

Application of Modified Carryover Basis Rules Under Section 1022



John R. Anzivino, CPA
Mark Scott, JD, LLM
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Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act)

- Important, but temporary, changes to estate, gift, and GST tax laws
- Extended sunset provisions of EGTRRA through 2011 and 2012
- Reinstated estate tax and GST tax to January 01, 2010
- Repealed the carryover basis regime
 - Basis not adjusted under Section 1014, but rather will be determined “as if transferred by gift”
- Granted a “special election” for those dying in 2010
 - Use old estate tax regime; or
 - Use new modified carryover basis regime
- Changes sunset after December 31, 2012
- Delineates filing deadlines of disclaimers and federal forms

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2010 Decedent Estates – Section 1014

- **Default Rule – Estate Tax Applies**
 - \$5 million exemption
 - Indexed from 2010 beginning in 2012
 - 35% marginal estate tax rate
 - Bases adjusted consistent with Section 1014
 - Holding period – deemed to exceed 1 year, therefore long-term capital gain treatment
 - **Form 706** – United States Estate (and Generation-Skipping Transfer) Tax Return

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2010 Decedent Estates – Section 1022

- **Election – Modified Carryover Basis applies**
 - Affirmative election out of the estate tax regime
 - Unlimited “estate tax” exemption
 - 0% estate tax / 0% GST tax
 - Bases adjusted consistent with Section 1022
 - Holding period – decedent/transferor’s holding period generally tacks
 - Where basis is the FMV (as opposed to decedent’s), the holding period may not tack
 - The holding period may not tack because the basis has not been determined “in whole or in part” by reference to the transferor’s basis under Section 1223(2)
 - If this is the case, then property equal to FMV on death must be held for more than a year after death to obtain long-term treatment
 - **Form 8939** – Allocation of Increase in Basis for Property Acquired From a Decedent

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2010 Decedent Estates - Disclaimers

▪ Qualified Disclaimers of Interest Under Section 2518

- With potentially no Estate Tax or GST tax in 2010, disclaimers should be considered
- Generally: A person can disclaim a full or partial interest in property within 9 months from the date of death
- For 2010 decedent estates, the deadline for making a disclaimer is 9 months from the date of the Tax Relief Act's enactment
 - Effectively extending disclaimer date to September 17, 2011
- Caution: Watch the impact of state law when disclaiming assets located in different jurisdictions
 - Florida law does not prohibit the extension of time as provided in the Tax Relief Act
- Caution: The disclaimant must NOT have accepted the interest or any of its benefits before disclaiming

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Due Dates – Estate Tax Regime

- Federal Estate Tax Return, Form 706
 - Date of death > January 01st - December 17th, 2010
 - **September 17, 2011, to file return and pay related taxes**
 - Date of death > December 18th – 31st, 2010
 - 9 months from d/o/d to file return and pay related taxes
- State Estate Tax compliance
 - State by state consideration
 - Some may comport with federal deadlines
 - However, a State Estate Tax return may already have been required to have been filed, with tax paid
 - i.e. decoupled states

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Due Dates – Modified Carryover Basis Regime

- Filing date for Form 8939 was expected to be the due date of the decedent's final Form 1040 (**April 18, 2011**)
- However, yesterday, the IRS posted additional information with respect to the availability of Form 8939
 - Form is not yet final
 - Form **should not** be filed with the decedent's final Form 1040
 - The election to have the modified carryover basis rules apply **should not** be made on the decedent's final Form 1040
 - Instructions as to how to make the election will be included in the instructions
 - Final Form will be posted at least **90 days** before required to be filed
 - Detailed information about filing the form (i.e. when, where, how, by whom, and for what purposes to file) will be included in the Instructions and Publication 4895
 - We expect the IRS will provide an extension period for Form 8939
- If contemplating the filing of Form 8939, decedent's Form 1040 should be extended
- Any beneficiary of a 2010 estate that has elected to use the modified carryover basis regime will **need to extend** their Form 1040 filing if they are waiting for basis information associated with a 2010 capital transaction

