Tax Basis Planning - The Basics

An Expanding Frontier for Tax and Estate Planning

(Part of a Series of Articles on Tax Basis Planning)

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***Editor's Note*: Jeff will be speaking on "Basis Planning" at the University of Florida Levin College of Law First Annual Tax Institute on February 21, 2014 in Tampa. For more information on the Florida Tax Institute go to: www. http://floridataxinstitute.org/. We hope to see you there.**

This article is part of a series of articles that will be written by the authors on tax basis planning issues over the coming year. The first article discussed the ramifications of Code section 1014(e).

Authors' Note: This series of articles will not drill down to every nuance of every planning issue nor will we discuss every possible topic. To aid you in your research, we have provided research sources on many of the ideas discussed in the articles. This article will not discuss tax basis issues and opportunities in community property states, the intricacies of partnership basis planning, or most basis planning perspectives in the context of business decisions.

EXECUTIVE SUMMARY:

For decades, income tax planning and its first cousin, tax basis planning, have often been a secondary planning issue for estate planners. The high transfer tax exemptions adopted in the American Taxpayer Relief Act of 2012, coupled with the recent significant income tax increases, are bringing income tax planning into the forefront of estate planning. As a result, tax basis planning is gaining increased attention. This article will delve into some of the basic rules and issues in basis planning. Future articles will discuss opportunities and traps in tax basis planning.

COMMENT:

The New Environment. There are two primary changes driving this new focus on basis planning: (1) for most taxpayers federal estate taxes are no longer relevant to their decision making and (2) income taxes can be substantially more costly, particularly for estates and trusts. While the imposition of transfer taxes has been substantially reduced, the reality is that the annual compounded cost of state and federal income taxes could take substantially more assets than the estate tax ever took. Moreover, the government does not have to wait until death to get their "fair share."

With the passage of the American Taxpayer Relief Act of 2012 ("ATRA") Congress permanently established the estate and gift tax exemption at $5,000,000 per person, indexed for inflation, with a flat transfer tax rate of 40%. The 2014 transfer tax exemptions are $5,340,000 per taxpayer. A Congressional Research Service report entitled "*The Estate and Gift Tax Provisions of the American Taxpayer Relief Act of 2012*," (issued on February 15, 2013) estimated that less than 0.2% of all estates would be subject to an estate tax in 2013.

While ATRA reduced the imposition of federal transfer taxes, the burden of state and federal income taxes is increasing:

- ATRA established a top federal income tax rate of 39.6% for taxable income in excess of $400,000 for an individual or $450,000 for a married couple filing jointly.
- The Patient Protection and Affordable Care Act ("PPACA") provides for a new 3.8% surtax.
- There are 18 Code sections in which tax benefits are phased out for higher income taxpayers, raising the effective tax rate. For example, ATRA restored the phase out of itemized deductions and personal exemptions.
- The top long term capital gains and qualified dividend tax rates increased in 2013 from 15% to 20%. Add the 3.8% PPACA tax and the federal capital gain tax rates are almost 24%.
- These higher tax rates apply to trust and estate taxable income at even lower thresholds than those for individuals. At taxable income over $12,150 (in 2014) the federal income tax rate is 39.6%, plus the potential 3.8% PPACA tax.
- State income tax rates range from 0% to 11% (in both Hawaii and Oregon).
- Many cities (e.g., New York City) and counties also impose local income taxes, particularly on their higher income residents.
- Meanwhile, the Alternative Minimum Tax is always lurking in the shadows.

Results of the New Environment. This new environment will encourage a number of significant changes in how we approach tax and estate planning, including (but certainly not limited to):

- *Valuation*. For many taxpayers, the valuation component of estate planning has taken a 180 degree turn. For years the focus on asset values has been to drive down the value of assets to reduce any transfer taxes. Now, many taxpayers may want to drive up the value of their assets to reduce the future income taxes on heirs. The increase in basis not only reduces the tax costs on sale transactions by heirs, it may provide heirs with a larger basis for depreciation and amortization deductions. Because of the increased importance of documenting tax bases, ATRA and PPACA make appraisals of non-readily marketable assets more important.

- *Busting Prior Work*. For clients who are no longer subject to an estate tax, practitioners will increasingly look at ways to terminate prior planning techniques to obtain greater tax basis benefits. For example, practitioners should consider using the IRS positions on Code section 2036 to pull gifted interests in partnerships and LLCs back into the decedent's taxable estate to gain a new basis step-up on previous gifts.

- *Terminally Ill*. Pre-mortem planning for those facing a more imminent demise (i.e., terminally ill, chronically ill, those with a looming incapacity, and the elderly) becomes more important because of the need to arrange their affairs, assets and documents in ways that allow for better tax basis results.

- *Documents*. The flexibility built into client estate planning documents must broaden to include greater flexibility to reduce income taxes and create better tax basis results. For example, executing a General Power of Attorney which specifically permits the holder to convert an IRA into a ROTH IRA or make pre-mortem decisions that increase the heirs' tax basis (e.g., gifting assets with unrealized losses before death).

- *Planning for the Long Term*. While estate tax planning has normally had a long term perspective, income tax planning has generally tended to focus on short term tax planning issues. Basis planning generally requires a longer term view.

- *Lower Thresholds.* Since 2001, estate tax planning has been largely dominated by the increasing federal estate tax exemption. As a result there has been a perception that only larger, potentially taxable estates need to be concerned about tax planning. However, tax basis planning works at much lower thresholds. For example, assume a son has worked in a chronically ill father's business for 30 years. All of the business assets have depreciated to zero, but the business and its assets have a fair market value of $500,000. Dad wants to gift the business to the son. That is a bad choice. Delaying the transfer to the father's passing can provide substantial tax basis benefits to the son. The estate plan needs to focus on how the son can be assured that the business ultimately passes to him at his father's death.

- *Granular Planning*. Planning for the estate tax is generally simpler than tax basis planning, because the transfer tax exemptions allow practitioners to focus on the entire estate as a single value. With tax basis planning, the analysis generally requires an asset by asset approach, resulting in greater detail and complexity.

- *Fiduciary Income Taxation*. With the substantial increase in the taxes on trusts and estates, clients and their advisors will increasingly focus on how to drive down the effective tax rate on both existing trusts and estates and those which will be created in the future. A working knowledge of FAI and DNI and how state laws impact their calculations (e.g., apportionment of income and expenses between principal and income) will become a necessity for all estate planners.

