

Carryover Basis Guidance Issued; Form 8939 Due Date Set

On August 5, 2011, the IRS issued long-awaited guidance on the operation of the modified carryover basis rules. The rules apply to the estates of decedents dying in 2010 that elected out of the application of the estate tax.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) (EGTRRA) repealed the estate tax for decedents dying after December 31, 2009. In conjunction with the repeal of the estate tax in 2010, the “stepped-up” basis rule (under which the basis of property passing from a decedent's estate is generally the fair market value on the date of death) was replaced with a “modified carryover” basis regime. Specifically, the basis of property acquired from a decedent after December 31, 2009, is treated as if the property had been acquired by gift. Accordingly, recipients of such property will receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property at the date of the decedent's death. However, the executor is allowed to increase the decedent's adjusted basis in the property under certain circumstances as described below.

In addition to the one-year repeal of the estate tax, EGTRRA made chapter 13 of the Code (the generation-skipping transfer (GST) tax) inapplicable to GSTs after December 31, 2009. Under a sunset provision in EGTRRA, the estate and GST taxes would be reinstated for estates of decedents dying, and generation-skipping transfers made, in 2011 and thereafter. As a result, the stepped-up basis rule would return after a one-year hiatus.

On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was enacted (P.L. 111-312) (the Tax Relief Act of 2010). The Tax Relief Act of 2010 retroactively reinstated the estate and GST

taxes for 2010. However, the legislation allows the executor of the estate of a decedent who died in 2010 to elect not to have the estate tax apply to the decedent's estate and instead have the modified carryover basis provisions of Code Sec. 1022 apply. The provisions of chapter 13 (the GST provisions) still apply if the executor makes the election out of the estate tax; however, the Tax Relief Act of 2010 provides that the applicable tax rate for each GST occurring during 2010 is zero.

The IRS has released guidance on the application of the modified carryover basis rules for estates that elect out of the estate tax in 2010, estimated by the IRS to be approximately 7,000 estates. The guidance has two components: (1) Notice 2011-66, which explains how the Code Sec. 1022 election is made and addresses GST tax issues in 2010, and (2) Rev. Proc. 2011-41, which provides a safe harbor with regard to the interpretation and application of Code Sec. 1022. (Both items are scheduled to be published in IRB 2011-35, August 29, 2011.)

Notice 2011-66: Code Sec. 1022 Election

Form 8939 due date—The executor of the estate of a decedent who died in 2010 will make the Code Sec. 1022 election by filing Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, no later than November 15, 2011. The election is irrevocable once made. If an executor had previously made a filing that purported to be an election under Code Sec. 1022, that filing must be replaced with a timely filed Form 8939. According to IR-2011-83, which accompanied the carryover basis guidance discussed here, “[t]he IRS expects to issue Form 8939 and the related instructions early this fall.”

A Form 8939 filed prior to November 15, 2011, may be amended or revoked, but only on a subsequent timely filed (on or before November 15, 2011) Form 8939. According to the notice, the Form 8939 that is timely filed by an executor is the *last* Form 8939 filed by that executor on or before November 15, 2011. No executor's Form 8939 will have any effect on a Form 8939 filed by a different executor.

No extensions to be granted; limited exceptions—No extensions of time to file a Form 8939 will be granted by the IRS, nor will the IRS accept a Form 8939 or an amended Form 8939 filed after the due date. However, as explained below, there are limited exceptions to this rule in the case of conflicting filings or when certain relief provisions are available. According to the notice, “a taxpayer may not file an estate tax return as well as a conditional Form 8939 that would take effect only if an estate tax audit results in an increase in the gross estate above the applicable exclusion amount.”

Combat zone and disaster exceptions—For those persons qualifying for relief under the combat zone or disaster area provisions of the Code (Code Sec. 7508 and 7508A), the due date for filing a Form 8939 is postponed as provided in those sections. Any executor filing a Form 8939 after November 15, 2011, pursuant to Code Sec. 7508 or 7508A should write “Filed Pursuant to Section 7508” or “Filed Pursuant to Section 7508A,” as applicable, on the top of the form. Furthermore, for decedents qualifying for relief under Code Sec. 692, an executor must file a Form 8939 to make the Code Sec. 1022 election.

