IRS Clarifies Certain Filing Dates And Procedures For 2010 Decedents And Application Of Carryover Basis Rules

August 2011

On August 5, 2011, the Internal Revenue Service issued two pronouncements related to the estates of persons who died in 2010. Notice 2011-66 explains how and when certain elections are to be made and Rev. Proc. 2011-41 provides certain clarifications of the manner in which the carryover basis rules of Internal Revenue Code Section (Section) 1022 are to be applied.

NOTICE 2011-66

Election to Have No Estate Tax for 2010 Decedents. Notice 2011-66 provides that to make the election not to have estate tax for the estate of a 2010 decedent, the executor must file Form 8939 by November 15, 2011. In other words, the "no estate tax" benefit for a 2010 decedent's estate is not automatic. If this election is made, then the carryover basis provisions of Section 1022 are applicable. The Notice refers to the election not to have estate tax apply as the "Section 1022 Election."

The IRS has not yet published Form 8939 even though it is due on November 15, 2011. The IRS previously released and then withdrew a draft of the form, and a copy of the prior draft form is available on the IRS' website through this link http://www.irs.gov/pub/irs-dft/f8939--dft.pdf. The form likely will look considerably different when finally issued, however. With limited exceptions, no extension of this filing date is available. The Notice emphasizes that if the executor has previously attempted to make the election by filing anything else, a properly completed Form 8939 still must be filed by November 15, 2011, and any prior filing will be ineffective.

If no executor is appointed for a decedent's estate, as could be the case if the decedent had transferred all of his or her assets to a living trust, then anyone in actual or constructive possession of the decedent's assets may file Form 8939. If the IRS receives conflicting filings, such as both Form 8939 and an estate tax return on Form

706, it will notify all filers that they must sign and submit a single filing within 90 days. If this filing is not made, the IRS will determine whether Section 1022 applies to the decedent's estate or whether the estate is subject to estate tax.

Reporting of Basis Increase. Form 8939 must report the allocation of the basis increases permitted to the decedent's assets under Section 1022. The executor must include with Form 8939 information and documentation to support the valuation that substantiates this allocation of basis. Each decedent is permitted an increase of: (i) $1,300,000; (ii) the amount of any unused net operating loss or capital loss carryovers; and (iii) the amount of unrealized losses in assets owned at death. An additional $3,000,000 increase is permitted for assets transferred directly to the decedent's surviving spouse or property that is "qualified terminable interest property" (QTIP) as defined in Section 1022(c)(5). This is property with respect to which the spouse is entitled to receive all of the income for his or her life, and during the life of the surviving spouse, no person has the power to appoint any portion of the property to any person other than the surviving spouse. These are basically the same requirements as for a QTIP marital deduction under Section 2056(b)(7). In Revenue Procedure 2011-41, the IRS states that QTIP does not necessarily have to be held in trust (although most often it is) and for purposes of Section 1022, property can qualify as QTIP even if the election under Section 2056(b)(7) is not made. Subsequent references to "QTIP" mean to property that satisfies these Section 1022 requirements. If the IRS receives multiple Forms 8939, which in the aggregate allocate a larger basis increase than permitted, it will notify all filers that they have 90 days to submit a single Form 8939 signed by all of the filers. If this filing is not made, the IRS will allocate the permitted basis increase.

Within 30 days after the executor files Form 8939, the filer must provide a statement to each recipient of the decedent's property. The statement must provide information about the property, including a description of the property, the decedent's basis, the amount of basis increase allocated to the property, the decedent's holding period for the

property and information as to whether the property is a capital asset or an ordinary income asset.

Reporting Assets to Which Basis Increase Cannot Be Allocated. Form 8939 must also report all assets of the decedent to which no basis increase may be allocated. This includes property that the decedent owned at death that the decedent received as a gift within three years prior to the date of his death, except where the donor was the decedent's spouse. A subsequent part of this Alert that discusses Revenue Procedure 2011-41 contains additional information about assets to which not basis increase may be allocated.

Relief From Filing Deadline. In general, no extension of time to file Form 8939 can be obtained. Notice 2011-66 also states that a "protective" Form 8939, to be applicable only if it is finally determined that the value of the decedent's assets exceeds his or her applicable estate tax exclusion amount, cannot be filed. A limited number of exceptions are provided by which a timely filed Form 8939 can be amended after November 15, 2011.