- *Reduced IRS E&G Staff*. In July 2006, the IRS announced that it was laying off roughly half of the attorneys (157 out of 345) who worked in the Estate and Gift Tax Division of the IRS. Once the 2012 glut of gift tax returns are handled, we should expect another staff reduction. With the reduced number of taxable estates and limited number of IRS estate and gift tax staff, it is probable that IRS rulings on transfer tax issues will be substantially reduced or delayed.

- *Increased Estate Tax Audits*. With so few decedent estates subject to an estate tax, the remaining estates will be subject to a higher likelihood of audit, excluding returns filed to obtain portability. The IRS reported that for the fiscal year ending on September 30, 2012, estate tax returns with a gross estate over $10 million had a 116% audit rate. The high rate was because of the audit of decedents' gift tax returns. See the 2012 Internal Revenue Service Data Book, issued March 25, 2013.

- *Fiduciary Income Tax Audits*. Will the former estate and gift tax agents move over to the fiduciary income tax side of the IRS? If audits are driven by revenue, this is certainly a reasonable expectation, because fiduciary income tax audits could be a highly lucrative revenue source for the government.

- *Uncertainty*. While the “permanent” large estate and gift tax exemptions provide many tax planning opportunities, practitioners need to balance the planning with the potential for a significant decrease in the exemptions and/or loss of planning techniques as Congress inevitably looks for new sources of increased revenue. See the discussion at the end of this article.

<u>Complexity</u>. Properly determining a tax basis is a bedrock issue of income taxation. As a consequence, tax basis determinations are intricately complex and contain a mind boggling plethora of rules, exceptions and limitations, and a fair degree of ambiguity. The Code's terminology reflects this complexity. For example:

- One-hundred-sixty-six active and repealed Code sections use the phrase "*adjusted basis*."
  - The phrase "*adjusted basis*" is never uniformly defined in the Code, which makes sense when you realize the number of Code sections that provide for adjustments to the tax basis of assets and the lack of uniformity in the nature of those basis adjustments.
  - Code section 1016 contains the closest example of a uniform definition of adjusted basis.
  - Code section 118(c)(4) makes things easy by saying the applicable adjusted basis will always be zero.
- The phrase "*cost basis*" appears in four Code sections.
- The phrase "*aggregate basis*" is found in four active Code sections.
- The phrase "*qualified basis*" is found only in Code section 42.
- The phrase "*substituted basis*" is used in ten Code sections.
  - The phrase "*substituted basis property*" is used in four Code sections and is defined in Code section 7701(a)(42) as "*transferred basis property*" or

"*exchanged basis property*." Each of these two phrases is then defined in succeeding paragraphs of section 7701(a).

- The phrase "*transferred basis*" is used in six Code sections.
  - The phrase "*transferred basis property*" is defined in 7701(a)(43).
- The phrase "*exchange basis*" does not appear in any Code section.
  - The phrase "*exchanged basis property*" is defined in 7701(a)(44) and appears in four Code sections.
- The phrase "*carry-over basis*" is used in three active Code sections.
  - Practitioners often use the phrase "*carryover basis*" when referring to the basis in gifting transactions, but Code section 1015 does not use the phrase.
- The phrase "*uniform basis*" is largely a judicial and regulatory concept that appears in one Code section.
- The phrase "*negative basis*" is never used in the Code, but does appear a number of times in the Treasury Regulations.
- The phrase "*unitary basis*" is never used in the Code, but is often found in the context of partnership basis determinations.
- The phrase "*step-up in basis*" is often used to describe the new basis heirs receive upon the passing of a decedent. However, the phrase is technically incorrect because the basis at death could step-down if the fair market value of the inherited asset was less than the decedent's tax basis. While the phrase (or similar language) appears in three Code sections, none of the references deal with the death of a transferor.

When dealing with basis issues, even the grammar can get tricky. What is the plural of basis? Is the word "basises"? Is it one of those odd words whose singular version is the same as the plural version? According to the Webster Dictionary, the plural version is "*bases*." Somehow, that just does not seem correct.

<u>Variables</u>. Tax basis planning is significantly different from estate tax planning and generally requires a much more detailed analysis because tax basis determinations are made on an asset by asset basis. Among the variables that have to be analyzed in the course of the planning process are:

- What is the current tax basis of each asset in the plan?
  - Is there any potential depreciation recapture or other tax recaptures applicable to the asset?
- What is the current fair market value and projected fair market value at death of each asset in the plan?
- What is the health of the transferor and potential transferees? For example, in many cases, death can be a cleansing agent for tax basis problems. Depreciation recapture is eliminated for the heirs. Negative basis problems can be wiped out. Assets which have a nominal basis (e.g., an artist's work product) can suddenly gain basis.
- Is the asset depreciable or amortizable?
- How does the state of domicile of the transferor and potential transferees impact planning?
  - Relative income tax brackets
  - Estate and inheritance taxes
  - Community property issues

- What are the relative income tax brackets of the transferor and potential transferees?
- Are the transferor and the transferee expected to have taxable estates for state or federal tax purposes?
  - Is there sufficient liquidity to cover any state or federal estate taxes?
- What are the relative tax rates on the asset if it is sold (e.g., deprecation recapture or the higher capital gain rates for collectibles pursuant to section 1), gifted or bequeathed?
- Are assets located in states other than the state of domicile and how will local laws impact the basis of a non-domiciled asset?
- Are there existing trusts and/or estates that need to be analyzed as a part of the plan?
  - What is the basis and fair market value of assets in the estate or trust?
- Is the client charitably inclined?
  - Are there charitable bequests in the will that do not reference specific assets (e.g., "I give $100,000 to my University.")?

THE BASIS RULES FOR LIFETIME TRANSFERS

<u>General Rule.</u> The general rule is that the donor's basis for lifetime gifts carries over to the donee. IRC section 1015(a) provides as follows: "*If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.*"

The effect of this rule is that any unrealized gain in the gifted asset will be taxed to the donee when the asset is sold, but unrealized losses are lost to both the donor and donee.

The donor's accumulated depreciation on a donated asset carries over to the donee. See Code section 1016(a) and Treasury Regulation section 1.1016-10.

With regard to the donee's holding period, Code section 1223(2) provides as follows: *"In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if ..... such property has, <u>for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part</u> in his hands as it would have in the hands of such other person."* (emphasis added)

But as with any rule under the Code, there are multiple exceptions and nuances to the general rule, including (but certainly not limited to) those noted below:

<u>The No-Tax Window</u>. If the donor's basis in the gifted asset is greater than the asset's fair market value, and the donee sells the asset below the donor's tax basis, then the donee's tax basis for determining any recognized loss is the lower fair market value, effectively eliminating the donee's benefit of the donor's unrealized loss. This rule creates an interesting anomaly in the Code. If a gifted asset has a basis that is greater then its fair market value and the asset is later sold by the donee for a price between the donor's basis and the fair market value, neither a gain nor a loss is reported on the sale.

