Proskauer

Wealth Management Update

August 2011

Electing Out Of the Application of the Estate Tax and Allocating Basis Step-Up for 2010 Decedents

I. Election Out Of the Application of the Estate Tax For 2010

The legislation enacted in December 2010 retroactively reinstated the federal Estate tax for 2010 decedents but allows an applicable Executor to "opt out" of the Estate tax regime by making a "Section 1022 Election". If this Section 1022 Election is made then (a) the decedent's assets are not subject to estate tax, but (b) basis step-up for income tax purposes on assets acquired from and owned by the decedent is limited. IRS Form 8939 is to be used both for electing out of the application of the estate tax and to allocate the available basis step up among the decedent's eligible assets.

IRS Notice 2011-66 (August 5, 2011) and Revenue Procedure 2011-41 provide (finally) much of the information needed for executors to determine whether, and how, to make the Section 1022 Election. The main requirements are summarized below:

What Form should be used to make the Section 1022 Election?

Form 8939 should be used for this purpose. If a prior filing was made in an attempt to make the Election, that prior filing is ignored and a Form 8939 must now be filed. Once made the Election is irrevocable.

When must the Form 8939 be filed?

The Form 8939 is due on or before November 15, 2011. Forms filed earlier may be amended or revoked by a subsequent Form 8939 filed on or before November 15, 2011. If multiple forms are filed then in general the latest timely filing (up to the due date) will control. The Revenue Procedure provides rules for instances where multiple representatives purport to file inconsistent Forms 8939 or both a Form 8939 and a Form 706 for the same estate (see below).

Except for limited exceptions (discussed below), no extensions are allowed. Importantly, if a Form 706 is filed along with a "conditional Form 8939" (to take effect only if the value of the decedent's estate is determined to exceed his/her unified credit), the Form 8939 will not be deemed timely filed.

Who must file the Form 8939?

Generally applicable rules under Internal Revenue Code Section 2203 govern. Accordingly, the person appointed and acting as personal representative of the decedent's estate by a court with jurisdiction is the "executor" required to file. If there is no court supervised administration of the decedent's assets (i.e., if there is no probate), the "executor" for this purpose is anyone in possession of the decedent's property.

What relief is allowed for amending or late filing of the Form 8939?

Form 8939 may be amended solely for purposes of allocating the "Spousal Property Basis Increase" ("SPBI") if: (a) the Form 8939 was timely filed except for the allocation of the full SPBI, and (b) the amendment is filed no later than 90 days after the property is distributed to the spouse.

In addition, if an executor timely files Form 8939, he/she may also amend it for any permissible purpose under the provisions of Treas. Regs. Section 301.9100-2 other than to make or revoke the Section 1022 Election. That amendment must include the following language on the top: "Filed Pursuant to Section 310.9100-2". Any such amendment must be filed on or before May 15, 2012.

In limited circumstances an executor may also apply for relief to supplement a Form 8939 under Treas. Regs. Section 301.9100-3. Relief – which would permit an extension of time to allocate "Basis Increase" that has not previously been validly allocated – will only be granted if: (a) the executor discovers additional property after the timely filing of the Form 8939, and/or (b) the fair market value of the property reported on the Form 8939 is adjusted by the IRS on audit.

Finally, an executor can apply under Treas. Regs. Section 301.9100-3 for permission to file a late Form 8939 (to make the Section 1022 Election and to allocate Basis Increase). The IRS, however, is unlikely to grant that relief if a significant amount of time has passed from the due date. This is especially true if the government's interests would be prejudiced if hindsight is used to achieve a better tax result.

What if multiple Forms 8939 are filed?

If more than one person files a Form 8939 for the same decedent, the IRS will contact all such filers and provide them 90 days to file one form that all sign. If such form is not filed, the IRS reserves the right (based on all facts and circumstances) to determine how to allocate basis among the decedent's assets. There is no indication whether such IRS allocation might be pro rata based on fair market value, pro rata based on the amount of unrecognized appreciation, or otherwise.