When both Form 706 and Form 8939 are filed—If the IRS receives both a Form 8939 and Form 706 (or 706-NA) for the same decedent, the IRS will issue a letter to each person who filed such a form. The letter will include the name and address of each person who filed a Form 706 (or 706-NA) or Form 8939 with respect to the decedent, and will explain that each of those persons must collectively sign and file either a restated Form 706 (or 706-NA) or Form 8939 no later than 90 days from the date that the IRS mailed such letters.

If no restated Form 706 (or 706-NA) or Form 8939 is filed within the 90-day period, the IRS will determine whether the executor has made a Code Sec. 1022 election for the estate or whether the estate is subject to the estate tax. In making the de-

termination, the IRS will take into account all relevant facts and circumstances, “including without limitation the relative total fair market values of the decedent's property in the possession of the executors and the nature and significance of the economic impact of the Section 1022 Election (or its loss) on the beneficial owners of the property held by each executor.” The most relevant factors, and the weighting of the factors, may vary from one estate to another.

When multiple Forms 8939 overallocate basis increase—The executor (as defined in Code Sec. 2203) must allocate basis increase on a timely filed Form 8939. (Guidance on allocating basis increase is contained in Rev. Proc. 2011-41, discussed in detail beginning on page 149.) However, if no executor has been appointed, any person in actual or constructive possession of property acquired from a decedent may file a Form 8939 for the property that he or she so possesses. Similar to the situation described above when both a Form 706 and a Form 8939 are filed, if the IRS receives multiple Forms 8939 that collectively attempt to allocate basis increase in an amount greater than the maximum allowable, the IRS will issue a letter to each person who filed such a form. The letter will include the name and address of each other person who filed a Form 8939 with respect to the decedent, and will explain that each of those persons must collectively sign and file a single, restated Form 8939 allocating the basis increase in order to make the Code Sec. 1022 election. The restated Form 8939 must be filed no later than 90 days from the date that the IRS mailed such letters.

If no restated Form 8939 is filed within the 90-day period, the IRS will allocate the available basis increase as the IRS, *in its discretion*, (emphasis added) may determine. In exercising this discretion, the IRS will take into account all relevant facts and circumstances. “That allocation might be made on a pro-rata basis, based on the amount of unrecognized appreciation in the property owned by the decedent (within the meaning of section 1022(d)) ... at death and acquired from the decedent that was reported on the timely filed Forms 8939, or in any other manner deemed appropriate for the particular decedent's estate ...”

Relief from the Form 8939 filing due date—There are four types of relief available from the filing due date requirements. Under the first, an amend-

ed Form 8939 may be filed after the due date for the purpose of allocating “spousal property basis increase,” as that term is defined in Code Sec. 1022(c)(2) and Rev. Proc. 2011-41, among the property eligible to receive an allocation of that basis. In order to do so, the following two requirements must be satisfied: (1) the Form 8939 must have been timely filed and been complete when filed except for the allocation of the full amount of the spousal property basis increase to the eligible property reported on that Form 8939; and (2) each amended Form 8939 must be filed no more than 90 days after the date of the distribution of the qualified spousal property to which spousal property basis increase is allocated on that amended Form 8939.

The second relief provision allows an executor who timely filed a Form 8939 to file an amended Form 8939 under the provisions of Reg. §301.9100-2(b) on or before May 15, 2012, for any purpose except to make or revoke a Code Sec. 1022 election. The executor must write “Filed Pursuant to Section 301.9100-2” on the top of the amended Form 8939.

Reg. §301.9100-3 provides a third approach for an executor to apply for relief to supplement a timely filed Form 8939. A request for relief to supplement a timely filed Form 8939 is limited to an extension of time to allocate any basis increase that has not previously been validly allocated, and such relief, if appropriate, will be granted only if: (1) after filing the Form 8939, the executor discovers additional property to which remaining basis increase could be allocated; and/or (2) the fair market value of property reported on the Form 8939 is adjusted as the result of an IRS examination or inquiry. No relief will be granted to reduce an allocation of basis increase made on a timely filed Form 8939.

