Sec. 1022(d)(1)(B)(i).
13 Code Sec. 1022(d)(1)(C).
14 Code Sec. 1022(d)(3).
15 Code Sec. 1022(d)(3)(A).
16 Code Sec. 1022(d)(3)(B).
17 Code Sec. 1022(f).