Step Up In Basis - What's Estate Tax Inclusion Got To Do With It?

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In short, everything. Perhaps you don't work with taxable estates and therefore feel that you don't need to know the estate tax inclusion rules. Because basis adjustment (step up in basis) generally applies to all property included in the decedent's taxable estate, knowledge of the inclusion rules is essential if you give income tax advice with respect to estate planning or estate administration.

The purpose of this article is to address some of the common misunderstandings about "basis adjustment on death," commonly referred to as "step up in basis." A non-technical definition of "basis" that clients seem to understand is that it is the "cost" to be subtracted from the sales price to calculate the taxable capital gain upon the sale of property. When explaining step up in basis to your client, be prepared for this response: "What? You mean nobody ever pays the tax on that increase in value?" Of course, that is correct.

So the larger the basis of an asset, the less tax is due upon sale of the asset. Beyond that, basis is also important for retained inherited assets for which a depreciation deduction is allowed, such as rental real estate.

As one commentator humorously observed: "Step up in basis represents the best strategy available to the average taxpayer to avoid the capital gains tax on investments; you just have to die to get it."

The current estate tax exemption ($11.4 million in 2019) has eliminated the need for estate tax planning for most clients. Many estate planning attorneys are now focusing more on income tax planning. Basis adjustment is often a very important component of such planning.

Basis adjustment at death is statutory; it is part of the Internal Revenue Code ("IRC"). To understand what property might be subject to basis adjustment, it is necessary to review the relevant IRC sections which are paraphrased below. I have included the actual IRC section numbers in the text of this article, rather than as a footnote, to assist the reader in referring to the Code for further amplification. Quoting the entire code sections would be space prohibitive.

Furthermore, space requires that this article be limited solely to basis adjustment issues, and therefore does not address other planning issues. For instance, whether or not a mother should deed her home to her son involves far more planning issues than just basis adjustment on death.

IRC Section 1014 is the sole source for basis adjustment upon death: The basis of property acquired from a decedent shall be the fair market value of the property at the date of the decedent's death (or the alternate valuation date is so elected in the estate tax return).

IRC 1014(c) excludes from this section any property which represents income in respect of a decedent (see IRC 691). Therefore, there is no step in basis on annuities, Section 529 plans, the interest build-up in U.S. Savings Bonds, and IRAs, 401(k)s, or other such plans, and the deferred recognition of capital

gain in an installment note owned by the decedent.

IRC 1014(e) denies step up in basis for appreciated property which is gifted during the one year period prior to the decedent's date of death and which is reacquired from the decedent by the donor (or the donor's spouse) upon the decedent's death. Carry over basis applies to both the original transfer of property as a gift, as well as when the property is reacquired by the original donor. This provision prohibits the taxpayer from obtaining a step up in basis by transferring property to a dying person who then leaves the property back to the taxpayer.

Planning note: Some clients might be willing to take a chance on this, figuring they have little to lose if neither the donor nor the donee are likely to be subject to federal estate taxes. A donor may even consider having the donee (a dying parent?) change the donee's estate plan such that if the donee does die within one year of the transfer, that the asset will pass NOT back to the donor, but to the donor's children. Those children would inherit with a basis step up even if the donor's parent dies the next day. That strategy should work as long as the children retain the asset or proceeds from sale. But if they return the property to the donor, the IRS would likely deny basis adjustment under the step transaction theory.

IRC 1014(b) lists the property which is considered to have been acquired from or to have passed from the decedent, which, of course, includes all property acquired by bequest, devise, or inheritance, or by the decedent's estate, from the decedent.

IRC 1014(b)(6) provides for a basis adjustment for 100% of community property; that is, for both spouse's shares on the first death. Although Colorado is not a community property state, it may be important for couples moving to Colorado to retain their existing property as community property.

IRC 1014(b)(9) is perhaps the most relevant subsection for this article for it states that the value of the decedent's gross estate shall include: "... property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), *if by reason thereof the property is required to be included in determining the value of the decedent's gross estate (my italics).* ...

If property gifted by the decedent prior to death is not included in the decedent's taxable estate, there is no basis adjustment, and carry over basis applies. However, if the gifted property is includible in the decedent's gross estate and has not been sold by the donee prior to the decedent's date of death, there will be a basis adjustment in the hands of the donee. Pursuant to IRC 1014(b)(9), the adjusted basis, however, will be reduced by any income tax deduction taken by the recipient for depreciation, depletion, or amortization.

Treasury Regulation 1.1014-2(b) provides that IRC 1014 includes all property acquired from a decedent which is includible in the decedent's taxable estate, and that this section applies even if an estate tax return is not required to be filed.

IRC 1014(b)(9) leads to the question: What property is required to be included in the value of the decedent's gross estate? Here is a brief summary of some of the more relevant code sections that require inclusion:

IRC 2033 includes the value of all property to the extent of the interest therein of the decedent at the time of his death. Example: Everything the decedent owns.

IRC 2036 includes the value of any property which the decedent transferred, by trust or otherwise, but in which the decedent retained the right to income or enjoyment, or the right to change the beneficiaries thereof. Examples: Property transferred to the decedent's revocable living trust prior to death is included in the decedent's gross estate, as is property transferred by the decedent in which he decedent retained a life estate.

IRC 2040(a) includes the value of all property held in joint tenancy by the decedent and another person, except to the extent the other person contributed to the acquisition of such property or otherwise received the property from someone other than the decedent.