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Form 8939 - Penalties

- **\$10,000** - Non-filing penalty **for each such failure**
 - Reasonable cause exception
- **\$500** - failure to report property decedent received within 3 years of death
- **\$50** - failure to furnish asset basis to property recipient
- Return preparer subject to penalties under Section 6694
 - If reported information affects an entry on the recipient's return and constitutes a "substantial portion" of that return
 - If form placed in category similar to W-2's/1099's
 - » Preparer's conduct > willful / reckless
 - If form placed in category similar to 1065's/1120's
 - » Preparer's conduct may not need to reach willful or reckless threshold

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Modified Carryover Basis – Section 1022

- **Treatment of Property Acquired From a Decedent Dying in 2010**
 - **Basis shall be the LESSER of the adjusted basis of the decedent or the fair market value of the property at the date of death**
 - a) **Asset may have a step down in basis (FMV less than basis)**
 - b) **No alternative valuation**
- **Modifications:**
 1. **“Aggregate basis increase” - \$1.3 million**
 2. **“Qualified Spousal Property” basis increase - \$3.0 Million**
 - a) **Outright transfer property to spouse**
 - b) **Qualified terminable interest property Section 2056(b)(7)**
 - **Actual QTIP election not required (maybe disclaim?)**
 - **Can spouse disclaim and property pass to credit shelter trust?**
 - **Can a Charitable Remainder Trust qualify - all income, no invasion for others?**

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Modified Carryover Basis – Section 1022 - Cont'd

3. **“Additional basis increase”** modifications include:
 - a) **Capital loss carryovers** under **Section 1212(b)** and
 - b) **Net operating loss carryovers** under **Section 172**, if not for their death the decedent would have been able to carry over to a later year, and
 - c) **Losses** that would have been allowable under **Section 165** if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death (**“Built in Losses”** on Form 8939, page 1, line 10, i.e. unrealized losses on marketable securities)
 - d) **Passive losses**, there are three possible alternatives
 - (1) Losses are added to basis without limit 469(j)(6)
 - (2) Losses added to basis under IRC 1022 but limited to FMV as loss would have been allowed under IRC 265 if sold prior to DOD.
 - (3) Losses deductible on final 1040 IRC 469(g)(2)
4. **Decedent nonresidents who are not citizens of the US**
 - a) Aggregate basis increase of **\$60,000**
 - b) Additional basis increase modifications do NOT apply

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Assets Eligible For Basis Modification

- To be “eligible” property must be both “acquired from a decedent” and “owned by the decedent at the time of death”:
 1. **One-half of jointly-held property with spouse**
 2. **Jointly-held property with someone other than the spouse** – decedent’s portion based upon consideration.
 3. Property transferred by the decedent to a **qualified revocable trust**
 4. Surviving spouse’s **one-half community property**
 5. Any other property passing from the decedent due to death to the extent the property passes without consideration

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Ineligible Property For Basis Modification

- **“Ineligible” Property**
 1. **“IRD”- income in respect of a decedent, Section 1022(f)**
 2. **Property acquired by the decedent by gift or lifetime transfer for less than adequate consideration during the 3 year period ending on the DOD**
 - **Property gifted from the spouse is eligible unless spouse acquired by gift during the 3 year period**
 3. **Stock in certain entities**
 - **Foreign personal holding companies**
 - **Domestic International Sales Company (DISC or former DISC)**
 - **Foreign investment companies**
 - **Passive foreign investment companies (PFIC) - Unless a qualified electing fund with respect to the decedent**

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Additional Ineligible Property For Basis Modification

- 4. Property over which the decedent held power of appointment**
- 5. The decedent's beneficial interest in a QTIP created prior to 2010. (If estate elects out of estate tax it appears neither IRC 1014 nor 1022 apply?)**
- 6. Other property not considered "owned by the decedent"**
 - a) General Power of Appointment Marital Trusts
 - b) Qualified Personal Residence Trust (QPRT)
 - c) Qualified Retained Annuity Trust (GRAT)

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Estates of 2010 Decedents – Section 121

- **Section 121 Exclusion of Gain From Sale of Principal Residence**
 - **General Rule:** Gross income shall not include gain (up to **\$250,000** or **\$500,000** filing joint) on the sale or exchange of property, if the property is considered the principal residence for 2 out of the preceding 5 years.
 - **For estates of 2010 decedents electing Section 1022 treatment,** Section 121(d)(11) **excludes** up to **\$250,000** of gain on a sale of the decedent's principal residence by
 - a) the estate;
 - b) a beneficiary who received the residence from the estate; or
 - c) a qualified revocable trust established by the decedent
 - **Surviving spouse** may qualify for an additional \$250,000 exclusion for a total of **\$500,000**.
 - The exclusion applies if the **transferee and the decedent together** meet the 2 out of 5 year ownership and use test.
 - **Caution:** Be careful of the over allocation of the basis increase to the principal residence which might be wasted due to the Section 121 exclusion.