What if a Form 8939 and a Form 706 are filed for the same decedent?

If a Form 8939 and a Form 706 are filed for the same decedent, the IRS will contact all filers and provide them 90 days to file one form or the other which all must sign. If such form is not filed, the IRS will determine whether to treat the estate as if a Section 1022 Election has been made or whether the estate is subject to Estate tax instead.

Is the Form 8939 used to allocate generation-skipping tax exemption for decedents dying in 2010?

If the Section 1022 Election is made, the GST exemption of that 2010 decedent is allocated by attaching Schedule R of Form 8939 to the Form 8939 filed for that decedent. If the Form 8939 is timely filed, the allocation will be considered as made timely under Internal Revenue Code Section 2632.

Is the Form 8939 used to elect out of the automatic allocation of generation-skipping tax exemption for 2010 inter vivos transfers?

No. If a donor wants to elect out of the automatic allocation of GST exemption to inter vivos transfers made in 2010, he/she must do so on a timely filed Form 709 which identifies the transfer to which the automatic allocation is not to apply. However, because it is clear that a 2010 transfer to a skip person not in trust would never be a transfer to which the donor would want to allocate GST exemption, any such direct skip reported on a timely filed Form 709 will be treated as an election out of the automatic allocation of GST exemption to that direct skip.

There are circumstances where a donor might want GST exemption to be allocated to a direct skip to a trust made in 2010. In that circumstance, the donor will have to affirmatively elect out of the automatic allocation – rather than rely on the special rule described in the preceding paragraph.

Note: the time for filing the Form 709 to elect out of the automatic allocation of GST exemption to direct skips, taxable distributions or taxable terminations made after December 31, 2009 and before December 17, 2010 is extended to September 19, 2011 – except in the case of a Schedule R attached to a Form 8939 filed for a person who died in 2010 (which is due on or before November 15, 2011). If, however, the inter vivos transfer relates to an indirect skip or a direct skip made on or after December 17, 2010, the original due date (unless extended) to file the Form 709 to elect out of the automatic allocation of GST exemption was April 18, 2011, including extensions. Thus, if the donor extended the due date of his/her Form 709 to October 17, 2011, he/she may elect out of the automatic allocation of GST exemption on a timely filed Form 709. However, if the donor did not extend the due date of his/her return, then the time to elect out of the automatic allocation of GST exemption has already passed. If the donor filed a timely Form 709 for 2010 but failed to allocate GST exemption to a transfer for that year, relief may be available under Treas. Regs. Section 301.9100-2.

Where can I get a copy of the Form 8939?

The Form 8939 will be available, along with instructions, “early this Fall”! Previously the IRS indicated that the final Form would be available to taxpayers at least 90 days before the due date (which means that the Form should be available by August 15, 2011 if the due date is November 15, 2011), but that may no longer be the case if the Form is not available until “early this Fall”. For now, the information needed for the Form 8939 should be collected immediately, so that when the Form is finally issued taxpayers are in position to timely file no later than November 15, 2011.

II. Allocating Basis Step-Up on the Form 8939

What property must be reported on the Form 8939?

All property other than cash or items of IRD “acquired from the decedent” must be reported on the Form 8939. The executor must also report property that was required to be included on another donor’s Form 709 that was gifted to the decedent within 3 years of the decedent’s death (unless given to him by his spouse). The exception that allows gifts from the decedent’s spouse to be omitted from the Form 8939 does not apply if the donor spouse received that property from another within 3 years of the decedent’s death. The purpose is to prevent allocation of Basis Increase to property received by the decedent by gift just prior to his/her death.