Spousal basis increase. If Form 8939 was timely filed, it may be amended after November 15, 2011, to report the spousal basis increase attributable to assets transferred to the surviving spouse. The amended Form 8939 must be filed no later than 90 days after the date of any distribution of property to the spouse. While this provision will be useful in cases when it is not possible to determine by November 15, 2011, the identity of the property passing to the surviving spouse, Form 8939 must be timely filed by November 15, 2011, in order to be eligible to file an amended From 8939 for this purpose.

Amendment within six months. A Form 8939 that was timely filed may be amended by May 15, 2012, utilizing the procedures of Treas. Reg. Section 301.9100-2(b), which

provides automatic extensions of time for certain actions and elections. This amendment may not be used to make or revoke the election under Section 1022.

Subsequently discovered property. If Form 8939 was timely filed, the executor may apply under Treas. Reg. Section 301.9100-3 to allocate previously unallocated basis if additional assets are discovered after the filing to which the unused increase could be allocated, or when asset values are increased as the result of an IRS audit or inquiry.

Reasonable cause. An executor is permitted to apply for reasonable cause relief under Treas. Reg. Section 301.9100-3 for the late filing of Form 8939, and therefore the making of a late election to apply Section 1022.

Generation Skipping Transfer Tax Exemption for 2010 Decedents. If the executor elects to apply Section 1022 to a 2010 decedent's estate, any allocation of generation skipping transfer (GST) tax exemption is made on Schedule R of Form 8939.

Electing No Allocation of GST Tax Exemption for Inter Vivos 2010 Direct Skips. Normally, GST tax exemption is automatically allocated to direct skip transfers. In 2010, when the GST tax rate was zero, this automatic allocation would waste GST tax exemption that could be utilized more effectively in other years. The Notice provides that if Form 709 is filed for the transfer, the IRS will treat the filing as an election out of the automatic allocation of GST tax exemption to the direct skip transfer. If a direct skip transfer is made to a trust or at the end of an estate tax inclusion period, the normal rules continue to apply. GST tax exemption will automatically be allocated to these transfers unless the transferor affirmatively elects not to have the exemption allocation apply. If a transfer to a trust is not a direct skip, however, these rules do not apply and the normal considerations for applying (or not applying) GST tax exemption must be evaluated.

Filing Deadlines. A variety of elections related to the GST tax are made on Form 709, including whether GST tax exemption is allocated to various transfers. Any Form 709 due for transfers constituting direct skips, taxable terminations or taxable distributions occurring between January 1 and December 16, 2010, is due on September 19, 2011. Any Form 709 required to be filed for: (i) gifts that do not constitute GST transfers; (ii) returns reporting direct skip transfers made after December 16, 2010; (iii) returns reporting indirect skips; and (iv) returns electing to treat a trust as a GST trust were due on April 18, 2011.

GST Tax Rules Applied as Though Estate was Subject to Estate Tax. A variety of GST tax related provisions refer to various provisions of the estate tax law or to transfers subject to estate tax under Chapter 11 of the Internal Revenue Code. Section 301(c) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, provides that under Section 2652(a), the transferor of property is determined as though estate tax applied, even if the Section 1022 Election is made. There was some uncertainty as to how other provisions making reference to the Chapter 11 estate tax would be applied to estates of 2010 decedents that elected not to have estate tax apply. In the Notice, the IRS provides that these estates nonetheless will be treated as though they were subject to the Chapter 11 estate tax for purposes of interpreting and applying various GST tax provisions. As a non-exclusive list of GST tax provision references to the estate tax, the Notice mentions Sections 2612(c)(1), 2642(b)(2)(A), 2642(f), 2651(e)(1)(B), and 2661(2). For example, Section 2612(c)(1) provides that a direct skip is a transfer subject to the tax imposed by Chapter 11 or Chapter 12 of an interest in property to a skip person. In the case of a 2010 decedent, for purposes of identifying a direct skip with respect to the GST tax, his or her estate is considered to have been subject to estate tax under Chapter 11 even if the Section 1022 Election was made.

Transfer Certificates Not Required for Transfer Agents for 2010 Decedents. The Notice provides that in the case of a 2010 decedent who is neither a citizen nor resident

of the United States, any transfer agent holding property of this decedent does not need a transfer certificate (nor will the IRS issue one) in order to transfer the property of the decedent whose executor makes a Section 1022 Election. Normally, the transferor would be liable for any unpaid estate tax to the extent of the value of the assets in its custody if it transferred the decedent's assets without first having obtained a transfer certificate.