Finally, an executor may apply for relief under Reg. §301.9100-3 by requesting an extension of the time in which to file the Form 8939, which relief may be granted if the requirements of §301.9100-3 are satisfied. The notice states that “[t]axpayers should be aware, however, that, in this context, the amount of time that has elapsed since the decedent’s death may constitute a lack of reasonableness and good faith and/or prejudice to the interests of the government ... which would prevent the grant of the requested relief.”

Reported basis subject to examination—Notice 2011-66 also provides that a recipient’s basis in a particular property (including the amount of basis increase allocated to the property) is subject to adjustment by the IRS upon the examination of any tax return reporting a value dependent upon the property’s basis. Examples would include the property’s depreciation, sale, or other disposition that results in gain or loss on the property.

Items to be reported on Form 8939—If the executor makes the Code Sec. 1022 election, the executor is required to report and value on Form 8939 all property (excluding cash and property that constitutes the right to receive an item of income in respect of a decedent under Code Sec. 691 (IRD)) acquired from the decedent (Code Sec. 6018(b)(1)). The executor also must report all appreciated property acquired from the decedent, valued as of the decedent’s date of death, that was required to be included on the donor’s Form 709, if such property was acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money’s worth during the three-year period ending on the decedent’s date of death (Code Sec. 6018(b)(2)). However, this generally does not include property transferred to the decedent by the decedent’s spouse.

In addition to the information detailed above, the executor must include with the Form 8939 any other information and supporting documentation as identified in the Form 8939 instructions or in any Internal Revenue Bulletin.

Statement provided to property recipient—The executor must provide a statement, within 30 days after filing Form 8939, to each recipient acquiring property reported on that form, setting forth the information required under Code Sec. 6018(c), regardless of whether the executor allocated basis increase to such property on the form (Code Sec. 6018(e)). And, if a subsequent adjustment is made to the basis of property reported on a Form 8939, the executor must provide updated statements to each recipient of property affected by that adjustment within 30 days after making the adjustment or receiving notice of the adjustment from the IRS, whichever is applicable.

Notice 2011-66: GST Tax in 2010

GST tax applies regardless of Code Sec. 1022 election—Notice 2011-66 confirms that the GST tax

was retroactively reinstated by the Tax Relief Act of 2010 and applies to the estates of all decedents who died after December 31, 2009, regardless of whether a Code Sec. 1022 election is made. The 2010 Act also provides that, for each GST occurring during 2010, the applicable rate under Code Sec. 2641(a) is zero. Practically speaking, this means that the maximum federal estate tax rate for purposes of computing the GST tax on such a transfer is deemed to be zero which, when multiplied by any inclusion ratio, will result in an applicable rate of zero.

Allocating exemption where Code Sec. 1022 election made—As under the law prior to 2010, the only way to achieve a zero inclusion ratio for a transfer is to make a timely allocation of GST exemption to the transfer. If the executor of a decedent who died in 2010 makes the Code Sec. 1022 election, the executor is to allocate the decedent's available GST exemption by attaching Schedule R to the Form 8939 for that decedent's estate. If the Form 8939 is timely filed, this allocation will be considered a timely allocation of the decedent's GST exemption.

Electing out of automatic allocation—For inter vivos direct skips that occurred in 2010, if the donor wishes to pay GST tax at the rate of zero percent and, thus, does *not* wish to have any GST exemption allocated to that transfer, the donor may elect out of the automatic allocation of GST exemption to that direct skip in one of two ways.

First, the donor may affirmatively elect out of the automatic allocation, on a timely filed Form 709, by describing both the transfer and the extent to which the automatic allocation is not to apply (Reg. §26.2632-1(b)(1)(i)). That same regulation provides an alternative method by which, “. . . a timely-filed Form 709 accompanied by payment of the GST tax (as shown on the return with respect to the direct skip) is sufficient to prevent an automatic allocation of GST exemption with respect to the transferred property.” Because a 2010 transfer not in trust to a skip person is a direct skip to which the donor would never want to allocate GST exemption, the IRS indicates that it will interpret the reporting of an inter vivos direct skip not in trust occurring in 2010 on a timely filed Form 709 as constituting the payment of tax (at the rate of zero percent) and therefore as an election out of the automatic allocation of GST exemption to that direct skip.