> ***Planning Example:*** For example: assume a donor gifts an asset worth $100,000 which has a basis of $200,000. If the donee subsequently sells the asset for any price between $100,000 and $200,000, neither gain nor loss would be recognized on the sale. For gain purposes, the $200,000 basis is used. For loss purposes, the $100,000 fair market value is used.
>
> ***Perspective***: The combination of this loss rule for donees and the high transfer tax exemptions available to most donors create an incentive for donors and donees to value gifts of non-readily marketable assets at a value that exceeds the donor's tax basis. Why? The higher fair market value can provide the donee with a possible loss when the asset is sold.

Spousal and Divorce Transfers. Code section 1015(e) contains a special exception in Code section 1041. Section 1041(a) and (b) reads as follows:

> "(*a) No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) (1) a spouse or (2) a former spouse but only if the transfer is incident to the divorce.*
>
> *(b) In the case of any transfer of property described in subsection (a): (1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and (2) the basis of the transferee in the property shall be the adjusted basis of the transferor."*

Although the basis in non-spousal gift transfers is generally the lesser of the asset's fair market value or donor's basis, this limitation is not applicable to transfer to spouses or certain ex-spouses. The transferee/spouse or ex-spouse will take the transferor's basis even if the basis is greater than the asset's fair market value. The holding period of the transferor spouse also carries over to the transferee spouse.

If the property transferred pursuant to Code section 1041 is passive activity property, any suspended passive activity losses for the property may be added to the basis of the property. See Code section 469(j)(6)(A). But see TAM 9552001 where the IRS provided that Code section 1366(d)(2) specifically denies any carryover of suspended S corporation losses on transfers made pursuant to Code section 1041.

Research Sources:

- Bittker & Lokken, Federal Taxation of Income**,** Estates and Gifts, (WG&L), section 44.6**,** Transfers Between Spouses and Former Spouses.
- Tax Management Portfolio, Divorce and Separation, No. 515-2nd.

Liability in Excess of Basis. In many cases, the liability secured by an asset exceeds the tax basis of the asset. For example, a client may have entered into a series of like kind exchanges to roll realized gains forward, while obtaining larger loans based upon the increased fair market value of the asset.

The general rule is that gifts of such property during life create current taxable income to the transferor to the extent of the difference between the basis and the applicable debt. See Commissioner v. Crane, 331 US 1 (1947). The assumption of the debt by the transferee is treated as a sale transaction. Treasury Regulation section 1.1001- 2(a)(1) provides that *"...the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.*"

If an asset is gifted and the donor recognizes gain as a result of the assumption of debt by the donee, the transaction is treated as a part sale/part gift. Such transactions will be discussed in more detail in a later article.

It is interesting that the IRS has never asserted that an heir's assumption of debt upon the death of the taxpayer could create a taxable event to the donor's estate. Death apparently eliminates the potential tax liability, even if the liability exceeds the fair market value of the inherited asset.

Planning Opportunity: Code section 1041(e) provides an exception to the above rule. If property is transferred <u>directly</u> to a spouse or ex-spouse and has a liability in excess of its basis, no recognition occurs on the transfer and the recipient spouse takes the transferor spouse's basis. See PLR 9615026 and Treasury Regulation 1.1041-1T(d), Question 12. However, there are limits to this exception:

- Code section 1041(e) provides that transfers <u>in trust</u> for a spouse or ex-spouse do not receive this tax treatment.
- Code section 1041(d) provides that if a property settlement is made with a non-resident alien, section 1041 does not apply and the transfer may create a taxable event.

Planning Opportunity: Current income taxation created by the transfer of an asset with a liability in excess of basis can be avoided by the grantor transferring the asset to an income defective grantor trust. See PLR 9230021. However, if the trust ceases to be an income defective trust during the grantor's life, the grantor may be treated as transferring the asset and taxation may occur. See Revenue Ruling 77-402 and Treasury Regulation section 1.1002-2(c), Example 5. There is disagreement among commentators on whether the death of the grantor would trigger an income tax.

Research Source:

- Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts (WG&L), section 43.4. "*Relief From Liability as an Amount Realized*."
- Zaritsky, Tax Planning for Family Wealth Transfers: Analysis With Forms (WG&L), section 11.02. "*Transfers of Encumbered Property*."
- Cantrell, "*Gain is Realized at Death*," Trusts and Estates (February 2010)
- Blattmachr, Gans & Jacobson, "*Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*," Journal of Taxation (September 2002).

<u>Basis Adjustments for Taxable Gifts</u>**.** Although taxable gifts will be rare in this new environment, there is a tax basis impact from such gifts. IRC section 1015(d)(6) provides as follows: *"In the case of any gift made after December 31, 1976, the increase in basis provided by this subsection with respect to any gift for the gift tax paid under chapter 12 shall be an amount (not in excess of the amount of tax so paid) which bears the same ratio to the amount of tax so paid as (i)* ***<u>the net appreciation</u>*** *in value of the gift, bears to (ii)* ***<u>the amount of the gift</u>****. Net appreciation… in value of any gift is the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift."* (emphasis added)

At least two issues should be noted in dealing with 1015(d)(6). First, only the gift tax on the net <u>appreciation</u> in gain is taken into account. Second, the Code would appear to differ from the regulations on what is "*the amount of the gift*." Treasury Regulation section 1.1015-5(c)(2) reads as follows: *"In general, for purposes of section*

1015(d)(6)(A)(ii), the amount of the gift is determined in conformance with the provisions of paragraph(b) of this section. Thus, the amount of the gift is the amount included with respect to the gift in determining (for purposes of section 2503(a)) the total amount of gifts made during the calendar year (or calendar quarter in the case of a gift made on or before December 31, 1981), <u>reduced by the amount of any annual exclusion allowable with respect to the gift</u> under section 2503(b) …" (emphasis added)

Although there is no similar language in IRC section 1015(d)(6), the above regulation reduces the "*amount of the gift*" by any applicable annual exclusions.

Bottom line: when gift tax will be due, consider using annual exclusions to both reduce the taxable gift and provide a greater basis adjustment for the donees.