Section 645 Election. Section 645 permits a qualified revocable trust to elect to be treated as part of the decedent's estate for income tax purposes. If an estate tax return is filed for an estate, the Section 645 election remains in effect until six months after the date of the final determination of the estate tax liability. If no estate tax return is filed, the Section 645 election is effective for two years after the date of the decedent's death. The Notice provides that if an estate makes the Section 1022 Election not to have estate tax apply, a Section 645 election made for any qualified revocable trust will be effective for two years from the date of the decedent's death. This will serve as an important limitation for trusts holding stock of S corporations. Prior to the end of the two year period, the stock will have to be sold or distributed, or the trust will have to make a QSST or ESBT election.

REV. PROC. 2011-41

Rev. Proc. 2011-41 contains a variety of safe harbor rules that can be applied to implement the carryover basis provisions of Section 1022 applicable if an executor elects not to have estate tax apply for a 2010 decedent. We previously published an Alert on the Section 1022 rules, which is available at www.loeb.com/practioneralertircsection1022. The Revenue Procedure expands upon and in some cases changes the information that was available about Section 1022 at the time of our previous Alert.

Overview of Section 1022. Section 1022 provides that property acquired from a 2010 decedent whose estate elects not to have estate tax apply will be treated as though it

was transferred by gift. Its basis in the hands of the recipient is the lesser of the decedent's adjusted basis at his death and the fair market value of the property at the decedent's death. A limited basis increase is permitted. The permitted increase is: (i) $1,300,000; (ii) the amount of the decedent's unused net operating loss and capital loss carryovers; and (iii) the amount of unrealized losses in the decedent's assets. An additional $3,000,000 increase is permitted to be allocated to assets transferred directly to the decedent's surviving spouse or property that is QTIP. The permitted increase may be allocated among the decedent's assets by the executor, but not in an amount that causes the tax basis of any asset to exceed its fair market value at the date of the decedent's death.

Property Owned By or Acquired From a Decedent. Rev. Proc. 2011-41 explains the significance of and the difference between the concepts of "property owned by a decedent" and "property acquired from a decedent." All property "acquired from a 2010 decedent" whose estate has elected not to have estate tax apply is subject to the carryover basis rules of Section 1022. If property is acquired from this decedent, its initial basis will be the lesser of the decedent's basis and the fair market value of the property at the time of the decedent's death. In order for the property to be eligible for the basis increases described above, the property must have been "owned by the decedent."

Property Acquired From the Decedent. Under the Revenue Procedure, property acquired from the decedent, and therefore subject to the carryover basis rules of Section 1022, is property acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent. The term also includes property transferred by the decedent during the decedent's lifetime: (i) to a qualified revocable trust, as defined in Section 645(b)(1), regardless of whether the election under Section 645 is made for that trust; and (ii) to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust. Finally, the term includes any other property that passes

from the decedent by reason of death to the extent that the property passes without consideration, such as: (i) any property transferred at the decedent's death by reason of the decedent's holding and/or exercising a general power of appointment with respect to the property if that power was not created by the decedent, (ii) property held by the decedent and another person as joint tenants with right of survivorship or as tenants by the entirety; and (iii) the surviving spouse's one-half interest in community property. The last item is a welcome clarification for surviving spouses in community property states such as California.

The term does not include a decedent's interest in a qualified terminable interest property trust or similar arrangement funded for the benefit of the decedent by the decedent's predeceased spouse (Marital Deduction QTIP). As a result, this property is not subject to Section 1022, and a recipient's basis in this property will be determined under other tax principles. Although Marital Deduction QTIP is not eligible for any step-up in basis when a Section 1022 Election is made, we believe it is important that in filing the Form 8939, the executor lists all of the Marital Deduction QTIP assets to clarify that the election not to have the estate tax apply extends to the Marital Deduction QTIP assets.

Property Owned by the Decedent. In order to be eligible for allocation of the permitted basis increase, the property acquired from the decedent must also have been owned by the decedent. Property owned by the decedent at death includes, but is not limited to: (i) any property legally titled in the name of the decedent at death (and not held by the decedent solely in a legal or representative capacity); (ii) certain jointly owned property, whether owned as tenants in common or with rights of survivorship; (iii) property transferred by the decedent during life to a qualified revocable trust as defined in Section 645(b)(1), regardless of whether the election under Section 645 is made for that trust; and (iv) certain community property of the decedent and his or her spouse.