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Example: Personal Residence – Section 121

- **Changes to Section 121(d)(11) – Property Acquired From a Decedent**
 - **Facts:**
 1. House @ DOD has FMV of \$2,000,000
 2. Decedent's basis = \$800,000
 3. Decedent & transferee together meet the 2 out of 5 year personal residence ownership and use test
 4. Estate elects carryover basis under Section 1022 and has \$600,000 of increase modifications to basis (basis now \$1.4MM)
 5. Seller is the estate, an individual who acquired the property from the decedent, or a qualified revocable trust under Section 645(b)(1) established by the decedent.
 6. The property is sold during the 2 out of 5 year qualifying period
 - **Outcome:**
 1. \$250,000 of the gain is excluded and \$350,000 gain is taxed.
 2. If the beneficiary is the surviving spouse then \$500,000 gain is excluded and \$100,000 is taxed.

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Allocation of Increase in Basis for Property Acquired From a Decedent Form 8939

- Latest draft issued on December 16, 2010 with no instructions
 - Please see draft copy included at the end of your handout
- Reconciliation of basis adjustments
- Built in losses, loss carry forwards and net operating loss carry forwards
- Reconciling aggregate basis increase
- Reconciling spousal basis increase
- Schedule of property acquired by surviving spouse
- Schedule of property acquired by entity/individual other than surviving spouse
- Property information included:
 - Accurate description
 - Date decedent acquired property
 - Decedent's basis in property
 - Fair market value of assets as of the date of death
 - Modifications to the asset basis

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Some Open Issues Associated with Form 8939

- **American Bar Association submitted questions and comment**
 - **Carol Cantrell of Briggs & Veselka Co., Heckerling presenter**
- Are appraisals going to be required to be attached?
- Will grouping and de minimis rules be allowed?
- Where is community property reported?
- Where is undistributed property reported on the Form 8939?
- Can a Form 8939 be amended?
- How should multiple fiduciaries be handled?
- Will there be a box for the election?
- Where is generation skipping transfer tax exemption allocated?
- Can estates make a “protective election” to be able use the Modified Carryover Basis regime, to hedge the event of the IRS changing values on assets reported on a Form 706?

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IRS Comments Associated with Form 8939

- **Comments from Robert Chapman, IRS Tax Forms & Publications Desk's, (February 8, 2011) :**
 - Official **due date** is the same as the decedent's final Form 1040, but it is thought that the IRS may extend that date.
 - **Appraisal** guidance is forthcoming, from James Hogan, Branch 4 Chief, IRS Office of Associate Chief Council.
 - Form must disclose **recipient of property as of the file date**. It may just list assets to the estate if distributions have not been made.
 - IRS plans to provide a place on Form 8939 similar to Schedule R of the Form 706 to allocate the decedent's GST tax exemption.
 - It is expected that in the description of property, the date of acquisition statements such as "various" and "unknown" will be acceptable as they are on Schedule D of the Form 1040.
 - The final draft and instructions of **Form 8939**, as well as **Publication 4895, Tax Treatment of Property Acquired from a Decedent Dying in 2010**, are expected to be released by **May 2011**

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How Do We Decide?

**How do we decide whether or not to
elect out of estate tax regime and into
modified carryover basis?**

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Factors to Consider

- **Election Between Estate Tax and Carryover Basis Regimes**
 - Calculation and apportionment of estate tax burden
 - When taxes (estate or income taxes) will be due
 - The possibility of a “Protective” election under Section 1022
 - 4 types of property NOT eligible for basis increases under Section 1022:
 - a) General Power of Appointment Marital Trust
 - b) Qualified Terminable Interest Trust (QTIP)
 - c) Qualified Personal Residence Trust (QPRT)
 - d) Qualified Retained Annuity Trust (GRAT)
 - Charitable deduction
 - Marital deduction
 - State death tax and income tax effect

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Additional Factors to Consider

