

Carryover Basis Guidance: Notices 2011-66 & 2011-76 and Revenue Procedure 2011-41

September 2011
Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com

Copyright © 2011 Bessemer Trust Company, N.A. All rights reserved.

This summary reflects the views of Bessemer Trust and is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current opinions only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Table of Contents

INTRODUCTION 1

BRIEF BACKGROUND 1

NOTICES 2011-66 AND 2011-76 1

I. Section 1022 Election and Filing Requirements 1

A. Section 1022 Election..... 2

1. Form 8939..... 2

2. Irrevocable..... 2

3. Form 706 and Form 8939 for Same Estate 2

B. Method to Allocate Basis 2

1. Executor 2

2. Appointed Executor 2

3. Statutory Executor 2

4. Statute of Limitations Remains Open 3

C. Reporting Requirements for Form 8939 3

1. Information Required..... 3

2. Supporting Documentation 3

3. Providing Information to Recipients 3

D. Time for Filing Form 8939 3

1. In General..... 4

a. form 8939 January 17, 2012 Due Date and Amendments 4

b. Form 706 Due Date and Automatic Extensions With Form 4768..... 4

c. No Extensions!! 5

d. No Protective Elections 6

e. Exceptions for Postponement of Due Date Under §§ 7508, 7508A or 692 6

f. Extended Due Date of Form 8939 Does Not Extend Dates of Other Returns 6

2. Relief Provisions 6

a. Allocating Spousal Property Basis Increase Following Distribution to Spouse 6

b. File Amended Form 8939 Under Automatic Six-Month Extension Per Regulation § 301.9100-2..... 7

c. Supplement a Form 8939 Under Reg. § 301.9100-3 to Allocate Additional Basis Increase If There Is After-Discovered Property or If IRS Adjusts Fair Market Value of Property..... 8

d. Relief Exception for Extension to File Form 8939 Under Reg. § 301.9100-3..... 10

II. GST Tax in 2010..... 11

A. With Respect to Decedents Who Died in 2010 11

1. Inclusion Ratio is Not Zero..... 11

| | |
|--|----|
| 2. If Section 1022 Election is Made, Allocate GST Exemption on Schedule R to Form 8939..... | 11 |
| B. Inter Vivos Direct Skips | 11 |
| 1. Timely Filed Form 709 Describing Election Out | 11 |
| 2. Timely Filed Form 709 Reporting Direct Skip Not in Trust | 12 |
| C. Filing Deadlines for Reporting GST Transfers and for Making GST Exemption Allocations..... | 12 |
| 1. GST Transfers..... | 12 |
| 2. GST Exemption Allocations | 12 |
| 3. Indirect Skip or GST Transfer After December 16, 2010..... | 13 |
| D. Chapter 13 Applies to Testamentary Transfers in 2010 Even If Section 2011 Election is Made | 13 |
| III. Income Tax Penalty Relief For Recipients of 2010 Estates That Sell Assets in 2010 | 13 |
| A. Reason for Relief | 13 |
| B. Penalty Relief..... | 14 |
| IV. Collateral Provisions Regarding Nonresident Aliens and Section 645 Elections..... | 14 |
| A. Transfer Certificates for Nonresident Aliens..... | 14 |
| B. “Applicable Date” For Trusts Making Section 645 Election | 14 |
| V. Miscellaneous..... | 14 |
| A. IRS Will Issue Regulations | 14 |
| B. Separate Schedules for Each Recipient..... | 14 |
| C. Anticipated Number of Returns | 14 |
| D. Retain Books and Records | 15 |
| REVENUE PROCEDURE 2011-41 | 15 |
| VI. Overview..... | 15 |
| VII. Section 4.01 — Application of Section 1022 | 15 |
| A. Section 1022 Applies Regardless When Property is Sold | 15 |
| B. Property Not Subject to Section 1022..... | 15 |
| C. “Property Acquired From the Decedent,” Which Is Therefore Subject to Modified Carryover Basis Under § 1022(a) | 16 |
| 1. Bequeathed Assets; Revocable Trust Assets..... | 16 |
| 2. Trusts Includable Under §§ 2036(a)(2) or 2038; Retained Reversionary Interest or Power of Appointment..... | 16 |
| 3. Not Trusts Includable Under § 2036(a)(1)..... | 16 |
| 4. Surviving Spouse’s One-Half Interest in Community Property..... | 17 |
| 5. General Power of Appointment | 17 |
| 6. Not QTIP Property | 17 |

| | |
|--|----|
| D. “Property Owned by the Decedent” to Which Basis Increases May be Allocated..... | 17 |
| 1. Examples of Assets That Constitute “Property Owned by the Decedent” That Can Receive Basis Increase Allocations..... | 18 |
| 2. Not Property Subject to Any Power of Appointment..... | 18 |
| 3. Not Trusts Includable Under §§ 2036(a)(1), 2036(a)(2) or 2038 Unless Retained Reversionary Interest | 18 |
| 4. Not Section 679 Trusts | 18 |
| 5. Decedent Held Reversionary Interest; Does Constitute “Owned by Decedent” | 18 |
| 6. Not QTIP | 18 |
| E. Other Assets Not Eligible For Basis Increase Allocations | 18 |
| 1. Property Acquired by Gift within Three Years of Death..... | 18 |
| 2. Certain Foreign Entities..... | 18 |
| VIII. Section 4.02 — Amount of Basis Increase That May be Allocated to Appreciated Assets | 18 |
| A. Overview and Nomenclature..... | 19 |
| B. General Basis Increase..... | 19 |
| 1. Aggregate Basis Increase..... | 19 |
| 2. Carryovers/Unrealized Losses Increase..... | 19 |
| C. Spousal Property Basis Increase..... | 20 |
| 1. Allocation Only to Assets Transferred to Spouse or QTIP Trust..... | 20 |
| 2. Allocation to Property Where Net Sales Proceeds Will be Distributed to Spouse or QTIP Trust..... | 20 |
| 3. Allocation to Charitable Remainder Trust With Spouse as Sole Beneficiary..... | 21 |
| D. Nonresident Alien Decedents | 21 |
| IX. Section 4.03 — General Rules for Allocating Basis Increase..... | 21 |
| A. Property by Property..... | 21 |
| B. Interest in Property | 21 |
| C. Formula Allocations..... | 22 |
| D. Negative Basis Property | 24 |
| E. Partnerships and Section 754 Election | 26 |
| X. Section 4.04 — Determination of Fair Market Value..... | 26 |
| A. Significance..... | 26 |
| B. General Estate Tax Valuation Principles; Appraisals..... | 26 |
| C. Aggregation Rule | 27 |
| XI. Section 4.05 — Special Rules for Community Property | 27 |
| A. Surviving Spouse’s One-Half Interest Is Treated as Acquired From and Owned by the Decedent | 28 |
| B. Determining Carryovers/Unrealized Losses Increase for Community Property..... | 28 |

| | |
|---|----|
| XII. Section 4.06 — Interaction of § 1022 With Certain Other Income Tax Provisions..... | 28 |
| A. Holding Period | 28 |
| B. Tax Character..... | 29 |
| C. Depreciation of Property Acquired from the Decedent..... | 29 |
| D. Passive Activity Loss Provisions | 29 |
| 1. Background | 29 |
| 2. Suspended Losses Are Added to Basis, Not Deducted on Decedent’s Final Return..... | 30 |
| 3. Addition of Suspended Losses to Basis Either Increases Basis of the Passive Loss Asset or Increases Unrealized Losses That Are Added To General Basis Increase That Can Be Allocated to Other Appreciated Assets | 30 |
| 4. Community Property Passive Losses | 31 |
| E. Rule Limiting Gain Recognition on Funding Pecuniary Bequest to Post-Death Appreciation Is Extended to Qualified Revocable Trusts and § 2036, 2037, and 2038 Trusts..... | 31 |
| F. Gain Recognition Under § 684 On Transfers to Nonresident Aliens Is Determined After Applying Basis Increase Allocations..... | 31 |
| XIII. Section 4.07 — Testamentary Charitable Remainder Trusts Are Recognized..... | 32 |

Introduction

The IRS issued Notice 2011-66 and Revenue Procedure 2011-41 on August 5, 2011, and issued Notice 2011-76 on September 13, 2011. A summary on the IRS website provides that “[t]he IRS expects to issue Form 8939 and the related instructions early this fall.” Notice 2011-66 generally provides the procedures for electing into carryover basis and for making GST exemption allocations and electing out of automatic allocation. Notice 2011-76 provides further procedural relief. Revenue Procedure 2011-41 generally provides “safe harbors” regarding the meaning of terms in Section 1022 and how the carryover basis provisions apply.

Observation: IRS Releases in February and March, 2011 indicated that the Form 8939, instructions to the Form 8939, and Publication 4895, “Treatment of Property Acquired From a Decedent Dying in 2010” would be issued. So far, none of those have been issued. The IRS announcement of the issuance of Notice 2011-66 and Revenue Procedure 2011-41 stated that the Form 8939 and instructions to Form 8939 will be issued “early this fall,” but makes no mention of whether it is still in the process of issuing Publication 4895.

Brief Background

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “Tax Relief ... Act of 2010”) retroactively imposes the estate tax for decedents dying after January 1, 2010, but provides that an executor may instead elect for the carryover basis provisions of §1022 to apply. (This is referred to as the “Section 1022 Election.”) If the Section 1022 Election is made, all “property acquired from the decedent” will have a basis equal to the lesser of the decedent’s basis or fair market value. The executor can allocate several adjustments to increase the basis of assets received by recipients that are both “property acquired from the decedent” and “property owned by the decedent,” as those terms are defined in §1022. (The amount of increased basis from these allocations is referred to as the “Basis Increase.”)

Notices 2011-66 and 2011-76

Purposes of Notice 2011-66

1. How to elect into carryover basis.
2. How to elect out of GST automatic allocation to direct skips in 2010.
3. The due dates of returns for GST purposes (to report a generation skipping transfer, to allocate GST exemption, or to opt out of automatic allocation).
4. The application of the GST tax to testamentary transfers in 2010.
5. Collateral issues (no necessity of transfer certificates for nonresident aliens and the “applicable period” for purposes of § 645 if the carryover basis election is made).

Purposes of Notice 2011-76

1. The applicability of Form 4768 for automatic extensions of time to file and pay estate tax.
2. Provide an extended due date of Form 8939 (January 17, 2011)
3. Provide income tax penalty relief for recipients of 2010 estates that sold estate assets in 2010.

Most of the procedural detail is provided by Notice 2011-66. The discussion below generally will refer to information in Notice 2011-66 unless there is a specific reference to Notice 2011-76.