> ***Planning Example***: Assume in 2014 that a married client who has previously used all of her gift exemption transfers an asset worth $1.0 million (with a basis of $300,000) to 15 heirs. Gift splitting is elected for the gift, with the result that $420,000 (i.e., $14,000 times 15 heirs times two for gift splitting) of the gift are excluded as annual exclusion gifts. The gift tax is $232,000 (i.e., $580,000 times 40%). What is the basis addition pursuant to IRC section 1015(d)(6)?
>
> If the annual exclusions are not treated as a part of the "*amount of the gift*," the addition to basis is $162,400 (i.e., $232,000 times the sum of appreciation of $700,000 divided by the $1.0 million gift).
>
> But if we follow the regulations, the "*amount of the gift*" is reduced by $420,000 and the addition to basis in increased to $232,000 (i.e., $232,000 times the sum of the appreciation of $700,000 divided by the revised amount of the gift of $580,000, but with the basis adjustment not being in excess of the gift tax paid).

<u>Sale to a Related Party</u>. Code section 267(a) denies a recognized loss on sales to a related party. However, section 267(d) provides that if *"...the taxpayer sells or otherwise disposes of such property (or of other property the basis of which in his hands is determined directly or indirectly by reference to such property) at a gain, then such gain shall be recognized only to the extent that it exceeds so much of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer*."

<u>Installment Sales to Family Members</u>. So how do lifetime sales impact basis planning? The general rule is that deferred payment sales defer the taxation to the seller while the buyer normally obtains a basis in the property equal to the sale price of the property.

But as with many Code provision, there are exceptions, including:

- Pursuant to section 453(i) any sale which generates "recapture income" results in that income being recognized in the year of the sale. Code section 453(i)(2) defines recapture income as "*with respect to any installment sale, the aggregate amount which would be treated as ordinary income under section 1245 or 1250 (or so much of section 751 as relates to section 1245 or 1250) for the taxable year of the* *disposition if all payments to be received were received in the taxable year of disposition*."

- Pursuant to Code section 453(g) installment sale treatment is not permitted for the sale of a "depreciable property" to a "related party," unless it can be shown that "*to the satisfaction of the Secretary that the disposition did not have as one of its principal purposes the avoidance of Federal income tax.*"
- Pursuant to section 453(e) if a permitted sale to a "related party" is made on the installment sale basis and the buyer then disposes of (not necessarily sells) the property within two years of the original sale, the seller must recognize the gain on the sale in the year of the original sale. Section 453(e)(6)(C) provides that the death of the seller or buyer within the two year period eliminates the taxation on later dispositions.

The disposition of an installment sale at the time of death does not generally cause recognition of the unrealized gain in the installment note. Pursuant to Code section 691(c), the unreported gain is income in respect of a decedent. There is no step-up in basis for the installment sale note. Any remaining unreported gain is recognized as the installment payments are made. However, Code section 691(a)(5) provides that if the installment sale note is transferred to the obligor, the unreported gain in the note is immediately subject to taxation.

Unknown Gift Bases. In many cases, the donee has received no information from the donor on the basis of a gifted asset. Normally, the taxpayer bears the burden of proving any positions taken on a tax return. However, section 1015(a) provides as follows: *"If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary as of the date or approximate date at which, according to the best information that the Secretary is able to obtain, such property was acquired by such donor or last preceding owner*." (emphasis added). In Caldwell & Co. v. CIR**,** the Sixth Circuit Court of Appeals ruled that if neither the donee nor the IRS could make a basis determination, then neither gain nor less was recognized upon the sale of the gifted asset.

THE BASIS RULES FOR TESTAMENTARY TRANSFERS

General Rule. IRC section 1014(a) reads as follows: *"Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be (1) the fair market value of the property at the date of the decedent's death..."*

IRC section 1014(b) defines what property is deemed acquired from a decedent. It partially reads as follows: *"... the following property shall be considered to have been acquired from or to have passed from the decedent:*
(1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;
(2) 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 revoke the trust;
(3) In the case of decedents dying after December 31, 1951, 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;
(4) Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will..."

Unlike gifts, the basis of bequeathed assets governed by section 1014(a) is always the fair market value, even if that value is less than the decedent's tax basis before death (i.e., a "step-down" in basis). Effectively, unrealized gains and losses on assets in the decedent's gross estate are wiped out by death.

Exceptions and Nuances. To the extent assets are includible in a taxable estate, the assets generally obtain a basis equal to their fair market value determined at the date of death. There are a number of exceptions, including:

- *Income in Respect of Decedent*. Property which constitutes income in respect of a decedent ("IRD") does not change its tax basis. See Code sections 1014(c) and 691.
- *Partnerships and LLCs*. The tax bases of "hot assets" held in a partnership or an LLC taxed as a partnership are not changed by death of a partner. See Code section 751(a).
- *S corporation IRD*. Code section 1367(b)(4) reads as follows: *"(A) In general. If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item. (B) Adjustments to basis. The basis determined under section 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the decedent."*
- *Employer Stock*. According to the IRS, "net unrealized appreciation" ("NUA") in employer stock that was distributed from a qualified retirement plan before the death

of the participant does not obtain a basis step-up. See Revenue Ruling 75-125 and the discussion of NUA in the next article.

- *Alternative Valuation.* Code section 1014(a)(2) provides that if the estate elects an alternative valuation pursuant to Code section 2032, then the value at the earlier of the date of distribution from the estate or the six month alternative valuation date is the applicable asset's tax basis. Revenue Ruling 62-223 provides that the tax basis is reduced by any applicable depreciation taken from the date of death.
- *Special Use Valuation*. Code section 1014(a)(3) provides that if the estate elects special use valuation pursuant to Code section 2032A, then the special use value is the applicable asset's tax basis. Code Section 1016(c)(1) provides that if a recapture tax is imposed pursuant to section 2032A(c)(1), then the basis of the asset is adjusted.
- *Conservation Easements.* Code section 1014(a)(4) provides that to the extent of the qualified conservation easement election made pursuant to section 2031(c), the tax basis is the decedent's basis in the asset.
- *Jointly Owned Assets*. Jointly held assets have their own basis peculiarities. See the discussion in a later article in this series.
- *Gifted Appreciated Property*. Code section 1014(e) provides that if appreciated property is gifted to the decedent within one year of the decedent's death and the asset is acquired by the donor as a result of the donee's death, then the step-up in basis may not be permitted. See the article "*Understanding Section 1014(e)*" that is a part of this series of articles.
- *Disc Stock.* Pursuant to 1014(d), the basis of a decedent's interest in DISC stock is adjusted for unrealized dividends in the DISC.

Planning Opportunity. The post-2012 increase in income tax rates, especially on fiduciary taxable income, can significantly increase the income taxes imposed on IRD assets. Advisors should determine if a client’s estate is expected to have IRD and examine ways to reduce its impact. For example:

- Making lifetime charitable gifts of the IRD assets to reduce the decedent's income taxes.
- Because of the potentially high tax rate on income accumulated in an estate or trust:
  - Determining if it is advisable to distribute IRD assets to heirs after death to use the heirs' lower marginal income tax brackets, recognizing that such distributions may not be the best choice for immature beneficiaries.
  - Accelerating income into the client's lifetime taxable income to take advantage of the client's lower marginal income tax rates (e.g., doing a ROTH conversion before death).