- Anticipated sale date of each asset
- Tax character of any gains
- Who are the beneficiaries
- Ages of beneficiaries
- Future tax rates
- Future earnings
- Judicial interpretation of formula clauses to determine beneficiaries

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Example 1

- **Tyler died in 2010 and was survived by his wife Marla and his son Bob.**
 - **Facts:**
 1. Tyler's estate plan leaves to his wife Marla:
 - a) Personal residence
 - b) Rental property
 - c) Closely held stock – Family, Inc., received by gift in 2008
 2. Tyler's estate plan leaves to his son Bob:
 - a) Stock Portfolio
 3. Assume there are no capital loss carryforwards, NOL carryforwards nor built-in losses
 4. Tyler's executor elects out of estate tax regime

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Example 1 – Matrix of Assets and Adjustments

	FMV AT DOD	DECEDENT'S BASIS	\$1.3 MILLION AGGREGATE BASIS INCREASE	\$3 MILLION QUALIFIED SPOUSAL INCREASE	ADJUSTED BASIS SECTION 1022
RESIDENCE	3,500,000	2,000,000		1,500,000	3,500,000
RENTAL PROPERTY	2,000,000	1,500,000		500,000	2,000,000
Family Inc. - Closely Held Stock rec'd by gift in 2008	2,000,000	300,000			300,000
STOCK PORTFOLIO	2,000,000	1,000,000	1,000,000		2,000,000
TOTAL	9,500,000	4,800,000	1,000,000	2,000,000	7,800,000

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Example 1 – Explanation

- **Outcome:**

1. Although Tyler's estate has a \$5 Million difference between FMV at DOD and the decedent's basis, only \$3 million of basis modifications can be used under the carryover basis regime.
2. Only \$1.0 million out of a possible \$1.3 million aggregate basis increase is used (\$300,000 of basis increase is lost).
3. Only \$2.0 out of a possible \$3 million qualified spousal basis increase is used (\$1.0 million of basis increase is lost).
4. Because closely held stock was received by gift within 3 years of death, it is not eligible for a basis modification.

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Example 2

- **Mr. Garcia died in 2010 and was survived by his wife Jane.**
 - **Facts:**
 1. Garcia's estate plan leaves to his wife Jane:
 - a) Personal residence
 - b) Personal property
 - c) IRA
 2. The residue passes to a bypass trust that does not qualify for QTIP treatment.
 3. Garcia was the beneficiary of a QTIP from his predeceased wife from a previous marriage.
 4. Garcia has an NOL carryforward of \$2.0 million.
 5. Garcia's executor elects out of estate tax.

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Example 2 – Matrix of Assets and Adjustments

	FMV AT DOD	DECEDENT' S BASIS	BUILT-IN LOSSES & CARRY- FORWARDS	ADDITIONAL BASIS INCREASE	\$1.3 MILLION AGGREGATE BASIS INCREASE	\$3 MILLION QUALIFIED SPOUSAL INCREASE	ADJUSTED BASIS SECTION 1022
RESIDENCE	3,000,000	500,000				2,500,000	3,000,000
PERSONAL PROPERTY	1,000,000	1,500,000					1,000,000
STOCK PORTFOLIO	7,000,000	4,000,000		1,700,000	1,300,000		7,000,000
QTIP	5,000,000	2,000,000					2,000,000
IRA	2,000,000	-0-					-0-
FOREIGN PHC	1,000,000	500,000					500,000
NOL C/O	-0-	-0-	(2,000,000)				-0-
TOTAL	19,000,000	8,500,000	(2,000,000)	1,700,000	1,300,000	2,500,000	14,000,000

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Example 2 – Explanation

■ Outcome:

1. Although Garcia's estate \$10.5 million difference between FMV at DOD and the decedent's basis and there are potentially \$6.3 million ($3.0 + 1.3 + 2.0$) of adjustments, there is only \$5.5 million of basis increases can be used under the modified carryover basis regime.
2. The \$1.3 million aggregate basis increase is allocated to the portfolio.
3. Only \$2.5 million out of a possible \$3.0 million qualified spousal basis increase is used (\$500,000 of basis increase is lost).
4. An additional basis increase of \$1.7 million from NOL carryovers is allocated to portfolio (The excess \$300,000 NOL is lost).
 - Remember increases are limited to FMV.
5. Because the IRA is IRD, it is not eligible for a basis modification
6. Built-in losses on personal property are not eligible to be used as a basis modification because they are not deductible under Section 165.
7. The QTIP is not eligible for basis modification.
8. Foreign corporation stock is not eligible for basis modification