- I. *Section 1022 Election and Filing Requirements.*

A. *Section 1022 Election.*

1. *Form 8939.* The election is made by filing Form 8939. (**Observation:** If the executor previously filed something else to make the election, the Form 8939 still must be filed to make the Section 1022 Election.)
2. *Irrevocable.* The election may be changed up until the due date (January 17, 2012, as discussed below), but the election in effect on the due date is irrevocable (except as provided in Items I.D.1 and I.D.2, below).
3. *Form 706 and Form 8939 for Same Estate.* If the IRS receives a Form 706 and Form 8939 for the same estate, it will send a letter to the filers. They must collectively file either a restated Form 706 or Form 8939 within 90 days. If they fail to do so, the IRS will determine whether the carryover basis election has been made. The IRS “will consider all relevant facts and circumstances disclosed to the IRS, 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.” (**Observation:** Notice 2011-66 seems to contemplate Forms 706 and 8939 being filed by multiple persons. Does this procedure also apply if both forms are filed by the same person? What if the executor or (or multiple persons) purposefully file Form 706 and Form 8939 to provide additional time for making the election decision?)

B. *Method to Allocate Basis.*

1. *Executor.* Basis adjustments are allocated by the executor. The term “executor” is construed in accordance with § 2203 of the Internal Revenue Code. If there is no court-appointed executor, the term refers to any person in actual or constructive possession of property acquired from a decedent.
2. *Appointed Executor.* If there is a court-appointed executor, the IRS will only accept a Form 8939 filed by the appointed executor. (**Observation:** As discussed in Item I.C.1, below, the executor is required to list all “property acquired from the decedent” [other than cash or IRD assets], even if those assets are non-probate assets.)
3. *Statutory Executor.* If there is no court-appointed executor, any person in actual or constructive possession of property acquired from the decedent may file a Form 8939 of the property he or she actually or constructively possesses.

If multiple Forms 8939 that collectively purport to allocate more Basis Increase than is available to the estate, the IRS will send a letter to filers of the Forms. They must collectively file one restated Form 8939 within 90 days. If they do not do so, the IRS can allocate the Basis Increase in its discretion. It “might be made on a pro-rata basis, based on the amount of unrecognized appreciation ... or in any other manner deemed appropriate.”

(**Observation:** Notice 2011-66 does not address the situation of there being no court appointed executor and only some but not all persons in possession of property filing a Form 8939. Is the Section 1022 Election made (which would apply to all property acquired from the decedent, including property in the possession of those who did not file a Form 8939) or not? If the Election is made, are those persons in possession of property who did not choose to file Form 8939 liable for penalties

under § 6716(a) [\$10,000 for each failure] for failing to file the Form 8939 with respect to property in that person's possession?)

4. *Statute of Limitations Remains Open.* The IRS may contest the basis of a particular property (including the amount of Basis Increase allocated to the property) with respect to any tax return reporting a value dependent on the property's basis (such as depreciation or gain or loss recognition on a sale or disposition of the asset).
- C. *Reporting Requirements for Form 8939.*
1. *Information Required.* Notice 2011-66 summarizes the property that “the executor *must* report” (emphasis added) on the Form 8939 (as required by § 6018(c)). The property includes:
 - All property acquired from the decedent (other than cash or income in respect of a decedent property)
 - Gifts to the decedent within the last three years (other than gifts from the decedent's spouse, unless the spouse had also acquired the property by gift within that three-year period.)
 - For non-resident alien decedents, any property “acquired from the decedent” that passes to a U.S. person, as well as tangible property located in the U.S. that passes to others.
 2. *Supporting Documentation.* Supporting documentation should be included as provided in the instructions to the Form 8939 (which are not yet available). As discussed below, Section 4.04(1) of Rev. Proc. 2011-41 requires attaching “appraisals required under section 2031.” (**Observation:** Apparently, that includes appraisals that must be attached to estate tax returns pursuant to regulations and the Form 706 instructions. See the discussion below of Rev. Proc. 2011-41 for a discussion of what appraisals that appears to require.)
 3. *Providing Information to Recipients.* Within 30 days after filing the Form 8939 (i.e., by February 17, 2012) the executor must provide information to each recipient acquiring property that is reported on the form, regardless whether Basis Increase is allocated to the property. In addition, if any adjustments are made to the basis as reported on Form 8939, the executor must provide updated statements to each recipient affected by the adjustment within 30 days after making the adjustment or receiving notice of the adjustment from the IRS, as appropriate. (**Observation:** The information to be provided to each recipient is listed in 6018(c):
 - Name and TIN of the recipient
 - Accurate description of the property
 - Adjusted basis of the property in the hands of the decedent and fair market value at the date of death
 - Decedent's holding period of the property
 - Information to determine whether gain on sale of the property would be ordinary income
 - Amount of Basis Increase allocated to the property, and
 - Any other information that may be required by regulations.)
- D. *Time for Filing Form 8939 and Form 706.*

1. *In General.*

- a. *Form 8939 January 17, 2011 Due Date and Amendments.* Notice 2011-66 provided a due date of November 15, 2011, but Notice 2011-76 extends the due date to January 17, 2012. The Form may be amended or revoked before the due date, and if that is done, the last Form 8939 that is filed before the due date controls. No executor's Form 8939 will have any effect on a Form 8939 filed by another executor (however, if the multiple Forms filed by different "statutory executors" allocate more than the allowed Basis Increase, they will be contacted to file a collective restated Form 8939 (see Item I.B.3, above).) After the January 17, 2012 due date, the Form 8939 can be amended or supplemented only as provided in three relief provisions, discussed in Item I.D.2 below.

Observation: An IRS release on February 16, 2011 said that the due date of Form 8939 would be no earlier than 90 days after it was issued. (The IRS later backed away from that commitment in a March 31 release, instead stating that there would be "a reasonable period of time for preparation and filing.") The Form 8939 has not been released at least 90 days before the November 15, 2011 due date, but hopefully will be released at least 90 days before the extended January 17, 2012 due date.

Observation: For various reasons, the due date is a "drop dead" date, and it is very helpful that the due date is extended to January 17, 2012. Many difficult decisions must be made between now and then. (See Item I.D.2.c, below, for a discussion of some of the complexities that must be resolved by January 17, 2012.) Part of the critical importance of this "drop dead" date is that the relief exception that specifically addresses Basis Increase allocations prohibits *reducing* any allocation that has already been made, perhaps suggesting that no reduction of Basis Increase allocated to any particular property will be permitted under any of the exceptions. If all of the available Basis Increase is allocated on Form 8939, this effectively means that no changes in the Basis Increase allocations are possible after January 17.

Observation: The AICPA requested the IRS to delay the due date of the Form 8939 until 90 days after the publication of both the Form 706 for 2010 decedents and the Form 8939. The Form 706 for 2010 decedents has been issued and if the Form 8939 is published by October 20, 2011, the extension for filing Form 8939 to January 17, 2012 will satisfy that goal.

- b. *Form 706 Due Date and Automatic Extensions With Form 4768.*

As a practical matter, unless the estate is absolutely sure that it will make the Section 1022 Election, it will need to file a request for extension of time to file the Form 706 (which is extended under the Tax Relief ... Act of 2010 to September 19, 2011 for decedents who died in 2010 before Dec. 17, 2010). Notice 2011-76 acknowledges that because of the length of time that has been required to implement the carryover basis legislative changes and to issue the Form 8939 with related instructions, executors of 2010 estates may not have sufficient time by September 19 to decide whether to make the Section 1022 Election. Notice 2011-76 makes clear that an

automatic six-month extension of the time to file is available by filing Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes. (That was not totally clear previously because the Tax Relief ... Act of 2010 did not explicitly amend § 6075(a) and Reg. §20.6081-1(b) says the automatic 6-month extension applies “beyond the date prescribed in section 6075(a).” The Instructions to the 2010 Form 706 merely say to file Form 4768 “to apply for an automatic 6-month extension of time to file” and do not suggest any special restriction that applies to the extended September 19 due date. The Form 706 for 2010 decedents, posted on September 3, 2011, retains the usual “[i]f you extended the time to file this Form 706, check here” on Item 9 of Part 1, with no indication that any different rules apply for obtaining extensions.)

Furthermore, Notice 2011-76 very helpfully also provides that filing Form 4768 also results in an automatic six-month extension of time to pay estate tax, without any need to substantiate the reason for requesting a payment extension. (However, interest will accrue on the estate tax liability from the original due date, without extensions.) This applies to all 2010 decedent’s estates. For estates of decedents that died before December 17, 2010, the due date is September 19, 2012, so the automatic six-month extension runs to March 19, 2012. For estates of 2010 decedents dying on or after December 17, the automatic six month extension period will end 15 months after the decedent’s date of death. In light of the fact that the payment extension is granted automatically, there appears no reason to file the filing and payment extensions on separate Forms (as directed in the instructions to Form 4768), or even to list the estimated estate tax amount on Form 4768. However, Notice 2011-76 does not address these procedural details about filing the Form 4768 in light of the automatic payment extension provided in the Notice.

Filing the Form 4768 does not preclude the estate from later deciding to file the Form 8939 to make the Section 1022 Election. (This is implicit—though not stated directly—in Notice 2011-76’s reference to needing an extension of time for filing Form 706 because of the uncertainty of whether to make a Section 1022 Election.) If the estate later files the Form 8939, there should be no need to file anything further regarding the estate tax.

- c. *No Extensions!!* “The IRS will not grant extensions of time to file a Form 8939 and will not accept a Form 8939 or an amended Form 8939 filed after the due date” Notice 2011-76 similarly warns that the IRS will not grant any extensions beyond January 17, 2012. However, amended Form 8939s are allowed (i) if a Form 706 and Form 8939 are filed for the same decedent and the IRS notifies the filers to file either a restated Form 706 or Form 8939 [described in Item I.A.3, above], (ii) if multiple Form 8939s are filed allocating more than the allowed Basis Increase and the filers are notified to file a restated single Form 8939 [described in Item I.B.3, above]. and (iii) to report the allocation of Spousal Property Basis Increase to property within 90 days after that property has been distributed to the surviving spouse [described in Item I.D.2.a, below]. Also, there are three

relief provisions to file an amended or supplemental Form 8939 or to file a late Form 8939 under several “9100 relief” exceptions described in Item I.D.2.b-d, below.)

- d. *No Protective Elections.* “[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.” If an executor files a conditional Form 8939, apparently that sentence means the estate will be treated as not having made the Section 1022 Election.

Observation: This statement of a rule prohibiting protective elections does not explicitly cover the more common situation of an estate that is less than \$5 million and is therefore not required to file a Form 706, but the executor files a Form 8939 electing into the carryover basis regime if the gross estate is over \$x million. However, the IRS’s intent is clear that such protective elections on Form 8939 are not allowed and will not be recognized as making a Section 1022 Election even if the stated conditions occur.