***Research Source*:** Yuhas & Radom, "*Income in Respect of a Decedent: The Tables have Turned*," Estate Planning Journal, March 2013.

<u>Uniform Basis</u>. Treasury Regulation section 1.1014-4(a)(1) provides a description of the concept of uniform basis by stating as follows: *"The basis of property acquired from a decedent, as determined under section 1014(a), is uniform in the hands of every person having possession or enjoyment of the property at any time under the will or other*

instrument or under the laws of descent and distribution. The principle of uniform basis means that the basis of the property .... will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust. .....The sale, exchange, or other disposition by a life tenant or remainderman of his interest in property will, for purposes of this section, have no effect upon the uniform basis of the property in the hands of those who acquired it from the decedent. Thus, gain or loss on sale of trust assets by the trustee will be determined without regard to the prior sale of any interest in the property. Moreover, any adjustment for depreciation shall be made to the uniform basis of the property without regard to such prior sale, exchange, or other disposition."

<u>Determining Fair Market Value</u>. Treasury Regulation section 1.1014-3(a) provides as follows: *"For purposes of this section..., the value of property as of the date of the decedent's death <u>as appraised for the purpose of the Federal estate tax</u> or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018..., the value of the property <u>appraised as of the date of the decedent's death for the purpose of State inheritance</u> or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable*." (emphasis added)

But in Revenue Ruling 54-97, 1954-1 CB 113**,** the IRS provided**:** *"For the purpose of determining the basis ... of property transmitted at death (for determining gain or loss on the sale thereof or the deduction for depreciation), the value of the property as determined for the purpose of the Federal estate tax shall be deemed to be its fair market value at the time of acquisition. Except where the taxpayer is estopped by his previous actions or statements, <u>such value is not conclusive but is a presumptive value</u> which may be rebutted by clear and convincing evidence.*" (emphasis added)

In TAM 199933001, the IRS concluded: *"The Taxpayer is not estopped from claiming a basis in the stock different from the fair market value of the stock used on the decedent's estate tax return. Thus, under Revenue Ruling 54-97... the taxpayer may rebut the presumptive value of the stock by clear and convincing evidence."* In this ruling, the heirs wanted a higher basis for inherited stock than was reported on the estate tax return.

Even where elections (e.g., special use valuation for farmland) are made on a state inheritance tax return that reduced the value of real property for state tax purposes, the property's full fair market value could be used for purposes of determining its federal income tax basis. See PLR 8721056.

> ***Planning Opportunity:*** Particularly with non-taxable estates, heirs (who are not involved in the value decision making) and their advisors should closely review the appraisals of non-readily marketable assets and determine if they believe the values are understated. If the values appear low, the clients should consider promptly obtaining new appraisals of the property. Waiting until either a later sale or an audit may diminish the taxpayer's chance of sustaining the higher basis.

LINGERING TAX BASIS RULES

Basis planning is one of the few areas in which repealed Code provisions and IRS rulings can continue to linger long after the law has changed. This can complicate the calculation of a taxpayer's tax basis and offer planning opportunities in the right fact pattern. Here are a few of the lingering provisions that can impact the calculation of an asset's tax basis. There are many more.

- Gifts in Trust. Code section 1015(c) provides as follows: *"If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition."* There are probably not many of these trusts in existence.

- Carter's Carryover Basis. In 1976, Congress enacted Code section 1023 which eliminated the fair market value basis at a taxpayer's death and replaced it with a carryover basis. The new rules were put on hold in 1978 and then repealed in 1980. However, repealed Code section 1023 may still determine the basis of the assets if the basis ultimately comes from a decedent who died from January 1, 1977 to November 7, 1978.

- Annuities. Revenue Ruling 70-143 provided that: *"Since the annuitant, in the instant case, died prior to the starting date of the annuity and the value of the annuitant's right to the accumulated value under the annuity contract is includible in determining the value of the decedent's gross estate, ... It is further held that the basis of the right is its fair market value at the date of the decedent's death, ..."* (emphasis added) Revenue Ruling 79-335 revoked this beneficial step-up, effective for deferred annuity contracts purchased after October 20, 1979. See PLR 200439016 and Revenue Ruling 2005-30.

- Basis and Gift Taxes. The Technical Amendments Act of 1958 added Code section 1015(d) to the Code, permitting an increase in basis for the gift taxes paid on a gift, as long as the adjusted basis did not exceed the fair market value of the asset.

  For gifts made after December 31, 1976, a new limit on the basis adjustment was added: *"...the increase in basis provided by this subsection with respect to any gift for the gift tax paid under chapter 12 shall be an amount (not in excess of the amount of tax so paid) which bears the same ratio to the amount of tax so paid as the net appreciation in value of the gift, bears to the amount of the gift."*

- Residential Rollovers. The Taxpayer Relief Act of 1997 (effective August 5, 1997) replaced Code section 1034 (i.e., rollover of gain on personal residences), with Code section 121, (i.e., providing for a gain exclusion of up to $250,000 for a single taxpayer and $500,000 for a married couple). However, Code section 1016(a)(7) requires that any pre-August 5, 1997 rollover of residential gain under section 1034 must still be reflected in the basis of the residence.

- 2010 Carryover Basis. The estates of decedents dying in 2010 could elect to either eliminate their estate tax and receive an adjusted carryover basis on the decedent's assets, or be subject to a potential estate tax liability (with a $5.0 million estate exemption) and obtain a fair market value basis for assets in the gross estate. With a $5.0 million estate tax exemption, most estates took the second option. However, it has been estimated that in 2010 3,000-5,000 estates exceeded the $5.0 million exemption and many may have elected to obtain a adjusted carryover basis to eliminate the 35% estate tax that was due 9 months after the decedent's passing.

Tax Trap: The Code, IRS rulings and the Treasury Regulations are cluttered with effective dates for basis determinations. In computing the basis for a client it is vital that advisors obtain detailed facts, supporting material and determine relevant transaction dates to properly document the tax basis.

STATE BASIS ISSUES

State Estate and Gift Taxes. As of January 1, 2014, nineteen states and the District of Columbia impose a state estate and/or inheritance tax, with the Tennessee tax being eliminated in 2016. The estate tax exemptions vary widely from state to state and many are substantially lower than the federal estate tax exemption. Connecticut and Minnesota are the only states that impose a state gift tax.