And, the IRS further indicates that this interpretation will apply to a direct skip not in trust occurring at the close of an estate tax inclusion period (ETIP) in 2010 other than by reason of the donor's death. However, because a donor may or may not want to allocate GST exemption to a 2010 direct skip made to a trust, this interpretation will not apply to any transfer in trust that is a direct skip or that occurs at the end of an ETIP. In addition, because this interpretation only applies to inter vivos direct skips, it will also not apply to any direct skip, or to the close of an ETIP, by reason of the donor's death (Reg. §26.2632-1(c)(4)). Finally, the rules regarding the automatic allocation of GST exemption will apply to transfers described in the preceding sentence unless the transferor affirmatively elects to have those rules not apply.

GST return filing due date—The Tax Relief Act of 2010 extended the time for filing any return required under Code Sec. 2662 (including any election required to be made on such return) to report a GST made after December 31, 2009, and before December 17, 2010, to September 17, 2011. Because September 17, 2011, falls on a Saturday, the due date for filing a return reporting a direct skip, a taxable distribution, or a taxable termination (including any election required to be made on such return) that occurred on or after January 1, 2010, through December 16, 2010, is September 19, 2011, including extensions (except for a Schedule R attached to Form 8939, which is due on or before November 15, 2011).

However, the Tax Relief Act of 2010 did not extend the due date of all gift and GST returns for 2010. If a return relates to an indirect skip, or to a post-December 16, 2010, direct skip, the due date of the return is not extended. Thus, the due date for filing a Form 709 that does not report a GST or that reports a GST (or any election pertaining to such transfer) that occurred on or after December 17, 2010, through December 31, 2010, was April 18, 2011, including extensions. In addition, the due date for filing a Form 709 to elect to treat a trust as a GST trust or to allocate GST exemption to a transfer occurring during 2010 under Reg. §26.2632-1(b)(3) or (4) was April 18, 2011, including extensions.

For purposes of applying the GST tax, the notice states that the Treasury Department and IRS will construe and apply any reference to chapter

11 (i.e., the estate tax) without regard to whether the executor of a decedent who died in 2010 made a Code Sec. 1022 election.

Notice 2011-66: Collateral Issues

Transfer Certificates (Reg. §20.6325-1)—Notice 2011-66 also deals with various procedural issues. For example, Code Sec. 6325(c) and its related regulations provide procedures for issuing a certificate of discharge for any property subject to any lien imposed by Code Sec. 6324. In the case of a transfer agent holding property registered in the name of a nonresident decedent who is not a citizen of the United States, Reg. §20.6325-1(a) provides that

If the Code Sec. 1022 election is made, Code Sec. 1022 applies to determine a recipient's basis in all property acquired from that decedent, regardless of the year in which the property is sold or distributed.

the IRS may issue a transfer certificate to permit the transfer of property without liability for such decedent's estate tax.

Notice 2011-66 states that concerns have been raised as to whether it is still necessary to obtain such transfer certificates prior to transferring property owned by nonresident decedents who are not U.S. citizens, who died in 2010, and whose executors make the Code Sec. 1022 election. The notice clarifies that a transfer certificate is not required, and the IRS will not issue transfer certificates, with respect to the property of a nonresident decedent who is not a U.S. citizen, who died in 2010, and whose executor makes the Code Sec. 1022 election.

Election under Code Sec. 645—If an executor makes the Code Sec. 1022 election, no estate tax return is required to be filed. Accordingly, if an executor makes the Code Sec. 1022 election, the “applicable

date” for purposes of the Code Sec. 645 election to treat a decedent's qualified revocable trust as part of the estate for income tax purposes will be two years after the date of the decedent's death.