Property “acquired from a decedent” includes bequests, devises and inheritances. It also includes property transferred by the decedent during life: (a) to his/her revocable trust, or (b) to any other trust with respect to which the decedent reserved the right to alter, amend, revoke or terminate the trust (for this purpose the decedent’s reserved power is deemed to include a retained reversionary interest in the trust on death and trust property subject to any retained power of appointment). Property in a trust created by someone other than decedent, and over which the decedent held a general power of appointment at death, is also deemed to be property “acquired from a decedent”, as is property held by the decedent and another as joint tenants with right of survivorship or as tenants by the entirety, and the surviving spouse’s one-half interest in community property. Note: a QTIP Trust established for the decedent by his/her predeceased spouse is not property “acquired from a decedent”. Accordingly, not all property properly includible in the decedent’s gross estate for federal Estate tax purposes (if the decedent had not filed the Form 8939 and elected out of the Estate tax) is deemed “acquired from a decedent” for these purposes.

If the decedent is a non-citizen and non-resident of the United States, the report need only include tangible personal property situated in the United States and any other property acquired from the decedent by a United States person (see Internal Revenue Code Section 6018 for more detail).

Besides reporting the above, the executor must include other information and supporting documentation required by the Form 8939 or in any future Internal Revenue Bulletin.

What notice about basis must the executor give the recipients of property from decedent?

Within 30 days after the timely filing of Form 8939, the executor must provide a statement to each recipient of property acquired from the decedent reported on the Form 8939. That statement must include the information required under Internal Revenue Code Section 6018(c) – whether or not Basis Increase is allocated to the property.

If an adjustment is made on audit to the basis of property reported on the Form 8939, a similar notice to the person who was distributed the property that sustained a basis adjustment must be mailed within 30 days of the adjustment.

What property qualifies for allocation of Basis Increase on the Form 8939?

Two requirements must be met for property to qualify for allocation of Basis Increase on Form 8939: (a) the property must be property "acquired from the decedent" (defined above), and (b) the property must be property "owned by the decedent".

Property "owned by the decedent" includes, but is not limited to: (a) property legally titled in the name of the decedent at death, (b) certain jointly owned property (e.g., tenants-in-common property, or property that passes by right of survivorship), (c) property transferred to the decedent's revocable trust during his or her lifetime, and (d) certain community property.

But not all property "acquired from a decedent", or includible in his/her gross estate for federal Estate tax purposes (if the Estate tax were to apply), is eligible. Examples of property that is not treated as "owned by the decedent" for these purposes include: (i) property over which the decedent holds any power of appointment created by another, (ii) property transferred to a trust where decedent retained a power to alter, amend, or terminate the trust, but did not retain a reversionary interest, (iii) property transferred to a trust by the decedent during life in which the decedent retained only an income interest, (iv) property transferred to a foreign grantor trust, and (v) property held in a QTIP Trust for the benefit of the decedent. If, however, any such property reverts to the decedent at death, then such property is treated as property "owned by the decedent". (For example, a QPRT that ends on death and reverts to the grantor's estate qualifies, but a QPRT that ends on death with property passing directly to remainder beneficiaries does not.)

What basis adjustments are available for allocation on the Form 8939?

There are two types of Basis Increase: the General Basis Increase ("GBI") and the SPBI.

GBI

The GBI is itself comprised of two components: the "Aggregate Basis Increase" ("ABI"), and the "Carryovers/Unrealized Losses Increase" ("CULI").

The ABI is $1,300,000. Note that for decedents who were non-citizen non-residents of the United States, the ABI is $60,000, and (because there is no CULI allowed to such taxpayers) the effect is to limit the GBI to $60,000 for an NRA.

The CULI is: (a) the amount of capital losses that would have carried over to years after the decedent's death (but for his/her death), plus (b) the amount of any net operating losses that would have carried over to years after the decedent's death (but for his/her death), plus (c) unrealized losses that would have been allowable to the decedent under Internal Revenue Code Sections 165(c)(1) and 165(c)(2) if the property acquired from the decedent had been sold for fair market value immediately before the decedent's death. Note, losses under Internal Revenue Code Section 165(c)(3) do not qualify.