The Revenue Procedure highlights certain types of property that are "acquired" from a decedent so Section 1022 applies, but are not treated as "owned" by a decedent so they may not receive any of the permitted basis increase. For example, property over which the decedent holds any power of appointment is not considered owned by the decedent at death. In addition, although considered to have been acquired from the decedent, property transferred to a trust by the decedent during life in which the decedent retained a power to alter, amend or terminate the trust is not considered owned by the decedent at death for this purpose, unless the trust is a qualified revocable trust as defined in Section 645(b)(1). Property transferred to a trust by the decedent during life in which the decedent retained an income interest is not considered owned by the decedent at death solely by reason of that retained income interest. In addition, because of the different definitions of ownership in Sections 679 and 1022, although a transfer of property to a foreign trust by a United States grantor may be sufficient to cause that grantor to be treated as the owner of at least a portion of that trust for income tax purposes under Section 679, this transfer is not sufficient to result in the trust's being considered to be owned by the United States grantor at that grantor's death for purposes of Section 1022(d). Finally, an interest in a Marital Deduction QTIP trust or similar arrangement funded for the benefit of the decedent by a predeceased spouse of the decedent is not owned by the decedent for this purpose.

The Revenue Procedure does provide one example of property that will treated as owned by a decedent that is not apparent from the language of Section 1022. If the terms of a trust require the trust property to revert to the decedent upon death (as is often the case if a qualified personal residence trust terminates before the retained interest period ends), then this property is deemed to be owned by the decedent.

Other Property to Which Basis Increase Cannot Be Allocated. In addition to property not considered to be owned by the decedent, Section 1022 provides that basis increase cannot be allocated to: (i) property acquired by the decedent by gift less than three years prior to his death, unless the gift was from his spouse; (ii) stock of a foreign

personal holding company; (iii) a DISC [does this need to be defined?] or former DISC; (iv) foreign investment company; and (v) a passive foreign investment company (PFIC), unless the PFIC is a qualified electing fund. Basis increase also cannot be allocated to property that constitutes "income in respect of a decedent" under Section 691, as Section 1022 is not applicable to such property. See, Section 1022(f).

Other Provisions Governing the Amount of Basis Increase. As noted above, each decedent is permitted a basis increase of $1,300,000. This amount is increased by the amount of unused net operating loss and capital loss carryovers and the amount of unrealized losses. If the decedent filed joint returns with his or her spouse, only his or her share of net operating loss and capital loss carryovers is taken into account in determining the amount of the basis increase. In the case of unrealized losses, however, if the unrealized loss relates to a community property asset, the entire unrealized loss of both spouses in that asset is taken into account in determining the amount of the permitted basis increase.

Provisions Related to Spousal Increase. An additional increase of $3,000,000 is allowed for property transferred directly to the decedent's spouse and property that is QTIP. This increase may be allocated on Form 8939 even if the property has already been distributed to the spouse or to a qualifying trust. Basis increase may also be allocated to property that was sold prior to distribution to the extent that the proceeds of the sale are distributed to the spouse or to a qualifying trust. This is an important clarification because the IRS had given verbal indications to the contrary. The spousal increase also may be allocated to property held by a testamentary charitable remainder trust if the spouse is the only non-charitable beneficiary of the trust.

Nonresident Decedents Who Are Not U.S. Citizens. The basis increase in the case of a person who is neither a citizen of nor resident in the United States is $60,000 instead of $1,300,000, and is not increased by unused losses. The Revenue Procedure

points out that a nonresident, non-citizen decedent is still entitled to the $3,000,000 spousal increase for any property left to his or her spouse, however.

Allocation of Increase Amount. Basis increase cannot be applied to increase the tax basis of an asset to an amount in excess of its fair market value at the time of the decedent's death. Fair market value for purposes of determining the limit on allocating basis increase is determined in the same manner as it is for estate tax purposes. The Revenue Procedure notes that appraisals are required for basis allocation in the same instances they would be required to value an asset for estate tax purposes. Minority interest discounts do not have to be taken into account for purposes of determining the fair market value limitation on the allocation of basis increase. The Revenue Procedure states that when an asset is transferred to multiple people in fractional interests, the value of each interest is the fair market value of the entire asset at the decedent's death multiplied by the percentage the interest represents of the total asset.

The Revenue Procedure clarifies that the basis increase may be allocated to specific shares of stock or to a block of stock. It is not necessary to allocate basis increase to each share of a particular stock held by the decedent. This should also be true if fractional interests in real property are transferred to multiple beneficiaries.

Community Property. If an asset of the decedent is held as community property with his or her spouse, both halves of the asset are treated as owned by and acquired from the decedent. This means that basis increase can be allocated to the surviving spouse's half as well as to the decedent's half of the property. The Revenue Procedure also confirms that if the community asset is depreciated at the time of the decedent's death, the basis of the surviving spouse's half is reduced to fair market value, along with the half of the decedent.