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Fiduciary Duties

- The term “executor” means the executor or administrator of the decedent, or if there is no executor or administrator appointed, qualified and acting within the US, then any person in actual or constructive possession of any property of the decedent
- If assets in both an estate and a trust, then multiple fiduciaries charged with allocating and reporting basis
 - Not clear how their authority would be divided, especially if they owe fiduciary duties to different sets of beneficiaries
 - IRS may assign the authority to fiduciary with highest fair market value of assets
- Fiduciary is required to report transfers of gifts that the decedent received within 3 years of death, even though they are not eligible for a basis increase
- Fiduciary is required to make a return reporting all property (subject to basis modifications) acquired from decedent
- Fiduciary not liable for actions taken in good faith

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Fiduciary Duties Regarding Basis

- **Fiduciary is responsible to determine decedent's basis in assets**

- Determined for each asset, which may be difficult or impossible
 - When basis is unknown, previous carryover basis rules allowed the PR to use the market value on the date the decedent or last preceding owner acquired it (see Sec 1023(g)(3))
 - » Section 1022 does not have this provision
 - When basis is unknown, gift tax rules allow IRS to get facts from last preceding owner or any other person cognizant of the facts (see Reg. Sec. 1015)
 - Courts generally sustain the IRS' determination when reasonable support for position
- Court may rule that the basis is \$0 if the fiduciary has no basis information and cannot prove the acquisition date

- **Fiduciary is responsible to provide basis (and modifications) to beneficiary**

- Under duty of consistency, beneficiary is required to be consistent with information returns with respect to items of income, unless they assert a reasonable dispute
 - There is a question as to whether duty of consistency applies to basis issues
- Beneficiary may take an inconsistent position and prove the basis with his own information
- If beneficiary provides credible evidence, the burden of proof shifts to the IRS
- Provide information to beneficiary within **30 days** after furnishing information to the IRS
 - Name, description, and tax identification number of recipient property
 - Decedent's basis, FMV at date of death, and amount of basis increase allocated
 - Decedent's holding period
 - Sufficient information to determine whether gain on sale should be ordinary income
 - » May be obligated to furnish depreciation schedules on property to facilitate the calculation of recapture on sale of property

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Community Property Basis

- Fiduciary is responsible to determine decedent's interests in "community property"
 - Community property states and foreign jurisdictions
 - Surviving spouse's one-half share is treated as "owned by and acquired from" the decedent
 - Essentially treats the surviving spouse's ½ interest in community property as if it were transferred outright to the spouse by the decedent
 - Community property is eligible for the \$1,300,000 aggregate basis modification
 - Community property is eligible for the \$3,000,000 spousal basis modification
 - Useful when the decedent does not transfer sufficient assets to the spouse to use all of the basis increase available
- Watch when community property is divided in an "equal but non-prorata division"
 - IRS has previously held that such non-prorata divisions are tax-free because they are in substance the same as a division in a divorce
 - Rationale would seem to allow non-prorata divisions to be tax-free even in non-community property jurisdictions
 - The IRS needs to clarify whether the community half is measured on an aggregate or property by property basis

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Allocating Basis Increase

- Section 1022 seems to provide the executor complete latitude on how to allocate the basis increases
 - In small estates, where the basis increases will provide a full step-up to FMV, it makes no difference how the executor allocates them
 - It is more difficult in large estates, where the appreciation greatly exceeds the basis increases
 - If governing instrument gives the executor broad powers to make tax elections and allocate basis in the best interests of the beneficiaries, the executor should act reasonable, without gross negligence
- Simple methods
 - Divide total basis increases among beneficiaries, on a per capita
 - Allocate increases to assets most likely to sell in the near future
 - Allocate increases to ordinary income property
 - Allocate increases to property passing to beneficiaries in highest income tax brackets
 - Allocate increases to property of those not likely to die soon
- More complex methods
 - Allocate increases in proportion to each property's value as it relates to the total value of all the assets available for a basis increase (not to exceed FMV)
 - Allocate increases in proportion to each property's appreciation as it relates to the total appreciation in all assets available for a basis increase