Example 1: Mom retitles her home in joint tenancy with her son. No consideration is paid. Mom dies. The entire value of the home is includible in her gross estate. The son's basis is the full fair market value on Mom's death. Example 2: Son dies first. None of the value of the home is included in his taxable estate. Mom's basis is unaffected. Example 3: Mom dies and leaves her home in joint tenancy with her two children. One child dies. Only that child's 50% interest is included in the child's taxable estate. There is an excellent example of applying this contribution rule on Page 10 of IRS Publication 551 (December 2018).

However, IRC 2040(b) provides that with respect to a qualifying joint tenancy solely between a married couple, only 50% is included in the taxable estate of the decedent. Contribution is not a factor.

Example: Husband retitles his home in joint tenancy with his wife. Husband dies. One-half of the value is included in the value of his gross estate, and only his half receives a basis adjustment; ditto if the wife dies first.

However, if mom, dad, and son hold property in joint tenancy, and mom dies, the contribution rule applies as such tenancy is not a "qualifying joint tenancy."

IRC 2041 includes the value of all property over which the decedent held a general power of appointment at the time of his death, or the value when such power was relinquished during his lifetime.

A general power of appointment is defined as a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is not be deemed to be a general power of appointment.

Example: Decedent's father created a trust from which the decedent is granted the power to remove 10% of the trust corpus per calendar year. The decedent dies in January before removing any property. 10% of the trust value in included in the decedent's gross estate. 10% of the trust assets are subject to basis adjustment.

Had the trust been a purely discretionary trust for the decedent's general welfare, and the decedent was not serving as trustee and did not have the power to remove and replace the trustee, the value of the trust property would not be included in the value of the decedent's gross estate. Similarly, if the trust distributions to the decedent were limited to the decedent's ascertainable standards, there would be no inclusion (and no basis adjustment), even if the decedent had been serving as trustee.

IRC 2044 includes the value of any trust in which the decedent had a qualifying interest under IRC 2056. Example: John dies and leaves his assets to a Qualified Terminable Interest Trust ("QTIP") for the benefit of his surviving spouse. The QTIP election was made on the timely filed estate tax return. When the surviving spouse dies, the value of the QTIP trust is included in the value of her gross estate. Basis adjustment applies to the QTIP property.

Note, however, that even though a trust may meet the requirements for a QTIP election, unless an estate tax return was timely filed by the estate of the creator of the QTIP AND the QTIP election was made, the trust is not includible in the surviving spouse estate and receives no step up in basis.

Not surprisingly, the internet contains considerable incorrect advice on the topic of basis adjustment, and even including advice offered by some experienced attorneys, CPAs, and financial planners. Here are a few examples:

"There has to be a transfer at death to get a step up." Although the inclusion rules include property transferred at death, they also include property in a number of situations in which the property was transferred prior to death.

"You can elect step up in basis on the decedent's death." No, basis adjustment is mandatory, including a step down in basis if the fair market value on death is less than the decedent's basis in the asset.

"Step up in basis is an income tax concept and has nothing to do with the federal estate tax." (Just the opposite; if an asset is not included in the decedent's taxable estate, there is no basis adjustment; similarly, if the property is included in the decedent's taxable estate, there is basis adjustment for most property, even if no estate tax return is filed or required to be filed.

"Gifted property never receives a step up in basis." If the decedent makes a completed gift prior to the decedent's death, the value of the property is generally excluded for the decedent's gross estate and there is no basis adjustment. However, there are numerous situations discussed above in which the value of property that has been gifted may be included in the decedent's gross estate. As a result, such gifted property, if not sold before the donor's death, will receive basis adjustment.

"If mom deeds her home to her child, there will be no step up in basis on mom's death." That statement may or may not be true, depending on the circumstances. In the most common example, mom continues to live in the home until her death and pays no rent to her child. The IRS has consistently required inclusion in the taxable estate in situations like under IRC 2036, arguing that there is retained right to use the property, even though informal and perhaps not legally enforceable, but obviously by agreement.

On the other hand, if mom moves out and the child moves into the home or rents its out and keeps the rent, there would be no inclusion on mom's death, and thus no step up in basis.

Planning point: When deeding a home from a potential Medicaid applicant to the children, consider having both grantor and grantee(s) concurrently sign an agreement that the potential applicant has the right to return to the home to occupy the property at any time by giving sixty day notice. Doing so will result in the value of the home being included in the applicant's gross estate, even if the applicant spends many years in a nursing home, and thus a basis adjustment on the applicant's death.

"If mom deeds her home into joint tenancy with her daughter, there will only be a step up in basis on mom's one-half." Not true. The inclusion rule for non-spouses considers contribution. Assuming daughter did not contribute to the acquisition of the home, there is 100% inclusion on mom's death, and thus 100% step up in basis. Ironically, if the daughter gives her one-half interest in the home back to mom, and mom dies within one year of such transfer, basis adjustment on the one-half that was transferred back would be denied under IRC 1014(e).

Basis adjustment, although purely statutory with fairly specific rules, is a complex concept and may be fact specific when estate inclusion is not obvious. For example, when the daughter in the above example sells mom's home many years after mom's death, how does the daughter "prove" that she did not contribute to the acquisition of the property. The attorney settling an estate for which an estate tax return is not filed should consider advising such donee to retain whatever documentation may be available.

Conclusion: Basis adjustment on death is an income tax concept that is largely based upon estate tax inclusion. Therefore, knowledge of the estate inclusion rules is critical when advising clients - and their financial advisors - with respect to basis adjustment. Because there is considerable misinformation in general circulation, the knowledgeable attorney can help their clients to properly address "step up in basis" issues.

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