The Treasury Department and the IRS have invited the public to comment on the guidance contained in Notice 2011-66, and intend to issue regulations to confirm the guidance set forth in the notice.

Rev. Proc. 2011-41: Safe Harbor Guidance

Released in tandem with Notice 2011-66, Rev. Proc. 2011-41 provides optional safe harbor guidance under Code Sec. 1022. Accordingly, if the executor makes the Code Sec. 1022 election, follows the applicable provisions of the revenue procedure, and takes no return position contrary to the revenue procedure, the IRS will not challenge the taxpayer's ability to rely on the provisions of the revenue procedure either on the Form 9939 or any other tax return.

A portion of Rev. Proc. 2011-41 consists of stating the basic operation of Code Sec. 1022. The fundamentals

of the carryover basis regime have been previously discussed (see *Modified Carryover Basis: What an Executor Needs to Know*, ESTATE PLANNING REVIEW, September 23, 2010, page 68). In the interests of space, the discussion below will focus on clarifications made to the application of Code Sec. 1022 in circumstances not directly addressed by the statutory language.

Code Sec. 1022 applies to sale in any year—If the Code Sec. 1022 election is made, Code Sec. 1022 applies to determine a recipient's basis in all property acquired from that decedent, regardless of the year in which the property is sold or distributed. Accordingly, if such property is sold in 2010 or any subsequent year, the recipient's (seller's) basis in the property is determined under Code Sec. 1022, not Code Sec. 1014.

IRD not covered—Code Sec. 1022 will not determine the recipient's basis in all types of property

transferred from a decedent who died in 2010. Among the types of property not covered by Code Sec. 1022 is property that constitutes a right to receive an item of income in respect of a decedent (IRD) under Code Sec. 691. For example, annuities subject to income tax under Code Sec. 72 would be considered property that constitutes the right to receive an item of IRD.

Decedent's interest in QTIP not covered—The definition of property acquired from the decedent (Code Sec. 1022(e)) does not include a decedent's interest in a qualified terminable interest property (QTIP) trust funded for the benefit of the decedent by the decedent's predeceased spouse. (Similarly, such an interest in a QTIP trust is not considered to be owned by the decedent.) Accordingly, this property is not subject to Code Sec. 1022 and a recipient's basis in the property will not be determined under Code Sec. 1022.

Trusts created by decedent during life—Property transferred by the decedent during life to a trust in which the decedent retained a power to alter, amend, or terminate the trust is not considered owned by the decedent for purposes of Code Sec. 1022(d). Moreover, property transferred by the decedent during life to a trust in which the decedent retained an income interest is not considered owned by the decedent at death solely because of the retained income interest. However, if the terms of a trust require the trust property to revert back to the decedent upon death, then such property is deemed to be owned by the decedent.

Carryovers and unrealized losses—In calculating the "Carryovers/Unrealized Losses Increase" under Code Sec. 1022(b)(2)(C), losses described in Code Sec. 165(c)(3) (casualty, theft, etc.) are sustained prior to the decedent's death and would not arise on a hypothetical sale of the property. Such losses must instead be claimed on the decedent's final Form 1040, and may not be included in the Carryovers/Unrealized Losses Increase. For purposes of computing unrealized losses, the capital loss limitations referred to in Code Sec. 165(f) are ignored.

The decedent's share of loss carryovers and unrealized losses under Code Secs. 172 and 1212(b) will be determined pursuant to existing income tax rules if the decedent's final Form 1040 is filed jointly with the decedent's surviving spouse.

Allocating spousal property basis increase in event of sale—The executor may allocate "Spousal Property Basis Increase" (Code Sec. 1022(c)) to qualified spousal property that has already been distributed (see previous discussion of Notice 2011-66 regarding amending Form 8939 for the purpose of allocating Spousal Property Basis Increase) and to property that is sold prior to its distribution. The executor must (1) certify on the Form 8939 that the net proceeds from the sale will be distributed to the decedent's surviving spouse in a manner that would qualify property as qualified spousal property, and (2) attach to such form each document providing a bequest or devise to the surviving spouse.