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Fiduciary Duties of Impartiality and Prudence

- Obligation to properly report the basis and prudently allocate increases
 - Watch a conflict of interest that arises if a fiduciary allocates a basis increase to property passing to himself as beneficiary
 - Prudently allocating basis among the beneficiaries' recipient property may involve knowing:
 - Which assets are likely to be sold first
 - Which assets may generate ordinary income
 - The beneficiaries' individual income tax brackets
- Fiduciary may want to know how the beneficiary plans to use the property (principal residence versus commercial property)
- Fiduciary may want to consider a beneficiary's time horizon, thus the likelihood of another basis adjustment opportunity
- If a fiduciary exercises reasonable judgment, documents decisions, and relies on professional advice, then it seems that they would be absolved from liability for breach of duty

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Pecuniary Bequests

- **Funding a specific pecuniary bequest with non-cash assets.** Only post DOD appreciation is recognized.
 - **Example - Facts:**
 1. \$1,000,000 bequest
 2. Asset FMV at DOD is \$800,000
 3. Decedent's basis is \$500,000
 4. No basis modification made
 5. Date of distribution value is \$1,000,000
 - **Outcome:**
 1. The gain on disposal recognized by the estate is \$200,000 (\$1,000,000 - \$800,000)
 2. Carryover basis in the hands of the beneficiary is \$700,000 (\$500,000 original basis+ \$200,000 gain recognized)

Note: Rule under Section 1040 applies to estates. Until regs are issued, rev trusts of decedent should make Section 645 Election to be treated and taxed as an estate to qualify for this treatment.

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Highly Appreciated Real Estate

- Highly appreciated real estate
 - Especially when mortgage liabilities are greater than adjusted tax basis
 - Potential income tax liability is greater than estate tax savings
 - Only way out of negative basis is the step up in basis under estate taxation
 - Fully depreciated buildings, especially nonresidential and residential real property acquired before 1986, to the extent depreciation faster than straight line was allowed. May result in **depreciation recapture under Section 1245 taxable as ordinary income** and may be subject to state taxes
 - Other ordinary income risks such as:
 1. Code 179 write-offs and bonus depreciation
 2. Real property held for one year or less

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Example: Appreciated Real Estate – With Debt in Excess of Basis

- Property purchased in 1984 for \$20,000,000, allocating \$16,000,000 to the building, which is fully depreciated @ DOD. Appreciation over the years along with periodic refinancing has left the building with the following:
 - Gross Value \$ 54,000,000
 - Adjusted Basis 4,000,000
 - Mortgage 44,000,000
 - Equity 10,000,000
- **Under Estate Tax Rules:**
 1. 35% estate tax rate X \$10,000,000 = **\$3,500,000 Estate Tax**
 2. Tax free step up in basis of building to \$54,000,000. If the land appreciated to \$14,000,000, the buildings \$40,000,000 could be depreciated

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Example: Appreciated Real Estate – Cont'd

- **Under Section 1022 Election for Carryover Basis:**
 1. \$50,000,000 gain (\$16,000,000 which is ordinary due to depreciation recapture under Section 1245, taxable at 35% federal rate and could be subject to state income taxes)
 2. The \$34,000,000 capital gain would be taxed at 15%.
 3. **Result: \$10.7 million of Federal Income Tax vs. \$3.5 million of Estate Tax.**
Should we pay \$3.5 to get a basis step up of \$50,000,000.
 4. The income tax due of \$10,700,000 is actually greater than the net sales proceeds of \$10,000,000 after paying off the mortgage!

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Decision Time

- **General Consensus:**
 - Estates up to \$5 million (taking into account lifetime gifts):
 - Apply default rule
 - NO estate tax due
 - NO Form 706 filing requirement
 - Estates over \$5 million must be analyzed

We have 8 months to pull this all together. Even though Form 8939 may not be available until May and not due until October, we can be doing our analysis now!

“How much estate tax are you willing to pay to get a step-up in basis for income tax purposes?”

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Contact Info

Please let us know if we can help you!

John R. Anzivino, CPA

Phone: 305-857-6706

Email: janzivino@kaufmanrossin.com

Mark Scott, JD, LLM

Phone: 305-857-6768

Email: mScott@kaufmanrossin.com

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