- e. *Exceptions for Postponement of Due Date Under §§ 7508, 7508A or 692.* The due date for Form 8939 is postponed as provided in § 7508 (service in or in support of Armed Forces in a combat zone or contingency operation) and § 7508A (presidentially declared disaster or terroristic or military actions). A Form 8939 filed late under those sections should write “Filed Pursuant to Section 7508 [or 7508A if appropriate]” at the top of the Form. However, the failure to do so does not affect the validity of the extension. (**Observation:** As discussed in Item I.D.1.b, above, the IRS generally will not even accept a late filed Form 8939. The handwritten notation notifies the IRS of the reason for the late filing so that it is not rejected out of hand.) Decedents qualifying for relief under § 692 (providing that income taxes for the year of death and years after serving in a combat zone do not apply to an individual who dies while in active service in the Armed Forces in a combat zone, or as a result of wounds incurred while so serving) must still file Form 8939 to make the carryover basis election. Notice 2011-66 does not specifically say that the Form 8939 must be timely filed in that circumstance, but that appears to be the intent.
- f. *Extended Due Date of Form 8939 Does Not Extend Due Dates of Other Returns.* Notice 2011-76 makes clear that it does not extend the filing or payment due dates for any income tax, gift tax, or state estate or inheritance tax return.

- 2. *Relief Provisions.* There are four situations in which an amended (or in the fourth situation, an initial) Form 8939 is permitted. (The last three all involve “9100 relief” provisions.)

- a. *Allocating Spousal Property Basis Increase Following Distribution to Spouse.* An amended Form 8939 may be filed to allocate Spousal Property Basis Increase to property distributed to a spouse if two requirements are met: (1) there was a timely-filed complete Form 8939 (other than allocation of the full amount of Spousal Property Basis Increase), and (2) such

amended Form 8939 is filed within 90 days after distribution of property to the spouse to which such Basis Increase is allocated. See Item VIII.C.1 for further discussion of allocating the Spousal Property Basis Increase.

- b. *File Amended Form 8939 Under Automatic Six-Month Extension Per Regulation § 301.9100-2.* If the executor timely filed a Form 8939, the executor may file an amended Form 8939 under the provisions of Reg. § 301.9100-2(b), “for any purpose except to make or revoke a Section 1022 Election.” The executor must write “Filed Pursuant to Section 301.9100-2” at the top of the amended Form 8939.

Observation: Reg. § 301.9100-2 allows an automatic six-month extension to make regulatory or statutory elections whose due dates are the due date of the return or due date including extensions, provided the taxpayer timely filed its return for the year the election should have been made and the taxpayer takes corrective action within the six-month period. Corrective action “includes filing an original or amended return for the year the regulatory or statutory election should have been made and attaching the appropriate form or statement for making the election.” No request for letter ruling is required to obtain an automatic extension, and user fees do not apply to taxpayers taking corrective action to obtain an automatic extension under § 301.9100-2.

Observation: This is an important exception to the general rule that amended Forms 8939 are not permitted after the due date. An amended Form 8939 can be filed within the first six months after January 17, 2012, and no letter ruling or user fees apply. Allowing the amendment under Reg. § 301.9100-2 is helpful, in that no letter ruling or user fee is required. However, allowing this amendment under Reg. § 301.9100-2 is somewhat confusing in that the regulation applies to an automatic six-month extension “*to make regulatory or statutory elections,*” but Notice 2011-66 says that the amended Form 8939 cannot “make or revoke a Section 1022 Election.” What other “regulatory or statutory election” is made on the Form 8939? Despite that technical nicety in Reg. § 301.9100-2, the Notice states specifically that an amended Form 8939 may be filed under this second relief exception “*for any purpose* except to make or revoke a Section 1022 Election.” For example, apparently the amended Form can allocate Basis Increase, allocate GST exemption, or make changes to any information listed on the Form (such as listing property passing to particular recipients, descriptions of property, fair market values of property, etc.).

The third relief exception, discussed in Item I.D.2.c. immediately below, allows allocating additional Basis Increase in two limited circumstances, after going through the administrative complexity of obtaining a letter ruling and paying a hefty user fee. Apparently, the process the IRS has chosen to adopt (1) allows additional Basis Increase allocations by an amended Form 8939 under the automatic 6-month extension procedure of Reg. § 301.9100-2 from January 17, 2012 to July 17, 2012 (perhaps with the limitation that any prior allocations could not be reduced, as discussed

below in the discussion of the third relief exception), and (2) allows additional Basis Increase allocation after July 17, 2012 in only two limited situations and only by complying with the cumbersome procedures of Reg. § 301.9100-3.

Observation: Query, what is the policy reason for allowing additional Basis Increase allocations in the first six months by merely filing an amended Form 8939 under this second relief exception, but imposing severe limitations and administrative complexities after that six-month period? What is abusive about being able to allocate additional available Basis Increase allocations after the Form 8939 is filed under an easy-to-file procedure? Section 1022(d)(3)(A) states that the executor shall allocate the Basis Increase adjustments “on the return required by section 6018” (i.e., the Form 8939), but § 1022(d)(3)(B) provides that any allocation made pursuant to subparagraph (A) (i.e., Basis Increase allocations on Form 8939) “may be changed only as provided by the Secretary.” This appears to give the Treasury the authority to allow Basis Increase allocations under any procedure that it specifies and does not mandate having to use the Reg. § 301.9100-3 cumbersome procedures.

- c. *Supplement a Form 8939 Under Reg. § 301.9100-3 to Allocate Additional Basis Increase If There Is After-Discovered Property or If IRS Adjusts Fair Market Value of Property.* If a Form 8939 has been timely filed, the executor may request relief to supplement the Form under Reg. § 301.9100-3 for the sole purpose of allocating any Basis Increase that has not previously been validly allocated. However, relief can be granted only in two situations: (1) the executor discovers additional property after filing Form 8939, and/or (2) the fair market value of property reported on the Form 8939 is adjusted in an IRS examination.

The supplemental Form cannot *reduce* an allocation of Basis Increase made on the timely filed Form 8939 — it can only allocate additional Basis Increase that was not previously allocated. **Observation:** Query, does the prohibition on reducing a previously made Basis Increase allocation under this relief provision that specifically addresses changes to Basis Increase allocations reflect that the IRS intends that no reductions in Basis Increase previously allocated to a particular property will *ever* be allowed under any of the relief provisions?

Observation: Reg. § 301.9100-3 permits extensions of time for regulatory elections that do not meet the requirements for “9100-2 automatic extension relief.” Extensions are granted only if the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and the grant of relief will not prejudice the interests of the Government. Reasonable action and good faith include failing to make an election “because of intervening events beyond the taxpayer’s control.” Reg. § 301.9100-3(b)(1)(ii). The two situations described in this third relief exception seem to fall within the “intervening events” circumstance. An extension request under Reg. § 301.9100-3 is a request for a letter ruling and requires applicable user fee. The request must be accompanied by an

affidavit and declaration from the taxpayer describing “events that led to the failure to make a valid regulatory election and to the discovery of the failure.” In addition, there must also be affidavits from individuals having knowledge about events that led to the failure to make a valid regulatory election, including the taxpayer’s return preparer or other tax advisor who advised the taxpayer with regard to the election.

Reg. § 301.9100-3 allows the IRS to grant an extension of time for making “regulatory elections.” Apparently, the IRS is treating the Basis Increase allocation as a “regulatory election.”

Observation: Forcing taxpayers to go through the complicated process of a ruling request, with the required accompanying “fall-on-your-sword” affidavits, and with the required stout user fee of \$14,000 (unless the taxpayer qualifies for a reduced fee, which can apply for decedents with gross income under \$1 million), see Rev. Proc. 2001-1, Appendix A (A)(3)(c), in order to allocate additional Basis Increase in these two non-abusive situations seems quite unfortunate.

Observation: After July 17, 2012, this third relief exception is the only possible way of supplementing information on a timely filed Form 8939 (other than the very limited exception under the first exception for reporting Spousal Property Basis Increase to assets subsequently distributed to the surviving spouse). (The fourth relief exception, discussed below, only applies to an extension of time to file the Form 8939, thus making the Section 1022 Election, not to amending or supplementing a previously filed Form 8939.) This third relief exception only covers filing supplemental information in very limited situations (allocating additional Basis Increase but only if additional property is discovered or the fair market values of assets are changed in an IRS audit.) How can the estate provide updated information in the myriad other events that might occur necessitating supplemental information? Examples could include: discovering additional information about the accurate basis of assets; finding out that there are additional carryovers as a result of future income tax audits; finding out that there are additional unrealized losses as a result of actual sales, audit changes or other reasons; discovering fair market value changes by reasons other than an IRS audit (such as, for example, subsequent actual sales); or a subsequent determination by the IRS that the originally determined carryover basis of an asset was wrong, meaning that Basis Increase may have been either over-allocated or under-allocated to that asset.

Observation: The severe limitations on being able to make changes to the Basis Increase allocations suggested in this relief exception emphasizes the critical importance of making the decision of how the allowable Basis Increase will be allocated on the Form 8939 by January 17, 2012. These decisions can be quite difficult and complex, both in determining the tax effects of the allocations as well as the fiduciary issues of treating beneficiaries fairly. There may be considerable difficulty in even determining the amount of allowable Basis Increase, in light of the fact that

the \$1.3 million General Basis Increase is increased by the amount of unrealized losses, which obviously depends upon date of death valuations.

Furthermore, deciding how to allocate Basis Increases by January 17, 2012 may be very difficult. There are the obvious situations of conflicts of interests and fights among beneficiaries, with the executor caught in the middle. There may also be situations in harmonious family situations where the optimal allocation depends on future events. For example, Ron Aucutt (McLean, Virginia) poses the scenario of a will that bequeaths a highly appreciated ranch to a spouse and also provides that the spouse will receive one-half of the residuary estate consisting of highly appreciated stock and bonds with no significant appreciation. Does the executor allocate any of the Spousal Property Basis Increase to the ranch? If the executor ultimately decides to distribute the highly appreciated stock to the spouse in satisfaction of his or her part of the residuary estate, allocating the Spousal Property Basis Increase to the stock may be preferable to allocating it to the ranch, because the spouse may be much more likely to sell the stock than the ranch during the spouse's lifetime.

Observation: This exception makes clear that the executor will not be able to reduce the allocation of Basis Increase to any recipient. What if the executor incorrectly determines and overstates the amount of unrealized losses, and therefore overstates the amount of available General Basis Increase, and therefore over allocates Basis Increase? In that situation, there would have to be a reduction of the Basis Increase allocations. Presumably, that will be allowed.

- d. *Relief Exception for Extension to File Form 8939 Under Reg. § 301.9100-3.* An executor may request an extension of time “to file the Form 8939 (thus, making the Section 1022 Election and the allocation of Basis Increase)” pursuant to Reg. § 301.9100-3. Notice 2011-66 suggests that the IRS will apply a strict standard in determining whether relief will be granted:

“Taxpayers 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 (for example, the use of hindsight to achieve a more favorable tax result and/or the lack of records available to establish what property was or was not owned by the decedent at death), which would prevent the grant of the requested relief.”