Allocating spousal property basis increase to CRT—Spousal Property Basis Increase also may be allocated to property held by a testamentary charitable remainder trust (CRT) assuming the surviving spouse is the sole non-charitable beneficiary of such trust and the CRT would have qualified for the marital deduction under Code Sec. 2056(b)(8) if the executor of the decedent's estate had not made the Code Sec. 1022 election.

Allocating basis increase—Basis increase may be allocated to property owned by and acquired from the decedent even after the executor has disposed of or distributed the property. However, the executor may not allocate any basis increase to increases in value that occur after the decedent's death.

If, by reason of the decedent's death, the decedent's property is divided into different interests that are not undivided portions or fractional interests, basis increase may not be allocated separately to the various interests in that property created by reason of the decedent's death. For example, basis increase could not be allocated separately to the life estate and remainder interests created upon the death of the decedent where the property was owned outright by the decedent at death.

Determination of fair market value—The fair market value of property acquired from a decedent who died in 2010 is determined in the same manner for purposes of Code Sec. 1022 as it would be for purposes of the estate tax. Therefore, the executor must attach any appraisals required under Code Sec. 2031 to the Form 8939. For purposes of Code Sec. 1022, the fair market value of an undivided portion of the decedent's property that is

acquired from the decedent at death is a fractional share of the fair market value of the decedent's property at death.

Community property rules—The surviving spouse's basis in his or her one-half interest in community property, as determined under Code Sec. 1022(a), will be the *lesser* of the surviving spouse's adjusted basis for that interest in such community property or the fair market value of that interest on the decedent's date of death. Basis increase may be allocated to the surviving spouse's one-half interest in such community property.

If both spouses' interests in such community property are treated as owned by and acquired from the decedent, then all of the unrealized losses per Code Sec. 165 are eligible to be included in the General Basis Increase (Code Sec. 1022(b)). But, only the decedent's net operating and capital loss carryovers are eligible to be included in the General Basis Increase. And, to the extent such carryovers are deductible on the final jointly filed Form 1040, they are not available to be added to the General Basis Increase.

Charitable remainder trusts—A testamentary CRT that otherwise qualifies as a CRT under Code Sec. 664, but fails to meet the requirement for a deduction under Code Sec. 2055 solely because the decedent's executor makes the Code Sec. 1022 election, will qualify as a CRT.

Interaction of Carryover Basis With Other Provisions

Rev. Proc. 2011-41 also contains a section (4.06) detailing the interaction of Code Sec. 1022 with certain other income tax provisions. The basic principles are as follows:

1. To the extent that the recipient's basis in property acquired from the decedent is determined under Code Sec. 1022, the recipient's holding period of that property will include the period during which the decedent held the property,

whether or not the executor allocates any basis increase to that property.

2. The tax character of property acquired from the decedent by a recipient will be determined in the same way as the holding period. Thus, to the extent a recipient's basis in property is determined under Code Sec. 1022, the tax character of the property is the same as it would have been in the hands of the decedent.
3. If Code Sec. 1022 applies to property acquired from the decedent that is depreciable property in the hands of the recipient, 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.
4. With respect to passive activity losses, Code Sec. 469(j)(6) (the provision dealing with interests in passive activities transferred by gifts), rather than Code Sec. 469(g)(2), applies to determine the decedent's adjusted basis in such property.
5. The rules in Code Sec. 1040 relating to the distribution of appreciated property to satisfy a pecuniary bequest apply to qualified revocable trusts, as well as to trusts that would have been included in the decedent's gross estate under Code Sec. 2036, 2037, or 2038 had the decedent's executor not made the Code Sec. 1022 election. (However, the provisions of Code Sec. 1040 do not apply to the distribution of property that constitutes the right to receive an item of IRD in satisfaction of a pecuniary bequest.)
6. For transfers of property occurring at the death of a decedent whose executor makes the Code Sec. 1022 election, Code Sec. 684 also applies to transfers of property by U.S. persons to non-resident aliens. If the property is owned by and acquired from the decedent, the executor's allocation of basis increase will be deemed to occur prior to the application of Code Sec. 684.