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EGTRRA REPLACES STEPPED-UP BASIS FOR CARRYOVER BASIS IN 2010

Congress did not address the estate tax in 2009 which has resulted in the repeal of the federal estate and generation-skipping transfer (GST) taxes (but not the gift tax) during 2010 in accordance with the Economic Growth and Tax Relief Reconciliation Act of 2001's ("EGTRRA," P.L. 107-16). If no further legislative action is taken, the transfer tax system in effect prior to EGTRRA will be reinstated in 2011, when EGTRRA will "sunset." Even if Congress is willing to reinstate the estate tax before 2011, such legislation may, or may not, be retroactive to January 1, 2010.

As a result of repeal, the pre-2010 system that provided under IRC Section 1014, a basis step-up to fair market value at death, is replaced with a carryover basis system in which assets will receive a basis equal to the lesser of the basis of the property in the hands of the decedent or its fair market value on the date of death.

Three New Rules

1. Since stepped-up basis is repealed in 2010, the decedent's estate and beneficiaries will be allowed to "tack" the decedent's holding period only with respect to those assets having a basis determined by reference to the decedent's basis. Therefore, (1) assets that are "stepped up" under one of the basis allocation provisions described below, and (2) assets having a fair market value that is less than the decedent's basis must be held for one year prior to sale in order to get long term capital gain treatment in 2010;
2. Depreciable real estate subject to recapture in the hands of the decedent will be subject to recapture when sold by the estate or beneficiaries; and
3. Suspended passive losses that, under current law, are deductible at death only to the extent of the excess of the fair market value of the property in the hands of the transferee exceeds the basis in the hands of the decedent immediately before death should, in most cases be deductible in full in 2010.

"While EGTRRA repeals the death tax on decendents' estates in 2010, it increases the income tax liability for beneficiaries who sell assets inherited from those estates in 2010 without a full stepped-up basis."

The post-repeal carryover basis rules are set forth in new IRC Section 1022, which contains the following provisions:

Aggregate Basis Increase

The estate of each decedent will be allowed an "aggregate basis increase" in the amount of $1.3 million ($60,000 in the case of nonresident alien decedents), increased by the amount of the decedent's built-in capital and net operating loss carryovers, and certain losses that would have been allowable under Section 165 had the property been sold immediately prior to death. This amount will be indexed for inflation after 2010. The decedent's executor may allocate (on the return required under Section 6018 for "large transfers at death") the amount of the basis increase among assets owned by the decedent at death. Estate and gift tax returns will still be required in many cases post-repeal.

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Life Insurance Proceeds Received By Partnership Not Includible in Decedent/Insured's Estate

Basis Increase for Property Acquired by Surviving Spouse

An additional $3 million of basis (which will be indexed for inflation) may be allocated to qualified marital deduction property inherited from a spouse. The surviving spouse need not be a U.S. citizen or resident for the property to be eligible for this allocation. Property that is eligible for the spousal basis step-up must be bequeathed to or inherited by the surviving spouse either outright or in the form of a qualifying income interest for life.

Jointly-owned Property

Where property was owned jointly with a spouse, only that half of the property considered owned by the deceased spouse will be eligible for the basis increase. If the property was owned jointly with a person other than the surviving spouse, the decedent is treated as the owner of that proportion of the property for which he or she furnished the consideration (thus creating a difficult "tracing" problem for assets, such as improved real property, for which it may be difficult to trace respective contributions of co-tenants).

> *"An additional $3 million of basis (which will be indexed for inflation) may be allocated to qualified martial deduction property inherited from a spouse."*

Community Property

In the case of community property, the surviving spouse's one-half of the property also will be eligible for basis increase (as under current law).

Property must have been "Owned" by the Decedent

In order to be eligible for a basis increase, property must have been "owned" by the decedent on the date of his or her death. Property held by the decedent in a "qualified revocable trust," (which refers only to domestic - U.S. - trusts) will be treated as having been owned by the decedent for this purpose. However, property held by a surviving spouse in a "QTIP" trust, will not be treated as having been owned by the surviving spouse on the date of the surviving spouse's death. Nor will the decedent be treated as owning property over which he or she held a power of appointment at death, property held as the beneficiary of an "estate" trust, or, in most cases, property that the decedent acquired for less than adequate consideration within 3 years of death. Property acquired by the decedent as a gift from his or her spouse within 3 years of death will be considered to be owned by the decedent, except where the spouse acquired the property by gift within the 3 year period.