Observation: This is a broad sweeping relief exception, allowing the late filing for making the election itself and for allocating Basis Increases, but the IRS will apparently apply a strict standard before allowing relief under this exception. However, the stated exception does not (at least explicitly) include the ability to revoke a previously made Section 1022 Election. If relief is granted under this section, this is another situation (in addition to the third relief exception discussed above) in which Basis Increase

allocations could be made after January 17, 2012 if they have not been fully allocated by January 17.

An example of a situation in which this relief *might* be granted is if the executor thinks that the estate is under \$5 million and decides not to file Form 8939 by January 17, 2012 making the Section 1022 Election, but subsequently discovers additional assets that makes the estate larger than \$5 million, and therefore subject to estate taxation. In that situation, the estate may prefer to make the Section 1022 Election. Obviously, the good faith activities and due diligence of the executor would be critical factor in the IRS's consideration of the matter.

II. GST Tax in 2010.

A. *With Respect to Decedents Who Died in 2010.*

1. *Inclusion Ratio is Not Zero.* For 2010, the GST tax rate is zero. Because the GST tax equals the inclusion ratio times the maximum estate tax rate, and because the maximum estate tax rate is 35%, one might argue that the inclusion ratio must therefore be zero. Notice 2011-66 confirms, as expected, that the inclusion ratio is not zero. Rather, the maximum federal estate tax rate is deemed to be zero for this purpose.
2. *If Section 1022 Election is Made, Allocate GST Exemption on Schedule R to Form 8939.* For estates that make the Section 1022 Election, GST exemption is allocated by attaching the Schedule R of Form 8939 to the Form 8939. If the Form 8939 is timely filed by January 17, 2012, Notice 2011-76 makes clear that this allocation would be considered a timely allocation of the decedent's GST exemption effective as of the decedent's date of death pursuant to § 2632. (**Observation:** If an extension is granted under § 301.9100-3 for filing Form 8939, the Form would then be timely filed if filed within the extended period. Query whether a GST exemption allocation on a Form 8939 for which an extension has been granted under Reg. § 301.9100-3, perhaps several years after the date of death, will be treated as a timely allocation of GST exemption as of the date of death?)

Observation: The Schedule R that is attached to Form 8939 presumably will replace and be similar to the Schedule R that would have been filed with the Form 706. Therefore, the Schedule R attached to the Form 8939 (with a due date of January 17, 2012) will include (i) GST exemption allocations to assets passing at death to trusts, and (ii) direct skips occurring at death. See the discussion in Item II.C.1 below regarding reporting issues with the Form 8939 Schedule R.

- ### B. *Inter Vivos Direct Skips.*
- A donor will typically want to elect out of automatic GST exemption allocation for direct skip gifts in 2010, because the GST tax is zero even without any exemption allocation. (That may not be the case for a direct skip gift to a trust, the oldest beneficiary of which is at the grandchildren level, for example, if the donor anticipates that the trust will last for the lives of grandchildren and ultimately pass to more remote generations.) Election out of automatic allocation can be made in two ways.

1. *Timely Filed Form 709 Describing Election Out.* A timely filed Form 709 could specifically describe the extent to which automatic allocation will not apply.

2. *Timely Filed Form 709 Reporting Direct Skip Not in Trust.* Notice 2011-66 observes that a donor would never want to allocate GST exemption to a 2010 direct skip gift not in trust. Regulation § 26.2632-1(b)(1)(i) provides that “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.” To come within this regulation, the IRS will treat the reporting of any direct skip gift not in trust in 2010 as constituting the payment of tax (at a 0% rate), and therefore an election out of automatic allocation of GST exemption to that direct skip.
- C. *Filing Deadlines for Reporting GST Transfers and for Making GST Exemption Allocations.*

1. *GST Transfers.* The Tax Relief ... Act of 2010 provides that returns reporting GST transfers that occurred before December 17, 2010 are not due until September 19, 2011. Accordingly, the due date for reporting direct skips, taxable terminations or taxable distributions that occurred in 2010 before December 17, 2010 is September 19, 2011. However, if the executor files Form 8939, Notice 2011-66 gives this exception to the September 19, 2011 due date: “except in the case of a Schedule R attached to Form 8939, which is due on or before November 15, 2011.”

Observation: The Schedule R that is attached to Form 8939 presumably will replace the Schedule R that would have been filed with the Form 706. Therefore, the Schedule R attached to the Form 8939 (with a due date of January 17, 2012) will include (i) GST exemption allocations to assets passing at death to trusts, and (ii) direct skips occurring at death. Therefore, there is NOT an extended due date to January 17, 2012 for reporting taxable distributions and taxable terminations. They are not reported on Schedule R of Form 706, but they are reported on Form 706-GS(T), Form 706-GS(D) & (D-1). Also, there is no extension of time to January 17, 2012 to report inter vivos direct skips, which are reported on Form 709.

However, there is an extended due date (January 17, 2012) for reporting direct skips occurring by reason of the decedent’s death as well as for allocating GST exemption to transfers occurring at death.

2. *GST Exemption Allocations.* If an estate makes the Section 1022 Election, “the executor allocates that decedent’s available GST exemption by attaching the Schedule R of Form 8939 to the Form 8939 for that decedent’s estate.” Notice 2011-66 also explicitly states that a timely filing of the Form 8939 Schedule R, and an allocation of GST exemption on that form “will be treated as a timely allocation of the decedent’s GST exemption” (and therefore avoiding application of the deemed allocation rules of § 2632(e)(1)). Notice 2011-76 is even more explicit in stating the allocating GST exemption on Schedule R or R-1 of Form 8939 is considered timely and effective as of the date of death, and that “[a]lternatively, the automatic allocation rules under section 263 will apply.”

Observation: A decedent’s unused GST exemption is automatically allocated following death first to direct skips occurring at the decedent’s death, and the balance is allocated pro rata to all trusts from which a taxable termination may occur or a table distribution may be made. § 2632(e)(1). That automatic

allocation occurs on the due date for filing Form 706 (or Form 706NA) to the extent not otherwise allocated by the executor on or before that date. The automatic allocation occurs whether or not a return is actually required to be filed. Reg. § 26.2632-1(d)(2). Avoiding the deemed allocation at death rules may be especially important as to direct skips in 2010, for which the GST tax is zero even without allocation of GST exemption. The deemed allocation at death rules are clearly avoided to the extent that GST exemption is allocated otherwise on the Schedule R of a timely filed Form 8939. There is no necessity of filing Form 4768 to extend the Form 706 in order to extend the time for electing out of the deemed allocation at death rules—IF there is a subsequent timely filing of Form 8939 Schedule R. However, if an estate should decide not to file Form 8939 by January 17, 2012, the GST exemption automatic allocation would be deemed to have been made on the due date of the Form 706 (unless it is extended by filing Form 4768). This could be an important reason to extend the Form 706 if the estate is not absolutely sure that it will file Form 8939 to make the Section 1022 Election.

Observation: What is the statutory authority for extending the due date for reporting GST transfers in 2010 beyond September 19, regardless of whether the estate makes the Section 1022 Election? As discussed above, the extended due date to January 17, 2012 appears to apply only to reporting direct skips occurring at death and not other GST transfers. Section 2662 provides that a direct skip must be reported by the date on which an estate or gift tax return is required to be filed with respect to the transfer. For a testamentary direct skip in 2010, since no estate tax return is required if the Section 1022 Election is made, that ambiguity presumably authorizes the IRS to provide a time period appropriate for replacing the due date of the estate tax return, which obviously would not be relevant to the estate. For inter vivos direct skips, taxable terminations or taxable distributions, there does not appear to be statutory authority for extending the due date past September 19, 2011, and indeed the due date is not extended.

3. *Indirect Skip or GST Transfer After December 16, 2010.* For indirect skips (i.e., transfers to trusts from which there may be distributions to second-generation beneficiaries at some point in the future) and for GST transfers occurring after December 16, 2010, there is no extension of the time for filing GST returns. Therefore, the returns were due April 18, 2011 (or October 17, 2011 if the gift tax return was extended). If the gift tax return was timely filed but the GST exemption allocation was not made, an automatic six-month extension for making GST exemption may be allowed under Reg. § 301.9100-2 (b) (without requesting a letter ruling or paying a user fee).

- D. *Chapter 13 Applies to Testamentary Transfers in 2010 Even If Section 2011 Election is Made.* Notice 2011-66 reiterates provisions in the Tax Relief... Act of 2010 making clear that Chapter 13 applies to 2010 decedents even if the Section 1022 Election is made. (Without this provision in the Tax Relief... Act of 2010, arguably there would be no “transferor” for purposes of the GST tax, because the decedent would not be subject to the estate tax.)

III. *Income Tax Penalty Relief For Recipients of 2010 Estates That Sell Assets in 2010.*

- A. *Reason for Relief.* Notice 2011-76 acknowledges that if a recipient of property from a 2010 decedent’s estate sold any of that property in 2010, there can be considerable

uncertainty as to how to report the gain from that sale on the individual's 2010 individual income tax return, which is due October 15 at the latest, even with extensions. The individual may not know whether the executor will make the Section 1022 Election and may not know important tax information (such as basis, tax character and holding period of the asset), that the executor will eventually provide to the individual (by February 17, 2012).

- B. *Penalty Relief.* Even though the recipient may not know whether the estate will make the Section 1022 Election and may not know basis, tax character, holding period or other pertinent information, Notice 2011-76 recognizes that the recipient will have to file his or her income tax return by October 15, 2011, at the latest, and “will have to make a good faith estimate, based on the facts and circumstances, regarding such information with respect to the property acquired from the 2010 Decedent.” If a recipient's income tax liability is increased “by reason of the application of section 1022 to the estate of a 2010 Decedent,” Notice 2011-76 provides that the recipient's reasonable cause and good faith will be presumed and failure to pay penalties under § 6651(a)(2) and the 20 percent penalty under § 6662(a) will not be imposed.

IV. *Collateral Provisions Regarding Nonresident Aliens and Section 645 Elections.*

- A. *Transfer Certificates for Nonresident Aliens.* For the estate of a nonresident alien who died in 2010, a transfer certificate permitting the transfer of property without liability for estate tax is not necessary if the estate makes the Section 1022 Election, and the IRS will not issue such transfer certificates. Notice 2011-66, ¶III.
- B. *“Applicable Date” For Trusts Making Section 645 Election.* An estate and revocable trust may make an election under § 645 for the trust to be treated as part of the estate for income tax purposes from the date of the decedent's death until the “applicable date.” If the executor makes the Section 1022 Election, no estate tax return is required to be filed, and the “applicable date” will be two years after the date of death. Notice 2011-66, ¶IV.