SPBI

The SPBI is allocable to any property transferred outright to a surviving spouse or to a trust that would qualify as a QTIP Trust under Section 1022(c). Importantly, the QTIP election itself is not required – if a Section 1022 election is filed one would never make the QTIP election so that the assets in the QTIP trust would not be subject to estate tax on the surviving spouse's death.

The Revenue Procedure provides that the SPBI may be allocated to property that has already been distributed to the spouse before the Form 8939 is filed.

The SPBI may also be allocated to property sold before the filing of the Form 8939, but only if: (a) the executor certifies on the Form 8939 that the net proceeds of sale of the property will be distributed to or for the benefit of the spouse in qualifying fashion, and (b) the executor attaches to the Form 8939 each document providing a bequest or devise to or for the benefit of the surviving spouse.

Note that if sales proceeds are used for administrative expenses, then only the portion of the property sold representing the net proceeds actually passing to the spouse (and not used for administrative expenses) will qualify for the SPBI. Examples 4 and 5 in the Revenue Procedure illustrate this rule:

Assume decedent owned 20,000 shares of Corporation X stock at death and his executor makes the Section 1022 election. The stock has a basis of $600,000 ($30/share). Decedent's spouse is to receive one-half of his estate, outright. At death the stock is worth $2,000,000 ($100/share), and then it declines to $1,800,000 ($90/share) before the stock is sold. The net proceeds of sale (after commissions) are $1,770,000 ($88/share).

The executor uses $165,000 of the net proceeds to pay administration expenses. He then intends to distribute the $1,605,000 remaining to the decedent's surviving spouse as part of her one-half of his estate.

Since the spouse will only receive $1,605,000/$1,770,000 = 90.677966% of the proceeds, only 90.677966% of the 20,000 shares (18,135.6 shares) can receive an allocation of a basis step up of up to $70/share (the difference between the $100 value at date of death and the $30 basis at that time). In total, $1,269,450 of SPBI may be used. Of course, the certification and copy of dispositive instrument showing that the proceeds pass to the spouse must be attached to the Form 8939.

If a decedent leaves assets to a charitable remainder trust and the surviving spouse is the only non-charitable beneficiary (such that his/her interest would qualify for the marital deduction under Internal Revenue Code Section 2056(b)(8) if the Estate tax applied), property passing to that trust may also be allocated SPBI.

While the GBI is limited for a non-resident alien decedent's estate, the entire SPBI is available.

What special rules apply to community property?

The Section 1022 Election impacts both the decedent’s one-half interest in the community property, *and* his/her surviving spouse’s one-half interest in the community property. If the Election is made, Basis Increase may apply to both spouses' halves of the community property. In addition, if the Election is made, both shares of a property’s unrealized losses are available for the CULI basis step-up portion of the GBI. *The surviving spouse’s share of capital loss carryovers and NOLs, however, is not eligible to be included in the Basis Increase, but instead may be used on the surviving spouse's income tax returns*.

What happens to suspended passive losses if the Section 1022 Election is made?

Suspended passive losses are added to basis before the amount of additional basis step-up for unrealized losses is calculated. The effect is to preserve the suspended passive losses by allowing them to be added to basis first. If adding the suspended passive losses to basis causes basis to then exceed fair market value, the excess basis (which cannot be used because of the fair market value limitation) is added to the CULI part of the GBI calculation.

How does the Section 1022 election impact holding period?

The recipient’s holding period of property acquired from the decedent includes the period the decedent held the property, whether or not Basis Increase is allocated to the property.

How does the Section 1022 election impact the tax character of inherited property?

The character of the property is the same as it would have been in the hands of the decedent whether or not Basis Increase is allocated to the property.

How does the Section 1022 election impact the recipient’s ability to depreciate that property?

The recipient is treated for depreciation purposes as the decedent for the portion of the recipient's basis in the property that equals the decedent's adjusted basis in that property. As a result, the recipient determines any allowable depreciation deductions for this carryover basis by using the decedent's depreciation method, recovery period, and convention applicable to the property.