There have been a number of recent changes in relevant state tax laws, including:

- Death taxes in Indiana (inheritance tax), Ohio (estate tax), and North Carolina (estate tax) were repealed for deaths occurring after December 31, 2012.
- Effective June 30, 2013, Minnesota enacted a 10% gift tax, with a lifetime exemption of $1.0 million.
- The Tennessee legislature eliminated the Tennessee gift tax effective January 1, 2012. Louisiana effective July 1, 2008 and North Carolina effective January 1, 2009 eliminated their gift taxes.
- Tennessee repealed its inheritance tax in 2011, effective for deaths after December 31, 2015.

Research Sources:

- "*Survey of State Estate, Inheritance, and Gift Taxes*," Research Department Minnesota House of Representatives (updated December 2013, available at *http://www.house.leg.state.mn.us/hrd/pubs/estatesurv.pdf*.
- "*2014 McGuire Woods LLP State Death Tax Chart*," available at ***http://www.mcguirewoods.com/news- resources/publications/taxation/state_death_tax_chart.pdf***

Tax Trap: Thirty-one states do not impose a death tax. However, residents of those states may own assets in states which impose a state death tax on localized assets. As a part of the tax basis analysis, advisors should determine whether there are assets that may incur state death taxes in non-domiciled states and then analyze ways to reduce that tax cost at the client's death.

Planning Opportunity: There are a number ways to reduce the cost of state death taxes, including:

- Moving the client's residency to a state without a death tax.
- Moving the assets into a structure or state where they are no longer subject to a state death tax.
- Using life insurance to cover the anticipated cost of the state death tax.
- Clients should consider gifting assets before death to wipe out any state death tax. Inform the client of the relative tax costs of the basis step-up versus the state death tax and let the client decide which they are willing to incur. This approach needs to be evaluated against at least five concerns:
  - The loss of a step-up in basis that may occur at the death of the donor.
  - The financial needs of the client before they pass.
  - The liquidity of the estate. For example, if the estate lacks sufficient funds to pay the looming state death taxes, making the gift, even at the cost of a lower

basis, may make sense.
- The estimated tax cost of any state death taxes.
- The gift tax cost in Connecticut and Minnesota.

Research Source: Stetter, "*Deathbed Gifts: A Savings Opportunity for Residents of Decoupled States*," Estate Planning, June 2004.

Even where elections (e.g., special use valuation for farmland) are made on a state inheritance tax return that reduced the value of real property for state tax purposes, the property's full fair market value could be used for purposes of computing its federal income tax basis. See PLR 8721056.

Massachusetts and Decedents Dying in 2010. Estates of decedents who died in 2010 were allowed for federal tax purposes to elect to either eliminate their federal estate tax or provide for an adjusted carryover basis for all estate assets. However, the State of Massachusetts issued Directive 11-7 that required, for Massachusetts tax purposes, the use of an adjusted carryover basis calculated in accordance with Code section 1022. Code section 1022 permits a basis step-up of up to $1.3 million applicable to any estate and an additional basis adjustment of up to $3.0 million for qualified spousal transfers.

Research Sources:
- Massachusetts Department of Revenue Directive 11-7, found at http://www.mass.gov/dor/businesses/help-and-resources/legal-library/directives/directives-by-decade/2011-directives/dd-11-7.html
- Boyd, "*Proposed Massachusetts Carryover Basis Provision*," LISI Estate Planning Newsletter #1899 (December 2, 2011).

Differing Tax Bases. During the recent recession, Congress temporarily modified the federal tax code to create incentives for businesses to purchase and quickly write-off the cost of new equipment. Because of the adverse impact on their revenues, a number of states did not adopt all of the recent federal changes, resulting in one tax basis for federal tax purposes and a different tax basis for state tax purposes.

Research Source: Borieux, "*State Conformity with Federal Bonus Depreciation Rules.*" Bloomberg BNA Software, found at:
http://bnasoftware.com/Software_Resource_Center/Tax_Legislation_Updates/State_Conformity_with_Federal_Bonus_Depreciation_Rules.asp

Differences have long existed between the state and federal rules governing depreciation. Such differences create differing tax bases for state and federal purposes. As a result many states that use a federal tax return as the base for preparation of state tax returns provide for adjustments of state taxable income to reflect depreciation differences. For example, see Oregon statute 316.716.

State differences can occur in other areas. For example, a number of states provide for differing rules on the calculation, use and carry-forward of net operating losses, which can impact basis calculations.

> ***Research Source***: Nakamura, Thompson, & Ferris, "*Beware of State-Federal NOL Differences,*" Journal of Accountancy, August 2010.

Tax Trap: When dealing with any planning for a business or investment asset, always consult with the tax preparer and obtain both state and federal tax basis and depreciation information early in the planning process.

SOME INTERESTING BASIS RULES

Automobiles and Basis. Revenue Procedure 2010-51 provides in section 4.04 as follows: *"Under § 1016, a taxpayer must reduce the basis of an automobile used in business by the amount of depreciation the taxpayer claims for the automobile. If a taxpayer uses the business standard mileage rate to compute the expense of operating an automobile for any year, a per-mile amount (published in an annual notice) is treated as depreciation for those years in which the taxpayer used the business standard mileage rate."* IRS Notice 2013-80 provides these standard deduction numbers for 2014 and states that the basis reduction for 2014 for use of the business standard mileage is 22 cents per mile.

Moreover, Code section 1016(d) provides that if a "gas guzzler tax" was imposed on an automobile pursuant to Code section 4064, the basis in the vehicle may be reduced by the amount of the section 4064 tax that was imposed.

Gifts to Political Organizations. Code section 84 provides that if appreciated property is gifted to a "political organization" defined in Code section 527(e)(1), then the appreciation in the donated asset is taxable to the donor and the political organization takes the donor's basis increased by the gain taxable to the donor.

Discharge of Indebtedness. In certain circumstances, Code section 108 will permit debtors who would otherwise have discharge of indebtedness income to reduce the basis in assets related to the discharge. See Code section 1017 on how the basis adjustments are computed.

Basis and Distributions from Corporations. The General Utilities Doctrine has been removed from the Tax Code since 1986. Code section 301(c)(3)(A) provides as follows: "*that portion of [a corporate] distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property*." See also Code section 311(b) and 361(c)(2).

Annuity Contracts. Code section 1021 provides as follows: *"In case of the sale of an annuity contract, the adjusted basis shall in no case be less than zero."*

Taxidermy Contributions. Code section 170(e)(1)(B)(iv) limits the charitable deduction for certain contributions of taxidermy property to the lesser of the donor's basis or the property's fair market value. This assumes there are qualified appraisers who can determine the fair market value of taxidermy property.