V. *Miscellaneous.*

- A. *IRS Will Issue Regulations.* The “effective date” section of Notice 2011-66 states that the Treasury Department and the IRS intends to issue regulations to confirm the guidance in the Notice. This intention is repeated in Notice 2011-76. (**Observation:** It is somewhat surprising that the Treasury Department and IRS will go through the formal process of issuing regulations, given that the carryover basis provisions apply only to decedents who died in 2010 for which the estates make the Section 1022 Election.)
- B. *Separate Schedules for Each Recipient.* Section 6018(e) requires the executor to give carryover basis information to each recipient within 30 days after filing the Form 8939. Notice 2011-66 contemplates that the executor will attach separate schedules to the Form 8939 for each recipient detailing property distributed to that recipient, and will send each recipient's statement to the recipient to meet the information reporting requirement.
- C. *Anticipated Number of Returns.* The IRS anticipates that 7,000 estates of decedents who died in 2010 will file Form 8939. Even though only large estates (over \$5 million) will likely file the Form 8939, the IRS estimates that executors will need only approximately 10 hours “to comply with [the Form 8939] filing requirements” (presumably including compiling all of the carryover basis information, making Basis Increase decisions among estate recipients, and describing the assets, basis information, and Basis Increase allocations on the report). (Interestingly, Revenue Procedure 2011-41 estimates that

executors who file the Form 8939 will need approximately eight hours “to prepare the documentation.”) Of the 7,000 estates that file Form 8939, the IRS anticipates that approximately 6,000 of those estates will also file Schedule R to report GST transfers, GST exemption allocations, or elections out of automatic allocation.

- D. *Retain Books and Records.* “Books or records relating to collections of information *must be retained* as long as their contents may become material in the administration of any internal revenue law.” (Emphasis added.) This time period would presumably last until all estate assets have been sold by the recipients, and the statute of limitations has run on income tax returns reporting the gain transactions, and throughout the useful life of any assets being depreciated as a result of Basis Increases allocated to those assets.

Revenue Procedure 2011-41

- VI. *Overview.* Rev. Proc. 2011-41 purports to provide “optional safe harbor guidance” regarding § 1022. However, Revenue Procedure 2011-41 offers few (if any) “safe harbors,” but provides substantive information regarding the meaning of various definitions and the application of provisions in § 1022. (The only “safe harbor” even mentioned in the substantive discussion of Rev. Proc. 2011-41 is that revocable trusts and trusts that would be includable in the estate under §§ 2036, 2037 and 2038 [if the estate tax applied] qualify for the special rule that gain recognition can result from funding pecuniary distributions only with respect to post-death appreciation (see XII.E, below).) That is not really a safe harbor, because the statute specifically contemplates that trusts may be covered by that special rule, to the extent provided in regulations.)

Observation: Planners have been hoping that some true “safe harbor” situations would be addressed by the IRS. For example:

- De minimis rules — Is there a need to allocate basis adjustment to the piano, for example, or should there be de minimis rules?
- If an asset clearly has a value in excess of basis adjustment being allocated to the asset, is a “full-fledged” appraisal necessary, or might a statement that the value far exceeds the possible basis adjustments suffice?

Observation: Perhaps the Rev. Proc. references “safe harbors” because the IRS cannot issue retroactive interpretive regulations more than 18 months after the enactment of the statute under § 7805. Because the Rev. Proc. merely purports to provide safe harbors rather than providing substantive guidance of the meaning of provisions in § 1022, taxpayers may conceivably take contrary positions, knowing that they merely do not fall within a “safe harbor” that has been recognized by the IRS. However, much of the Rev. Proc. reads as substantive interpretation of the statute rather than as providing safe harbors.

VII. *Section 4.01 — Application of Section 1022.*

- A. *Section 1022 Applies Regardless When Property is Sold.* Section 1022 applies to determine a recipient’s basis in property acquired from a decedent “regardless of the year in which the property is sold or distributed.” Rev. Proc. 2011-41, § 4.01(1).
- B. *Property Not Subject to Section 1022.* Section 1022 (a) provides that the basis of “property acquired from a decedent” is the lesser of the adjusted basis of the decedent or fair market value of the property at the date of the decedent’s death. Examples of property not subject to § 1022 are income in respect of a decedent items, annuities subject to income tax under § 72, and the decedent’s interest in QTIP trust property. Another

example is property in which the decedent had a retained beneficial interest (such a QPRT or GRAT), but did not have a reversionary interest or a retained power that would cause estate inclusion under §§ 2036(a)(2) or 2038 (see Item VII.C.2-3 below). For those types of assets, “[t]he recipient’s basis in property that is not subject to section 1022 is determined under other applicable sections of the Code.” Rev. Proc. 2011-41, § 4.01(2).

Observation: If the Section 1022 Election is made, the basis would not be determined under § 1014. The Tax Relief ... Act of 2010 provides that if the Section 1022 Election is made, the provisions of subtitle A or E of title V of the Economic Growth and Tax Relief Reconciliation Act of 2001 are not “repealed.” Subtitle E included section 542, which added § 1014(f) providing that § 1014 would not apply to decedents dying after 2009. Therefore, the asset would retain its basis, not being subject to a “step up” or “step down” in basis under § 1014, and not being subject to a “step down” in basis under § 1022(a) (because it limits the basis to the lesser of the decedent’s basis or fair market value at the date of death).

Observation: For example, with respect to the decedent’s interest in a QTIP trust that was created at the predeceased spouse’s death, the basis established under § 1014 at the predeceased spouse’s death would continue. For property with a beneficial interest decedent, the basis established under § 1015 at the time of the gift would continue. (Under § 1015, the basis is the donor’s basis, but limited to fair market value at the time of the gift for purposes of determining the amount of loss.)

C. *“Property Acquired From the Decedent,” Which Is Therefore Subject to Modified Carryover Basis Under § 1022(a).* Rev. Proc. 2011-41, § 4.01(3).

1. *Bequeathed Assets; Revocable Trust Assets.* Property acquired by bequest, devise or inheritance or by the decedent’s estate from the decedent as well as property in a qualified revocable trust, whether or not the election under § 645 is made for that trust, constitutes “property acquired from the decedent.”
2. *Trusts Includable Under §§ 2036(a)(2) or 2038; Retained Reversionary Interest or Power of Appointment.* Property acquired from a decedent includes a trust with respect to which the decedent reserved the right to make any change in enjoyment through the exercise of the power to alter, amend, or terminate the trust, including trusts in which the decedent retained a reversionary interest or retained a power of appointment.

As an example, a QPRT, for which the decedent does not have a reversionary interest if the decedent dies during the term of the QPRT, is not “property acquired from a decedent.” However, if the grantor has a retained reversionary interest if the grantor dies before the end of the QPRT term (which is typical), it is “property acquired from a decedent,” and therefore subject to § 1022. (In addition, as described below, it is also treated as “owned by the decedent” and therefore qualifies to receive Basis Increase allocations.)

3. *Not Trusts Includible Under § 2036(a)(1).* Trusts in which the decedent has retained a beneficial interest, and that would be includable in the gross estate under § 2036(a)(1), are not “property acquired from a decedent” and are not subject to § 1022. (This is confirmed by Examples 1 [QPRT] and 14 [retained income interest] in Rev. Proc. 2011-41.)

Observation: As an example, assets in a GRAT would not be subject to § 1022 (assuming the grantor has not retained a power that would cause estate inclusion under §§ 2036(a)(2) or 2038). Therefore, even if the grantor dies during the term of the GRAT, such that the GRAT assets would ordinarily be included in the grantor's estate under § 2036(a)(1) if the estate tax applied, the basis of GRAT assets will not be "stepped down" to fair market value if there are depreciated assets, and the GRAT assets are not eligible to receive Basis Increase allocations.

Observation: The rationale for the difference in treatment of § 2036(a)(1) assets (assets with retained enjoyment) versus the treatment of §§ 2036(a)(2) or 2038 assets (for which the decedent can designate who can enjoy the assets including by altering, amending or terminating the trust) seems to be based on *control*. Because of the decedent's greater ability to control the assets in the §§ 2036(a)(2) or 2038 situation, the assets are deemed to be acquired from the decedent. Because the decedent can merely enjoy but not control the disposition of assets subject to inclusion under § 2036(a)(1), recipients of those assets are not deemed to have acquired them from the decedent.

4. *Surviving Spouse's One-Half Interest in Community Property.* The surviving spouse's one-half of community property is subject to § 1022 (and the basis of the surviving spouse's one-half is therefore subject to being "stepped down" to fair market value at the date of death).
5. *General Power of Appointment.* Property over which the decedent held a general power of appointment is "acquired from the decedent" and subject to § 1022. (However, as discussed below, such property is not eligible to receive Basis Increase allocations.)
6. *Not QTIP Property.* The decedent's interest in a QTIP trust that was created by the decedent's spouse for the decedent's benefit is not "property acquired from a decedent" and is not subject to § 1022. (The Revenue Procedure refers to a QTIP trust created by the decedent's predeceased spouse, but there is no reason to treat an inter vivos QTIP trust any differently at the beneficiary-spouse's death.)

Observation: Consider a situation in which a QTIP trust is the major asset that would be in the gross estate if the estate tax applied, and assume the gross estate would be under \$5 million. One ordinarily assumes that an estate of under \$5 million would prefer to be in the estate tax regime rather than making the Section 1022 Election. However, if the QTIP assets are depreciated and if the estate tax regime applies, there would be a "step down" in basis of the QTIP assets to the date of death value. If the Section 1022 Election is made, § 1014 does not apply to step down the basis of the assets, and the QTIP assets are not subject to the rule in § 1022(a) limiting basis to the lesser of the carryover basis or fair market value. The estate may strategically decide that it would prefer to make the Section 1022 Election.

- D. *"Property Owned by the Decedent" to Which Basis Increases May be Allocated.* The \$1.3 million "Aggregate Basis Increase"(together with the "Carryover/Unrealized Losses Increase") and the \$3.0 million "Spousal Property Basis Increase" can only be allocated to property that is both "acquired from the decedent" and "owned by the decedent." Rev. Proc. 2011-41, § 4.01(4).