To the extent Basis Increase is allocated to a property, however, that portion of the property is treated as a "new asset" placed in service on the day after the decedent's death. The recipient determines any allowable depreciation deductions for this "new asset" by using the method, recovery period and convention applicable to the property on its placed-in-service-date (or the date thereafter when converted to depreciable property).

Does an election under Section 1022 impact whether gain is realized on satisfaction of a pecuniary bequest with appreciated property?

Appreciation is still taxed – but if the Election is made, the gain is measured with reference to the difference between the fair market value on the date of distribution and the fair market value on date of death.

Are there limits to the amount of basis step up that may be allocated to a property?

Yes. In no event may basis be allocated in a manner which increases the basis of property above its fair market value.

It is unclear how this rule applies where a decedent owned a partnership or limited liability company interest with a "negative capital account", as illustrated by the following example:

Assume the decedent was a 50% partner in a Partnership. That Partnership owns an asset with a basis and fair market value of $200 subject to a liability of $300. The fair market value of the decedent's partnership interest is zero (the property is "underwater"), and the decedent's capital account is "negative" by $50 (one half of the $100 excess of the liability over the Partnership's basis in its asset). If the Partnership sold the asset immediately before the decedent's death for an amount equal to its liability the decedent would recognize $50 of gain from the deemed distribution of cash accompanying the relief of the liability. Can the executor allocate Basis Increase to the decedent's partnership interest to eliminate this gain (taking the position that the fair market value limitation in this circumstance is the fair market value of the Partnership's asset, without regard to the liability)? No guidance is given in the Revenue Procedure.

Do non-pro rata allocations of community property affect these rules?

It appears not. Assume the decedent and spouse owned as community property $20 million of cash, Whiteacre, with a value of $3 million and a basis of $1.7 million, and Blackacre, with a value of $3 million and a basis of zero.

It appears that the executor can make a non-pro rata allocation of $10 million cash and Whiteacre to the decedent's share of the community, and $10 million cash and Blackacre to the spouse's share, utilizing fully the aggregate $4.3 million of Basis Increase ($1.3 million GBI for Whiteacre, and $3 million SPBI for Blackacre).

Can Basis Increase be allocated separately to different interests in property created as a result of the decedent's death?

Basis Increase may be allocated to the decedent's property owned at death, but not to separate interests therein created as a result of a decedent's death. If, for example, a decedent creates a life estate in an asset wholly owned at death, Basis Increase may not be allocated separately to the life estate and resulting remainder interest, it must be allocated to the property owned by the decedent before differentiation.

Basis Increase may be allocated, however, to separate interests owned by the decedent at death (for example, to some shares of stock of a corporation owned by the decedent but not to others). Basis Increase may be allocated to an asset only if the decedent's property is divided into different interests that represent undivided portions or fractional interests in each and every property right that the decedent owned with respect to that asset.

Finally, if an undivided 50% interest in a property passes to one beneficiary and the other 50% undivided interest in that property passes to another beneficiary, if the executor decides to allocate Basis Increase to either or both 50% interests, such allocation must take place based on a 50% value of the entire property. This aggregation rule means that there are no "discounts" allowed for valuing one of the 50% interests by itself.

How do these rules apply for California (and other state) income tax purposes?

For California income tax purposes the decedent's assets receive a full step up in basis whether the executor opts to allow the federal Estate tax to apply or makes a Section 1022 Election. State laws must be reviewed on a state-by-state basis to determine if the California result is available in other states.

Is the Form 706 for non-electing decedents also due November 15, 2011?

If a Section 1022 election is not made the Form 706 is apparently due not later than September 19, 2011 (September 17 is a Saturday).

Related Professionals

- **Jay D. Waxenberg**
  Partner
- **Henry J. Leibowitz**
  Partner
- **Albert W. Gortz**