Holding Period and Character. If the basis of property of a decedent is determined under Section 1022, the holding period of his successor includes the decedent's holding period. The asset also initially will have the same character as a capital asset or

ordinary income asset in the hands of the successor as it had in the hands of the decedent.

Depreciation. Depreciating property acquired from a decedent will become complicated. As to the amount of basis equal to the decedent's basis in the asset at his death, the successor simply steps into the decedent's shoes with respect to depreciation method and remaining depreciation life. To the extent basis increase was allocated to the asset, the amount of the increase is treated for depreciation purposes as a separate asset that was placed in service by the successor on the day after the decedent's death. Although the Revenue Procedure does not cover it, depreciated property whose basis is stepped down to fair market value also presumably is treated as a separate asset in the hands of the decedent's successor.

Suspended Passive Losses. The IRS has applied a different rule for suspended passive losses from what we anticipated the rule to be in our prior Alert. We previously suggested that under Section 469(g)(2), death was treated as a disposition of the passive activity, and suspended losses should be deductible in the decedent's final tax year. The IRS has decided that because property with a Section 1022 basis is treated as having been transferred by gift, the gift provisions of Section 469 are applicable. Under Section 469(j)(6), if property with respect to which a person has a suspended passive loss is transferred by gift, the amount of the suspended loss is added to the basis of the property that is transferred in the gift. The IRS will also apply this rule to 2010 decedents subject to Section 1022.

The Revenue Procedure provides that the basis increase occurs the moment before the decedent's death. This subjects the increased basis to the fair market value limitation if the basis is increased to an amount in excess of the value of the asset at the decedent's death. For example, assume the decedent owns real property with tax basis of $6 and fair market value of $10 at the time of his death. He also has $7 of suspended passive losses from the property. The decedent's basis of $6 is increased by the suspended

loss of $7 to become $13. Because the value of the property is $10 (and therefore less than the basis), however, the basis to the successor is limited to $10. The reduction of $3 is treated as an unrealized loss in the asset and can be allocated to other appreciated assets.

Satisfaction of Pecuniary Bequests with Appreciated Property. The version of Section 1040 in effect for 2010 decedents with a Section 1022 Election provides that if property is distributed to satisfy a pecuniary bequest, gain is recognized by the estate to the extent the property has appreciated above its fair market value as of the date of the decedent's death. A similar rule is to be applied to trust property if the trust contains a provision equivalent to a pecuniary bequest. The rule prevents all of the gain inherent in the carryover basis asset from being triggered and instead subjects to tax only the post-death appreciation. The Revenue Procedure applies this same rule to qualified revocable trusts and to trusts that would have been included in the decedent's estate under Section 2036, 2037 or 2038, but for the Section 1022 Election.

Transfers to Nonresident Aliens. Section 684 treats as a taxable exchange the transfer of appreciated property to a foreign estate or trust. The provision also applies to transfers to nonresident alien individuals in the case of transfers from the estate of a 2010 decedent whose estate makes a Section 1022 Election. In the Revenue Procedure, the IRS clarified that any basis increase allocated to an asset under Section 1022 may be considered in determining the amount of gain recognized on the transfer under Section 684.

Testamentary Charitable Remainder Trusts. There was some question whether a testamentary charitable remainder trust created from the estate of a 2010 decedent that makes the Section 1022 Election will satisfy all of the requirements of Section 664, since no deduction under Section 2055 will be available for transfers to such a trust. The Revenue Procedure provides that if the trust otherwise meets the requirements of a

testamentary charitable remainder trust, it will not be disqualified solely because Section 2055 is not applicable due to the Section 1022 Election.

Form 706 for 2010 Decedents. The IRS has also published an advance proof copy of a 2010 federal estate tax return (Form 706) for decedent's estates with a value in excess of $5,000,000 that do not make a Section 1022 Election. If the value of the decedent's estate is close to $5,000,000 and some of the assets have subjective values, it may be advisable to file a Form 706 to commence a statute of limitations on such valuations. The Form 706 for a 2010 decedent must be filed and tax paid by September 19, 2011. The draft instructions for the Form 706 for 2010 decedents provide that a six-month extension of the time to file the Form 706 may be obtained by filing Form 4768.

If you have questions about any of the material covered in this alert, please contact your primary attorney in our High Net Worth Family group.

---

be used in connection with promoting, marketing or recommending to another person any transaction or matter addressed herein.