1. *Examples of Assets That Constitute “Property Owned by the Decedent” That Can Receive Basis Increase Allocations.* Examples of assets that qualify as “property owned by the decedent” include (i) assets legally titled to the decedent (unless held in a legal representative capacity), (ii) certain jointly owned property, whether as tenants in common or with right of survivorship, (iii) assets in a qualified revocable trust, and (iv) both halves of community property.
 2. *Not Property Subject to Any Power of Appointment.* Property over which the decedent holds any power of appointment is not considered owned by the decedent at death. (**Observation:** “General power of appointment property is “property acquired from a decedent” and therefore subject to the modified carryover basis rule of § 1022(a), but is not “property owned by the decedent” and therefore Basis Increase cannot be allocated to it.)
 3. *Not Trusts Includable Under §§ 2036(a)(1), 2036(a)(2) or 2038 Unless Retained Reversionary Interest.* A trust with respect to which the decedent had a beneficial interest or reserved the right to make any change in enjoyment through the exercise of the power to alter, amend, or terminate the trust is not “property owned by the decedent” (unless the decedent retained a reversionary interest, as discussed in Item VII.D.5, below).
 4. *Not Section 679 Trusts.* Property in a foreign trust treated as owned by the grantor for income tax purposes under § 679 is not considered to be owned by the decedent at the grantor's death for purposes of receiving Basis Increase allocations. (**Observation:** Presumably, the same result would apply to property that is treated as owned by a trust beneficiary for income tax purposes under § 678.)
 5. *Decedent Held Reversionary Interest; Does Constitute “Owned by Decedent.”* For the various trusts described above that are not treated as “owned by the decedent,” if the terms of the trust required that the trust property reverted back to the decedent upon his or her death, the property is deemed to be “owned by the decedent” (and therefore can receive allocations of Basis Increase).
 6. *Not QTIP.* An interest in a QTIP trust for the benefit of the decedent is not “owned by the decedent.”
- E. *Other Assets Not Eligible For Basis Increase Allocations.* Certain other assets are described that, by statute, are not eligible for Basis Increase allocations even though they are acquired from and owned by the decedent.
1. *Property Acquired by Gift within Three Years of Death.* Property acquired by the decedent by gift within three years of death is not eligible to receive Basis Increase allocations unless the property was acquired by gift from the decedent's spouse (except where the spouse also received the property by gift within the three-year period). I.R.C. § 1022(d)(1)(C).
 2. *Certain Foreign Entities.* Stock in certain foreign entities, including a foreign personal holding company, DISC, foreign investment company, are not eligible for Basis Increase allocations.

VIII. *Section 4.02 — Amount of Basis Increase That May be Allocated to Appreciated Assets.*

The total basis increase that can be allocated on Form 8939 to property owned by the decedent is referred to as the “Basis Increase.”

Observation: The Revenue Procedure makes clear that the permissible Basis Increase amounts may be allocated to appropriate assets, even if post-death depreciation in the assets would result in the recipient being able to take a loss on the sale of the assets. See, e.g., Rev. Proc. 2011-41, § 4.02(3) Ex. 4.

A. *Overview and Nomenclature.* An algebraic statement of the allowable Basis Increase, using definitions described in Rev. Proc. 2011-41, is as follows:

$$\text{Basis Increase} = \text{General Basis Increase} + \text{Spousal Property Basis Increase}$$

Where

$$\text{General Basis Increase} = \text{Aggregate Basis Increase (\$1.3 million)} + \text{Carryovers/Unrealized Losses Increase}$$

B. *General Basis Increase.* The General Basis Increase consists of the sum of the “Aggregate Basis Increase” (which is \$1.3 million) plus the “Carryovers/Unrealized Losses Increase.”

1. *Aggregate Basis Increase.* Section 1022(b)(2)(B) says that the Aggregate Basis Increase is \$1.3 million.
2. *Carryovers/Unrealized Losses Increase.* The \$1.3 million Aggregate Basis Increase is increased by the sum of capital loss carryovers, net operating loss carryovers, and unrealized losses. Rev. Proc. 2011-41, § 4.02(2)(b).

The carryovers include *capital loss carryovers* under § 1212 (b) and *net operating loss carryovers* under § 172 that would be carried over from the decedent's last taxable year to a later taxable year (but for the decedent's death). If the spouses file a joint return, only the decedent's share of the loss carryovers may be added to the General Basis Increase. (**Observation:** Publication 536, “Net Operating Losses for individuals, Estates, and Trusts” and the § 2503 regulations both address methods to determine the decedent's share of losses. See Cantrell, Leimberg Estate Planning Email Newsletter #1848 (Aug. 15, 2011).) For community property, as discussed below in Item XI.B below, only the decedent's one-half of loss carryovers may be added to the General Basis Increase, and the surviving spouse would retain his or her one-half of the loss carryovers to report on future income tax returns.

Unrealized losses that may be added to the \$1.3 million Aggregate Basis Increase include all losses described in §§ 165(c)(1) (losses incurred in a trade or business), 165(c)(2) (losses incurred in any transaction entered into for profit though not connected with a trade or business — which would include losses from typical capital assets, including passive losses under § 469, but would not include personal use assets such as autos, unless used in a trade or business) from all property acquired from the decedent that would have been allowable as a deduction if the property had been sold at fair market value immediately before the decedent's death. (Losses described in § 165(c)(3) (losses from fire, storm, shipwreck, or other casualty or from theft) would by their nature have been incurred prior to death and would be reported on the decedent's final income tax return and are not included in the Carryovers/Unrealized Losses Increase.)

The full amount of such unrealized losses may be added in determining the General Basis Increase, and the capital loss limitations in §§ 1211 and 1212 (and referred to in § 165(f)) are ignored for this purpose. Accordingly, the \$3,000 annual limitation on losses (\$1,500 for a married individual filing a separate return), to

the extent that losses cannot be offset by gains, is not applicable, and the full amount of unrealized losses can be used.

C. *Spousal Property Basis Increase.* The executor can allocate \$3 million of basis increase to property (i) passing outright to the surviving spouse, or (ii) that is QTIP property (even though there is obviously no QTIP election in light of the fact that an estate tax return is not filed for the estate). (For simplicity, “QTIP property” will subsequently be referred to in this summary as a QTIP trust, since that is the most common type of QTIP property.) This is referred to as the “Spousal Property Basis Increase.” Rev. Proc. 2011-41, § 4.02(3).

1. *Allocation Only to Assets Transferred to Spouse or QTIP Trust.* The executor can allocate Spousal Property Basis Increase on Form 8939 only to property that is transferred outright to the surviving spouse or a QTIP trust. Spousal Property Basis Increase may be allocated to qualified spousal property that has already been distributed. (**Observation:** The Revenue Procedure does not specifically address the allocation of Spousal Property Basis Increase on the Form 8939 to property that is bequeathed or otherwise specified to pass to the surviving spouse or to a QTIP trust, but presumably that is allowed. However, it is not clear whether that can be done for property that may pass to the surviving spouse, where the executor has discretion in selecting assets to fund a pecuniary, fractional, or residuary bequest to the spouse, but the property has not been transferred to the spouse or QTIP trust at the time of the allocation. Notice 2011-66 allows filing an amended Form 8936 to allocate Spousal Property Basis Increase to property that is distributed to a spouse or QTIP trust after the Form 8939 is filed, and perhaps the discretionary funding situation is one of the circumstances contemplated where the executor would have to use the amended Form 8939 procedure to allocate Spousal Property Basis Increase to a particular asset that is ultimately distributed to the spouse or a QTIP trust.)
2. *Allocation to Property Where Net Sales Proceeds Will be Distributed to Spouse or QTIP Trust.* The executor can also allocate Spousal Property Basis Increase to property that is sold by the estate before the property is distributed, where the net proceeds from the sale will be distributed to the spouse or a QTIP trust IF:
 - (i) the executor certifies on Form 8939 that the net proceeds from the sale of the property will be distributed to or for the benefit of the spouse or a QTIP trust, AND
 - (ii) each document providing for a bequest to the spouse or QTIP trust is attached to the Form 8939.

If a portion of the net proceeds from the sale of assets are used to pay administration expenses, Spousal Property Basis Increase can be allocated only to the surviving spouse’s portion of the unrealized appreciation in the asset. Examples 4-6 of Rev. Proc. 2011-41 illustrate this computation.

Observation: This is excellent news for estates that have already sold assets, where the executor intends to distribute the net sales proceeds to the surviving spouse or a QTIP-type trust. If this procedure is not followed with respect to a particular asset, but the executor later decides to sell that asset, the proceeds of which will be distributed to the surviving spouse, there is no clear way under the Revenue Procedure for the executor to allocate Spousal Property Basis Increase to that asset

to decrease the amount of gain recognized by the estate on the sale. Perhaps an allocation of Basis Increase under the first relief exception in Notice 2011-66 (summarized in Item I.D.2.a above) to property distributed to a spouse after January 17, 2012 could allocate Basis Increase to property that is sold after the sale proceeds have been distributed to the spouse. Notice 2011-66 does not make clear that the first relief exception applies to the subsequent distribution of sales proceeds to the surviving spouse. In any event, executors must carefully consider before January 17, 2012 whether any assets will be sold by the estate, the net sale proceeds of which will later be distributed to the surviving spouse or a QTIP-type trust.

The Revenue Procedure addresses how to deal with a situation in which an asset is sold and used partly to pay administration expenses with the balance being distributed to the surviving spouse. What if, instead of using some net proceeds to pay administration expenses, the executor uses some of the net proceeds to fund bequests passing the beneficiaries other than the surviving spouse? Is it possible to allocate Spousal Property Basis Increase to the asset in an amount equal to the portion of the unrealized appreciation at death that is proportionate to the net sales proceeds that will be received by the surviving spouse? Presumably, that is allowed.

3. *Allocation to Charitable Remainder Trust With Spouse as Sole Beneficiary.* Assets distributed to a charitable remainder trust also qualify for the Spousal Property Basis Increase if the spouse is the sole beneficiary of the trust.

- D. *Nonresident Alien Decedents.* For nonresident alien decedents, the General Basis Increase is limited to \$60,000. However, the full amount of the \$3 million Spousal Property Basis Increase can be allocated to property to property passing to a spouse or QTIP trust.

IX. *Section 4.03 — General Rules for Allocating Basis Increase.* Rev. Proc. 2011-41, § 4.03.

- A. *Property by Property.* The allocations are made on a property-by-property basis, but the basis of each such property, after the allocation, cannot exceed the fair market value of the property at the decedent's death.
- B. *Interest in Property.* Basis Increase can be allocated to each “interest” in a property. For example, Basis Increase could be allocated to some but not all shares of stock in a particular company, or to a life estate or remainder interest owned by the decedent. However, it cannot be allocated separately to separate interests that are created by reason of the decedent’s death that are not undivided portions or fractional interests of each and every interest in the property that was owned by the decedent. For example, if the decedent’s will creates a life estate and remainder interest in property, the basis allocation could not be made separately to those separate interests. However, if the decedent bequeathed undivided fractional interests in the property to various recipients, the Basis Increase could be allocated to the fractional interests distributed to certain recipients and not others.

Observation: The draft Form 8939 available on the IRS website requires listing property acquired from the decedent by each recipient. Instructions have not been issued. It is not clear whether, or how the executor might be able to allocate any of the General Basis Increase to an interest in a property that will be distributed to one recipient but not interests in that same property that will be distributed to other recipients.