PLANNING DOCUMENTS, ADVICE AND FLEXIBILITY

In this new environment of values and basis which can be constantly changing, flexibility in a client's planning documents has become paramount. For example:

Powers of Attorney. Virtually every client should have a well crafted and flexible general power of attorney which will allow broad and flexible decision making to the power holder, including, but certainly not limited to:

- Allowing for gift advancements of bequests to individuals and charities that are provided for in the client's disposition documents. For example:
  - Gifting an asset with an unrealized loss before the donor's death.
  - Gifting a potential IRD asset to charity before death
- Allowing the power holder to change the client's domicile state for tax purposes.
- Allowing for changes in beneficiary designations of life insurance, retirement plans and IRAs (e.g., naming a donor advised fun to receive a large IRA).
- Permitting conversions of IRAs to ROTH IRAs during the client's life.

Disposition Documents. Attorneys who draft estate planning documents will increasingly shift the focus of their drafting to providing greater flexibility for income tax planning, especially basis planning. For example, standard form Wills and Revocable Living Trusts should be drafted to include one or more of the following provisions that deal with basis issues:

- Contemplating the possible application of Code section 1014(e) to bequests by limiting the power or benefits of the original donor in appreciated property that was gifted to the decedent within a year of death. Review the drafting recommendations in the article "*Understanding Section 1014(e)*" that is a part of this series of articles.
- Providing that the fiduciary has a legal obligation to appraise non-readily marketable assets that are gifted or bequeathed. The obligation should probably include (for all gifted or bequeathed assets, whether readily marketable or not) providing each beneficiary with a statement of the tax basis and supporting detail, sufficient to withstand an IRS audit. The cost of such work may be specially allocated to the beneficiaries benefitting from the reporting.
- Specifically recognizing any advancement of bequests which were made during the life of the decedent.
- Permitting the fiduciary to create sub-trusts designed to segregate assets which have unique basis issues, such as appreciated property potentially subject to section 1014(e).
- Consider providing indemnities and releases of fiduciaries on decisions which impact the tax basis of assets which pass through their hands and decisions they make that impact the tax basis.
- Excluding fiduciaries from decisions on basis issues that directly benefit the fiduciary or immediate family members.

Client & Advisor Actions. Clients should be encouraged to deal with basis issues in their planning, including:

- Clients with multiple residences need to declare the state that is their domicile state.

Domicile issues are generally fact specific and change over time (e.g., the decedent was in a nursing home in New Jersey for the last two years of his life). Properly documenting and periodically re-declaring residency can be an important part of tax planning.
- Clients should be encouraged to obtain detailed documentation of the basis of assets, store it in a safe place and provide the details and documents to their heirs and advisors.
- Advisors should consider drafting "CYA" letters outlining the facts they relied on in determining the basis of any asset. Consider having the donee/heirs confirm the facts by signing the letter, particularly when the facts are questionable.

Fiduciary Discussions. What issues should practitioners discuss with fiduciaries?
- With so few estates being subject to a federal estate tax, do fiduciaries have a fiduciary responsibility to appraise non-readily marketable property when there is clearly no state or federal estate tax due by the estate or concerns about a portable exemption? Can the fiduciary charge the cost of the appraisal to the donor's beneficial interest in the trust?
- Does the fiduciary have a fiduciary responsibility to independently appraise non-readily marketable property that a donee passes back directly or indirectly to the donor within one year of the gift? Interestingly, two appraisals may be necessary for non-readily marketable property that may be subject to section 1014(e). One appraisal will determine the fair market value at the time of the gift to determine if the asset is "*appreciated property*." A second appraisal would determine the date of death value. See the article "*Understanding Section 1014(e)*" that is a part of this series of articles.
- Despite the fact that the Congressional Research Service has estimated that 99.8% of all decedent estates will not have an estate tax liability or a requirement to file an estate tax return (except to assure portability of a deceased spouse's transfer tax exemption), fiduciaries may have a fiduciary responsibility to provide beneficiaries with proper basis information on the assets they are inheriting.
- If the fiduciary or their advisors make an error in the basis calculation, could the fiduciary be subject to claims by heirs who miscalculated their own taxes as a result of the fiduciary's mistakes?
- Advisors should encourage fiduciaries for trusts and estates with section 1014(e) appreciated property to consider placing the property and any sales proceeds into sub-trusts in order to segregate the property and provide a better audit trail. See the article "*Understanding Section 1014(e)*" that is a part of this series of articles.

COMPLIANCE, RECORD KEEPING AND AUDITS

There are a number of basis-related reporting and compliance requirements, including:

Keeping Basis Records. When should you destroy records dealing with the basis of assets, including related appraisals, tax returns (e.g., a parent's estate tax return), etc? Remember that the burden of proving basis facts rests on the taxpayer, not the IRS. My personal recommendation is to **never destroy basis records**! What happens when you gift an asset to your children and they come back 20 years later asking for basis information because they were audited on the sale of the gifted asset?

Gift Tax Basis Reporting. How do donees determine the tax basis of the gift made to them? There is no Internal Revenue Code requirement that donors provide donees with any tax basis information on the gift. However, a fiduciary duty may exist.

Effective for gifts in 2010, IRC section 6019(b) was to have provided that within thirty days of the filing of a gift tax return, each recipient of a gift must receive a copy of certain information included on the gift tax return. However, 6019(b) was retroactively repealed as a part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, adopted on December 17, 2010.

Code section 6034A imposes a requirement that a recipient of distributions from a trust or estate must report on the recipient’s income tax return the exact information contained on the trust or estate's schedule K-1. However, this provision applies only for income tax purposes and the schedule K-1 does not include direct tax basis information.

Treasury Regulation section 1.1015-1(g) provides as follows: *"To insure a fair and adequate determination of the proper basis under section 1015, persons making or receiving gifts of property should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value as of March 1, 1913, or its fair market value as of the date of the gift."* (emphasis added)

Transfers to Spouses or Ex-Spouses. Treasury Regulation §1.1041-1T, A-14 provides as follows: "*A transferor of property under section 1041 must, at the time of the transfer, supply the transferee with records sufficient to determine the adjusted basis and holding period of the property as of the date of the transfer...... Such records must be preserved and kept accessible by the transferee."* There is no similar Code requirement in Code section 1014 or 1015. There is also no penalty for non-compliance with the regulation.

Estate Tax Basis Reporting. There is no Internal Revenue Code requirement that fiduciaries provide heirs with any tax basis information on an inheritance. However, a fiduciary duty may exist.