Property Ineligible for Basis Increase

Property constituting "income in respect of a decedent" will not be eligible for basis increase. This rule is consistent with current law, and will principally affect property held in qualified retirement arrangements and individual retirement accounts. Stock of certain foreign entities also will not be eligible for step-up. However, inherited art work or similar property created by the decedent will be reclassified as a capital asset eligible for the basis step-up.

No Gain Recognition on Receipt of Property from a Decedent

A beneficiary, other than a tax-exempt beneficiary, will not recognize gain upon the receipt from a decedent's estate of property that has liabilities in excess of its basis – negative basis property. Situations in which gain will be recognized include the satisfaction of a pecuniary bequest with appreciated property (but only to the extent of appreciation in the value of the property occurring after the date of death) and transfers of property at death to nonresident alien individuals.

No Increase In Basis Above Fair Market Value

Under no circumstances may an allocation of basis increase the basis of property in excess of its fair market value on the date of the decedent's death.

Track Basis of Assets

Clients should be advised to keep records of the basis of assets - to the extent the basis can be determined - indefinitely, or, at a minimum, until it can be determined whether repeal will, in fact, occur. Unlike 1976 (the last attempt at enacting carryover basis) there is no "fresh start" to step up the basis of assets to 2010 values.

Empower Executor to Allocate Basis

Provisions should be added to existing estate planning documents giving the decedent's executor the power to allocate the decedent's aggregate basis increase among the assets includible in his or her gross estate, regardless of whether such assets pass under the will (i.e., probate assets) or outside of the will (i.e., non-probate assets). Executors should be indemnified and held harmless for making this allocation. Alternatively, specific direction should be given to allocate the basis step-up among assets. Such direction might include a direction to distribute low basis property to charity and/or a direction to allocate basis step-up first or ordinary income property, such as real estate subject to recapture.

Dispositive Scheme

Planners will want to recommend a "post-repeal" disposition that takes advantage of the client's available basis increase. This will be difficult because the increase does not refer to the absolute value of property eligible for the step-up, but to an addition to the basis of existing assets. Thus, a bequest to a QTIP trust of property having a value of $3 million would utilize the marital basis step-up only if the property was (i) not cash, (ii) eligible for the step-up, and (iii) had a basis in the hands of the decedent of zero. In drafting, therefore, a bequest of property to a surviving spouse should, subject to independent counsel review, refer to, for example, "an amount of 'qualified spousal property' (within the meaning of IRC Section 1022(c)(3)) which, in the aggregate, has a basis that is equal to the amount of its fair market value on the date of my death, less the amount of the 'aggregate spousal property basis increase' (within the meaning of IRC Section 1022(c)(2)) available to my estate on the date of my death." A similar formula could be used to make a bequest to children that will utilize the decedent's $1.3 million non-spousal basis step-up amount.

LIFE INSURANCE PROCEEDS RECEIVED BY PARTNERSHIP NOT INCLUDIBLE IN DECEDENT/INSURED'S ESTATE

The IRS, in PLR 200947006, has ruled that the proceeds of two life insurance policies received by a limited partnership on an insured's death will not be includible in the insured's gross estate under Internal Revenue Code Sections 2042 and 2035, even if the insured dies within three years of releasing his powers over one of the policies.

Facts

PLR 200947006 describes a complicated series of transactions designed to move the ownership of two life insurance policies to a single partnership that is, in turn, wholly owned by two trusts. Partnership 1 is a limited partnership in which Corporation 1, which is wholly owned by Taxpayer, owns a general partnership interest. Corporation 2, which is wholly owned by Trust 1, and Taxpayer own limited partnership interests in Partnership 1. Corporation 2 also owns limited partnership interests in Partnerships 2, 3, and 4. The general partners of Partnerships 2, 3, and 4 are separate limited liability companies or corporations, each of which is solely owned by Taxpayer or Taxpayer's parents.

Partnership 1 owns Policy, a life insurance policy on the life of Taxpayer. Taxpayer has contributed funds to Partnership 1 to pay premiums on Policy 1. The beneficiaries of Policy 1 are Partnerships 1-4. Partnership 1, as the owner of Policy 1, intends to designate Taxpayer's children as the beneficiaries of Policy 1. Partnership 1 owns no other assets.

Trust 1 was formed by Taxpayer's parents in Year 2. Taxpayer and Taxpayer's sister are the co-trustees of Trust 1, and Taxpayer is the sole current beneficiary. The trustees have a discretionary power to distribute income to Taxpayer, while Taxpayer is living. Upon Taxpayer's death, the assets of Trust 1 pass to a trust for the benefit of Taxpayer's descendants. Taxpayer has no power of appointment to change the disposition of Trust 1.