Observation: The Notice does not address the very common situation of real property consisting of a building and land. Will the building and land be treated as separate interests, such that Basis Increase could be allocated just to the building [which can be depreciated] and not the land [which cannot be depreciated]? Michael Jones (Monterey, California) points out that the IRS will likely view the building and land as separate interests. For example, a taxpayer is required to allocate acquisition costs between the land and building upon acquisition of the property. Cost segregation studies are common to assign acquisition costs to various assets that are part of an acquisition.

- C. *Formula Allocations.* **Observation:** For a variety of reasons, making a formula allocation of Basis Increase may be ideal. The Revenue Procedure does not address formula allocations specifically. It is likely that formulas based on subsequent events that do not exist at the date of death would not be recognized. For example, a formula allocation of Basis Increase to assets in the order that they are later sold by the estate or estate beneficiaries may not be respected. However, formula allocations based on facts (including values and the amounts of carryovers and unrealized losses at the date of death) should be respected. (If there are adjustments in the allocations under the formula based on finally determined values, carryovers, unrealized losses, etc., those automatic adjustments to the Basis Increase allocation under the formula should not be a “changed” allocation requiring the approval of the Secretary of the Treasury under § 1022(d)(3)(B).) It is unfortunate that the “safe harbors” in Rev. Proc. 2011-41 do not confirm the validity of using formula allocations.

The very narrow relief provisions in Notice 2011-66 suggest the wisdom of allocating Basis Increase by formula. Michael Jones (Monterey, California) recommends that planners “[c]onsider using a formula allocation to avoid wasting any part of the basis increase allowance.” The following are several situations in which having a formula allocation could prove helpful.

- *Values Reduced on Audit.* If the IRS on audit reduces the fair market value of an asset with the result that the executor purported to allocate more Basis Increase to the asset than was permissible, additional Basis Increase should be available to allocate to other assets. However, in that situation, Notice 2011-66 requires the executor to go through the complicated procedure of Reg. § 301.9100-3 (and pay a hefty user fee) to be able to allocate that additional Basis Increase to other assets. (In addition, it may be possible to file an amended Form 8939 making the additional Basis Increase allocation by July 17, 2012 under the more relaxed procedures—including no user fee—of Reg. § 301.9100-2, as allowed in the second relief exception in section I.D.2 of Notice 2011-66.)
- *Values Reduced for Other Reasons.* The executor may discover that the fair market value of an asset is different than believed at the time the Form 8939 was filed, for example because of an actual sale of the asset at a significantly different value even though general economic conditions for that asset have not changed.
- *After Discovered Property.* If the executor discovers additional property after the Form 8939 is filed and if the executor had not allocated all of the available Basis Increase, the executor again can use the complicated procedure of Reg. § 301.9100-3 (and pay a hefty user fee) to allocate the available Basis Increase to the after discovered property. (Again, the more simplified procedure may be available up to July 17, 2012.)

- *Additional Carryovers or Unrealized Losses.* If the estate (or IRS in an audit) later determines that the amount of capital loss carryovers, net operating loss carryovers, or unrealized losses was greater than estimated when the Form 8939 was filed, there would be an additional amount to be added to the \$1.3 million basis adjustment, resulting in additional Basis Increase that could be allocated to estate assets.
- *Incorrect Identification of Property Acquired By and Owned By Decedent.* If property is incorrectly identified as being acquired from and owned by the decedent, Basis Increase may have been allocated to it incorrectly. If property is incorrectly identified as *not* being property acquired from and owned by the decedent, available Basis Increase may not have been allocated to the property.

In each of these situations, a formula allocation of Basis Increase may operate to automatically allocate the additional available Basis Increase without the need to go through the complicated provisions of the relief provisions. If the situation is discovered before July 17, 2012, the simple “9100-2” relief under the second relief exception in section I.D.2 of Notice 2011-66 may be available. After July 17, 2012, the relief exceptions in Notice 2011-66 do not appear to allow any method for making revisions to the Form 8939 (such as Basis Increase allocations), other than the very limited first relief exception for allocating Spousal Property Basis Increase to property later distributed to the surviving spouse. The fourth relief exception applies only to file a Form 8939 late, rather than to supplement a previously filed Form 8939. Even if the fourth relief exception is somehow applied to permit later Basis Increase allocations, the estate would be forced to go through the complicated procedures for general “9100-3” relief (with a substantial user fee), for which the IRS hints that it will apply a strict standard before granting relief.

As an example, Michael Jones (Monterey, California) suggests the following formula language:

“The Executor hereby elects to allocate the entire amount General Basis Increase Allowance as finally determined under IRC § 1022(b), up to the whole thereof, to the assets contained in the list following this election statement (hereinafter referred to as “IRC § 1022(b) Allocation List”). The allocation shall be made to each item shown in the IRC § 1022(b) Allocation List in the order listed, and the amount of each such allocation shall be the minimum amount necessary, if any, to increase the income tax basis of each such item such that it be equal to the lesser of:

- (1) Its fair market value as finally determined for purposes of IRC § 1022 as of the date of the decedent’s death; or
- (2) If transferred in any transaction treated for income tax purposes as a taxable sale or exchange occurring on or before the date of this Section 1022 Election (determined without regard to whether or not treated as an installment sale under IRC § 453), its selling price, net of selling costs deductible therefrom.

To the extent that the General Basis Increase Allowance remaining available to allocate to any item appearing on the IRC § 1022(b) Allocation List is insufficient to so increase the basis of such item because of allocation to one or more items that precede such item in the IRC § 1022(b) Allocation List, then the remaining amount of the General Basis Increase Allowance shall be allocated to such item.”

[The attached list of assets would be arranged in the priority in which Basis Increase allocations are most desired.]

See Jones, Supplement to Guide to Electing Out of the 2010 Estate Tax (And Into Modified Carryover Basis)(2010)(book available at wwwcreatespace.com/3650512 and Supplement available at www.thompsonjones.com).

Caution: While using formula Basis Increase allocations is optimal for the reasons discussed above, the IRS has not yet confirmed that it will recognize formula allocations. Also, recognize that using formula allocations could lead to uncertainty regarding the finality of Basis Increase allocations. However, the uncertainty exists largely whether or not formula allocations are used (i.e., if the executor purported to allocate Basis Increase in excess of the fair market value of the asset or in excess of the available Basis Increase for other reasons), and the formula in some cases may merely operate to automatically allocate additional Basis Increase that would not otherwise be allocated without complying with the cumbersome relief provisions.

- D. “*Negative Basis Property.*” **Observation:** Revenue Procedure 2011-41 does not discuss the allocation of Basis Increase to “negative basis property.” (There are informal indications that IRS and Treasury officials working on the carryover basis guidance did not think about this issue to address it. There was not an affirmative decision to deny a safe harbor for this situation.) First, some background.

Generally, a transfer of an asset is treated as a taxable disposition to the extent that liabilities associated with the asset exceed the owner’s basis in the asset. That applies even for gifts. Transfers at death, however, generally are not treated as transfers that trigger the realization of the “phantom gain.” See e.g., Kasner, Strauss & Strauss, *Post Mortem Planning* ¶ 10.06 (3d ed. 1998).

To determine the basis of the estate beneficiary that receives a partnership interest, Reg. § 1.742-1 states that the basis of a partnership interest acquired from a decedent is the fair market value of the interest as of the date of death, or the alternate valuation date, with two important adjustments: (1) the value of the interest for estate tax purposes is increased by the successor owner’s share of partnership liabilities, and (2) the value is decreased by items of income in respect of a decedent.

Therefore, transferring a negative basis asset at the owner’s death effectively wipes out the inherent phantom gain associated with negative basis property—the estate does not recognize the phantom gain, and the beneficiary’s basis is stepped up by the amount of the decedent’s share of liabilities so that the beneficiary will not later have to recognize the phantom gain either.

If the estate makes the Section 1022 Election, however, the phantom gain problem is not wiped clean for the beneficiaries. Section 1022(g) provides that in determining whether gain is recognized by the estate on a disposition of negative basis property, “liabilities in excess of basis shall be disregarded” except for transfers to some listed government entities or exempt organizations. (The purpose of the exception for transfers to exempt entities is to keep the estate from avoiding gain recognition, and then distributing the asset to an entity that will never have to recognize the gain in the future either. Without this exception, a decedent could borrow against an asset, leave the cash to family beneficiaries, and leave the asset encumbered by the liability—perhaps with a zero net value—to exempt

entities that would never have to recognize the gain. Indeed, the statute says the IRS can by regulation apply this special rule to any person to whom property is transferred for the principal purpose of tax avoidance.) This generally means that the phantom gain associated with liabilities in excess of basis will not be triggered at the owner's death or upon the distribution of the asset to estate beneficiaries (as long as the property is not left to an exempt entity). However, that same rule also applies for purposes of determining the beneficiary's basis: "and in determining the adjusted basis of such property, liabilities in excess of basis shall be disregarded." Therefore, under the general carryover basis rules of § 1022(a), the beneficiary's basis is not stepped up by the amount of the decedent's share of liabilities, leaving the beneficiary with a phantom gain problem on a subsequent transfer of the asset by the beneficiary. (This is a reason that some estates over the \$5 million estate tax exemption amount may choose not to make the Section 1022 Election. An asset may have a negligible net value for estate tax purposes, but could have a huge potential inherent phantom gain upon ultimate disposition of the asset.) However, could the executor allocate Basis Increase to that property in a sufficient amount to eliminate the negative basis (i.e., allocate Basis Increase to the extent that the decedent's share of liabilities exceed the modified carryover basis of the asset)? The concern is that Basis Increase cannot be allocated to an asset to step up the basis above the fair market value of the asset. § 1022(d)(2). The fair market value of an asset is generally determined net of liabilities associated with the asset, which might suggest that there would be no way that Basis Increase could be allocated to cover the full amount of the liabilities in excess of basis. However, that produces an illogical result.

For example, Ellen Harrison (Washington, D.C.) poses the rather common situation of a partnership interest for which the decedent's share of liabilities exceeds his or her basis. For example, assume an estate makes the Section 1022 Election and assume the decedent (D) owned a partnership interest with the following characteristics:

Fair market value = \$50X

Basis = \$20X

D's share of liabilities = \$100X (resulting in negative capital account of \$100X - \$20X, or \$80X)

If no Basis Increase is allocated to the property, the basis of the estate beneficiary (C) in the partnership interest will be \$20X. When C later sells the partnership interest, there will be an amount realized of \$50 (cash received for the fair market value of the interest) + \$100 (relief of liability), or \$150X, resulting in a "phantom gain" of \$130X. Therefore, to eliminate this phantom gain problem, the executor would like to be able to allocate \$130X of Basis Increase to the partnership interest. But the fair market value of the interest is only \$50X after considering liabilities. There seems to be no rational reason to prevent the allocation of Basis Increase to cover the inherent phantom gain, as can generally be done with other assets. It is unfortunate that the Revenue Procedure does not provide a "safe harbor" that clearly permits the allocation of Basis Increase to the full amount of liabilities in excess of basis. (Perhaps the Instructions to Form 8939 will so provide when they are issued.) This would seem consistent with the approach of § 7022(g), which provides that in determining gain or loss, the fair market value of property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject. If § 1022 is applied to partnership assets under an "aggregation of assets" approach, that might provide a rationale for being able to allocate Basis Increase

up to the value of the decedent's pro rata share of partnership assets without considering liabilities, solely for the purpose of determining how much Basis Increase could be allocated to the partnership interest. In any event, being able to allocate sufficient Basis Increase to avoid gain recognition when the beneficiary later transfers the asset is not abusive and should be allowed. To avoid an automatic audit, Ellen Harrison suggests that the Form 8939 should list the fair market value of the asset without regard to liabilities with an attached explanation.