Treasury Regulation section 1.1014-4(c) provides as follows: *"The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this section is applicable, shall* *maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by sections 1016 and 1017, and shall furnish* <u>*to the district director*</u> *such information with respect to those adjustments as he may require."* (emphasis added)

<u>Brokerage Statements</u>. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) added Code section 6045(g) which requires that the basis of "covered securities" be reported by brokers to their customers and the IRS. The requirements were phased in from 2011 to 2013. Failure to comply with the reporting responsibilities can result in significant penalties being incurred.

Research Sources:

- Soled, Goodman and Pochesci, "*Penalty Exposure for Incorrect Tax Basis Reporting on Information Returns*," Journal of Taxation, August 2013.
- Internal Revenue Bulletin 2010-47 (TD 9504, issued November 22, 2010), "*Basis Reporting by Securities Brokers and Basis Determination for Stock."*

<u>Statue of Limitations</u>. IRS section 6501 provides that if there is adequate disclosure of a gift, then a three year statute of limitations from the date of gift tax filing. Advisors should thoroughly review the disclosure requirements contained in Treasury Regulation section 301.6501-1(c) before filing a gift tax return. While IRS form 709 (in Page 2, Schedule A, Column D) requires a disclosure of the donor's adjusted basis, it should be noted that there is no reference in the Code or Regulations to a closure of the statute of limitation for the basis in the gifted asset. It would appear that the IRS could challenge the basis of a gifted asset until the statute of limitations closes for the income tax return that reflected a sale of the gifted asset - an event that could be decades after the original gift. As a consequence, maintaining basis information is critical.

<u>Taxpayer Penalties</u>. The failure to properly handle basis issues can result in the imposition of a number of potential penalties. For example, Code section 6662 provides for a 20% penalty for a "*substantial valuation misstatement*," with the penalty increasing to 40% if there is a "*gross valuation misstatement*." Code section 6662(e) provides in part as follows: "*there is a substantial valuation misstatement ... if the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter l is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)*." Code section 6662(h)(2)(A)(i) increases the 150% to 200% to determine if a gross valuation misstatement occurred. In abusive cases, the IRS could apply Code section 6663 to impose a fraud penalty.

<u>Appraisals</u>. Practitioners should strongly encourage clients to obtain appraisals of gifted or bequeathed assets that are not readily marketable even when a transfer tax return is not due. How do you establish what the fair market value was of an asset that was gifted or bequeathed 20 years ago?

Treasury Regulation section 301.6501(c)-1(f)(3) provides information on what should be contained in a gift appraisal. It is also smart to review the appraisal requirements for charitable appraisals contained in Treasury Regulation 1.170A-13(c)(3) and the definitions of qualified appraisals and qualified appraisers contained in Proposed Treasury Regulation 1.170A-17.

It is important that the appraiser be seen as both independent and qualified. For example, see the definition of a "qualified appraiser" in Code section 170(f)(11)(E)(ii) and Treasury Regulation 1.170A-13(c)(5) and in Proposed Treasury Regulation 1.170A-17.

Appraisals which merely state an opinion of value without stating how the opinion was reached are substantially worthless.

Although it can be expensive, clients should be encouraged to obtain appraisals for income tax basis purposes, even when there is no state or federal estate or inheritance tax exposure.

POLICY AND LEGISLATIVE ISSUES

In 2012, Congress raised concerns that the combination of increased transfer tax exemptions and the fair market value step-up in basis would erode income taxes. See the Joint Committee on Taxation, "*Modeling The Federal Revenue Effects Of Changes In Estate And Gift Taxation,*" issued November 9, 2012. With basis planning providing new tax saving opportunities, it should be expected that Congress and the IRS will respond with new legislation and policy initiatives designed to blunt the income tax planning opportunities in this new environment.

If the large transfer tax exemptions hold over the next few years, practitioners should expect that Congress and the IRS will discuss reducing or eliminating the fair market value step-up that occurs at death. For those of us who have practiced long enough, remember the valuation mess of trying to determine the carryover basis of inherited assets under Code section 1023 (effective from January 1, 1977 to November 7, 1978).

Interestingly, the IRS and the Obama administration have dropped their discussions about scaling back techniques designed to discount the value of assets. In this new tax environment, they probably prefer that valuation discounts be applied. The Obama administration's prior proposal to require a minimum ten year life for GRATs will probably also disappear.

The Obama administration's 2013 and 2014 budgets made a number of proposals that are relevant to tax basis planning, including:

- The estate and GST tax exemption would be limited to $3.5 million and the gift exemption would be dropped to $1.0 million. The tax rate would increase to 45%. In the current legislative environment, it is unlikely that this proposal will pass.
- Under current law, a taxpayer who sells a part of his or her stock in an investment can choose the stock with the highest basis to reduce the recognized gain. The administration is proposing that investors be required to use an average cost basis in computing the recognized gain.
- Changes would require a consistency of basis calculations for transfer tax purposes and income tax purposes.
- A reporting requirement would be imposed on the executor of a decedent's estate and on the donor of a lifetime gift to provide required valuation and basis information to both the asset recipient and the Internal Revenue Service.
- The proposals would repeal of the Last-In-First-Out (LIFO) method of computing inventories.
- The proposals would amend section 704(d) to provide that a partner's distributive share of non-deductible expenditures may only be used by the partner to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership year in which such expenditure occurred.

Research Sources:

- "*General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals*," found at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf
- "*General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*," found at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf
- Joint Committee on Taxation, "*Modeling The Federal Revenue Effects Of Changes In Estate And Gift Taxation*," November 9, 2012.
- Steiner, "*A First Look at the Administration's Revenue Proposals for Fiscal Year 2014*," LISI Income Tax Planning Newsletter #43 (April 19, 2013).

CONCLUSIONS:

For roughly 99.8% of US residents, income tax planning will trump federal estate tax avoidance.

The income tax has replaced the estate tax as the confiscation tax that clients and their heirs need to be most concerned about. As a result, tax basis planning is becoming a critical part of estate and income tax planning.

The changes in the American Taxpayer Relief Act of 2012 have not simplified estate planning. ATRA made estate planning significantly more complex and increased the potential malpractice exposure of advisors and fiduciaries who do not pay sufficient attention to income tax and tax basis issues in their decisions, planning and advice.

The next articles in this series will discuss tax basis planning opportunities and traps.

Global Research Sources:

- Maule, 560-T.M., *Income Tax Basis: Overview and Conceptual Aspects*
- Zaritsky, Tax Planning for Family Wealth Transfers: Analysis With Forms (WG&L), Section 1.03 "Tax Considerations in Intrafamily Gifts."
- Scroggin, "*The Brave New World of Basis Planning*," Trusts and Estates, April 2005.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jeff Scroggin