Trust 2 was formed by Taxpayer in Year 1. The beneficiaries of Trust 2 are Taxpayer's wife and children. Trust 2 is the owner and beneficiary of Policy 2, a whole life insurance policy on the life of Taxpayer. Taxpayer has made gifts to Trust 2 to fund the premiums of Policy 2.

Taxpayer proposed to undertake a series of transactions that would result in Trust 1 and Trust 2 owning 100% of Partnership 1, which, in turn, will own Policy 1 and Policy 2. The beneficiaries of each policy will be Partnership 1.

On these facts, the Internal Revenue Service issued the following rulings:

Section 2042

Under section 2042(2), life insurance proceeds are includible in the estate of the insured to the extent that the insured possessed, directly or indirectly, "incidents of ownership" in the policy. Rev. Rule, 83-174, 1983-2 C.B. 158, considers whether incidents of ownership in an insurance policy owned by a general partnership would be attributed to the insured general partner. The ruling concludes that, where the insurance proceeds are payable to the partnership, the inclusion of the proceeds in the gross estate under section 2042 would result in "unwarranted double taxation" of a substantial portion of the proceeds because the proceeds were reflected in the value of decedent's partnership interest. However, where the proceeds are payable to a third party for a purposed unrelated to the general partnership business, and thus, would not be included in the value of the partnership interest included in the gross estate, the incidents of ownership are treated as held by the insured general partner in conjunction with the other partners. A similar rule applies, by regulation, to the proceeds of life insurance on a controlling shareholder that are held by and payable to a corporation.

"Section 2035(d) provides, however, that Section 2035(a) does not apply to any bona fide sale for an adequate or full consideration."

In addition, Rev. Rul. 84-179, 1984-2 C.B. 195, concludes, based on the legislative history underlying IRC section 2042(2), that the section generally applied to include life insurance in situations that parallel the inclusion of property under sections 2036-2038. Those sections generally involve the transfer of property where rights or powers are retained incident to the transfer.

Under the facts in Rev. Rul. 84-179, the decedent transferred the policy to his wife and subsequently, in an unrelated transaction, reacquired incidents of ownership over the policy in a fiduciary capacity. The ruling holds that under these circumstances, the decedent will not be considered to possess incidents of ownership in the policy for purposes of section 2042(2), provided the decedent did not furnish consideration for maintaining the policy and could not exercise the powers for the decedent's personal benefit. The ruling further provides that the result would be the same if the decedent acting as trustee purchased a policy as a trust asset. The ruling states, however, that if the decedent's powers over the policy could have been exercised for the decedent's benefit, they would constitute incidents of ownership in the policy without regard to how those powers were acquired and without consideration of whether or not the decedent was the source of the funds used to pay the premiums.

Lastly, the Internal Revenue Service in the Private Letter Ruling examined the insured Taxpayer's proposed release to his Sister any power to make any significant decisions with regard to Policy 1. The Taxpayer would not have the power to change the beneficiary of Policy 1, surrender or cancel the policy, assign the policy, revoke an assignment of the policy, pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy. Partnership 1 will pay all the premiums on Policies 1 and 2 and will be the beneficiary of the proceeds. Accordingly, the Internal Revenue Service concluded that the proceeds of Policy 1 and Policy 2 received by Partnership 1 upon Taxpayer's death will not be included in Taxpayer's gross estate.

Section 2035

Section 2035(a) of the Internal Revenue Code provides that (1) if the decedent transferred an interest in property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and (2) the value of the property (or interest therein) would have been included in the gross estate under sections 2035, 2037, 2038, or 2042 of the Code (regarding retained interests and powers) if the interest or power had been retained by the decedent on the date of death, then the value of the gross estate includes the value of any property (or interest therein) that would have been so included.

Section 2035(d) provides, however, that Section 2035(a) does not apply to any bona fide sale for an adequate and full consideration in money or money's worth. The IRS ruled that before and after the transaction the Taxpayer will not possess any incidents of ownership. Accordingly, the Internal Revenue Service concluded that the proceeds of Policy 1 and Policy 2 will not be includible in Taxpayer's gross estate under section 2035(a), if Taxpayer dies within three years of releasing (to Sister) his powers over Policy 1, and such powers are not, in the meantime, reinstated.

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