- E. *Partnerships and Section 754 Election.* **Observation:** If the partnership makes the § 754 election, the estate or successor partner adjusts its share of the inside basis of partnership assets to equal its outside basis. If Basis Increase is allocated to the decedent's partnership interest, presumably the adjustment of the estate's share of the inside basis of partnership assets would be based on the partnership interest's outside basis, *after* taking into consideration the Basis Increase allocation. If the fair market value of the partnership interest is greater than the estate's share of the basis of partnership assets, and if a § 754 election is in effect, if the estate makes the Section 1022 Election, allocating Basis Increase to the partnership interest, up to the fair market value of the interest, may result in an upward adjustment in the estate's share of the basis of partnership assets. However, that adjustment occurs automatically under the adjustment rules of § 743, and the estate does not have the ability to choose which particular partnership assets receive the basis adjustment.

A potential concern is that if a § 754 election has not already been made for the partnership, the election must be made on the return for the partnership year. For 2010 decedents, the partnership return for the 2010 year was due April 18, 2011, but can be extended under an automatic 5 month extension (by filing Form 7004) to September 15, 2011. To the extent that whether or not the § 754 election should be made depends in part on whether the estate makes or does not make the Section 1022 Election, this presents a potential timing problem (because the Form 8939 due date is not until over four months later on January 17). However, if the partnership does not make the § 754 election on its timely filed 2010 return, it can do so within 12 months of the original due date, with extensions, under Reg. § 301.9100-2(a), which provides an extended automatic 12 month period for making certain elections, including the § 754 election. No user fees apply to that automatic 12-month extension.

X. *Section 4.04 — Determination of Fair Market Value.*

- A. *Significance.* Determination of each property's value at the date of death is important because (i) the basis of the property will be the lesser of the decedent's basis or fair market value, and (ii) Basis Increase can be allocated to a property only to the extent that the resulting basis does not exceed the property's fair market value at the date of death.
- B. *General Estate Tax Valuation Principles; Appraisals.* Estate tax valuation principles apply, and the provisions in regulations to § 2031 regarding required appraisals also apply for determining the fair market value of any property acquired from the decedent for purposes of § 1022. "The executor must attach any appraisals required under section 2031 to the Form 8939."

Observation: Assuming the reference to "appraisals required under section 2031" includes appraisals that are required to be attached to a Form 706 (for estates subject to the estate tax) in either the regulations or the instructions to Form 706, the following would be required:

- Real estate (Form 706 Instructions). “[A]ttach copies of any appraisals.” (Therefore, the instructions do not require obtaining appraisals of real estate to attach to the Form 706, but they do require attaching any appraisals that are obtained.)
- Stocks and bonds (Form 706 instructions). The instructions applicable to Schedule B do not require attaching appraisals of closely held companies, but require sending “complete financial and other data used to determine value.” The required information includes balance sheets and statements of net earnings and dividends paid for each of the five years preceding the valuation date.
- Partnerships or unincorporated businesses (Form 706 instructions). The instructions do not require attaching appraisals, but require attaching statements of assets and liabilities as well as statements of earnings, both for the year of death and each of the preceding five years.
- Household and personal effects (Reg. § 20.2031-6(a)-(b)). Reg. § 20.2031-6(a) requires an itemization of each item of household furnishings or personal effects, except that items in the same room may be grouped as long as no individual item exceeds \$100. In lieu of an itemized list, a written statement may be attached “setting forth the aggregate value as appraised by a competent appraiser or appraisers of recognized standing and ability, or by a dealer or dealers in the class of personality involved.”

Reg. § 20.2031-6(b) requires that there be an appraisal of any household or personal effects article “having marked artistic or intrinsic value ... in excess of \$3,000.”

The instructions for Schedule F on the 2009 Form 706 requires an appraisal of “any one work of art or item with collectible value ... more than \$3,000” and “any collection of similar articles ... valued at more than \$10,000.” The instructions for the 2010 Form 706 drop the phrase about a collection of similar articles valued at more than \$10,000 (which is consistent with the regulations), but Question 1 on Schedule F of the 2010 Form 706 (apparently inadvertently) leaves in that phrase.

- Any appraisal obtained (Form 706 instructions). The “Checklist for Completing Form 706,” at the end of the Form 706 instructions, states: “attach any appraisals used to value property included on the return.” (Accordingly, this provision does not require obtaining appraisals, but does require attaching any appraisals that are obtained that are “used to value property included on the return.”)

- C. *Aggregation Rule.* The Basis Increase allocated to any asset cannot result in the basis of that asset exceeding the fair market value of the asset on the date of death. If Basis Increase is allocated to an “undivided portion” of an asset that is distributed to a particular recipient, the IRS takes the taxpayer-favorable position that discounts do not have to be applied in determining the fair market value limit of each recipient’s “undivided portion.” Instead, “the FMV of an undivided portion of the decedent’s property that is acquired from the decedent at death is a fractional share of the FMV of the decedent’s property at death.” Rev. Proc. 2011-41, § 4.04(2). (**Observation:** That rule would apply explicitly to undivided interests in real property. Presumably, it will also apply to minority interests in partnerships, LLC's, and corporations that are distributed among the estate beneficiaries.)

XI. Section 4.05 — Special Rules for Community Property.

- A. *Surviving Spouse's One-Half Interest Is Treated as Acquired From and Owned by the Decedent.* Each spouse's one-half interest in community property is treated as being acquired from and owned by the decedent for purposes of § 1022. (**Observation:** This rule applies if at least one-half of the whole of the community interest in such property is treated as owned by, and acquired from, the decedent, without regard to the special rule. That statement in the statute is confusing, but it mirrors similar phraseology in § 1014(b)(6). This requirement is satisfied in a typical situation where community property is owned one-half by each of the spouses. That interpretation is supported by the following statement of an assumed fact in Example 7: "Under the community property laws of State, upon the death of a married person, one-half of the community property belongs to the decedent and the other one-half belongs to the surviving spouse.")

Observation: If community property can be divided in a non pro rata manner under applicable state law, there appears to be nothing in the Revenue Procedure that would prevent allocating Spousal Property Basis Increase to a highly appreciated community property asset that is distributed to the surviving spouse as part of his or her share of the community (with other community property assets being distributed to the decedent's estate). That may assist in being able to utilize fully the \$3.0 million Spousal Property Basis Increase. Rev. Proc 2011-41, §4.06(6) provides that the Basis Increase is deemed allocated before transfers are made to nonresident aliens for purposes of determining the amount of gain recognition under § 684. That might suggest that all Basis Increase allocations are deemed to occur before distributions are made (such as non pro rata divisions of assets). A distinction is that § 684 is a taxable event and the Revenue Procedure supplies a safe harbor to reduce the amount of gain recognition under § 684. Non pro rata divisions of community property at a spouse's death are generally treated as nontaxable events, at least where the executor has the power to partition the assets without obtaining the spouse's consent. See, e.g., Private Letter Rulings 199935033, 199912040, 9422052. More importantly, the first relief exception in Notice 2011-66 contemplates that the \$3.0 million Spousal Property Basis Increase is allocated to assets that are actually distributed to the surviving spouse, suggesting that the allocation would be made after the executor has exercised its discretion in deciding what assets to distribute to the surviving spouse, which arguably includes a non pro rata division of community property assets in the executor's discretion where the executor has that discretion under state law.

- B. *Determining Carryovers/Unrealized Losses Increase for Community Property.* Both the decedent's and surviving spouse's share of unrealized losses in community property assets may be included to determine the General Basis Increase. However, only the decedent's one-half of net operating loss carryovers and capital loss carryovers will be included. The surviving spouse will be able to claim his or her one-half share of the carryovers on future income tax returns.

XII. *Section 4.06 — Interaction of § 1022 With Certain Other Income Tax Provisions.*

- A. *Holding Period.* Tacking of the decedent's holding period is allowed in determining the recipient's holding period, whether or not the executor allocates any Basis Increase to the property. Rev. Proc. 2011-41, § 4.06(1). (**Observation:** This is important, because the automatic long-term capital gains holding period under § 1223(11) does not apply under

the carryover basis regime [because § 1041(a) does not apply]. However, this is becoming less significant as each day passes. The estates of decedents who died even late in 2010 are getting close to meeting the one-year holding period required for long-term capital gains treatment. The Notice does not address the technical issue presented by § 1223(2), which specifies that tacking of a prior owner's holding period is allowed if the new owner has "the same basis in whole or in part in his hands as it would have in the hands of [the prior owner]." If a particular asset has a fair market value below the decedent's basis, the estate's basis is the fair market value at the date of death and arguably is not "the same basis in whole or in part" as the decedent's basis in the asset.) However, the safe harbor position clearly allows the estate or other recipient to tack the decedent's holding period.

B. *Tax Character.* If the recipient's basis in property is determined under § 1022, "the tax character of the property is the same as it would have been in the hands of the decedent." Rev. Proc. 2011-41, § 4.06(2). For example, this can determine whether an asset is treated as a capital asset, property used in a trade or business, property subject to depreciation recapture under § 1245 for certain depreciable property, or property subject to depreciation recapture under § 1250 upon disposition of certain depreciable real property. The Notice indicates that "the tax character of the property may be affected by subsequent change in the recipient's use of the property." (**Observation:** Apparently that sentence might apply, for example, if an asset changes from a capital asset of the decedent to being used in a trade or business by the recipient.) Example 9 indicates that if the decedent had claimed depreciation on tangible personal property that would have been subject to recapture under § 1245 if the decedent has depreciated the property prior to his or her death, the property will also be treated as § 1245 property in the hands of the estate recipient and subject to recapture when sold by the recipient, "regardless of whether the property is depreciable property in the hands of [the recipient] or whether the executor allocates any Basis Increase to that property."

C. *Depreciation of Property Acquired from the Decedent.* For the portion of the recipient's basis in the property that equals the decedent's adjusted basis, allowable depreciation deductions are determined "by using the decedent's depreciation method, recovery period, and convention applicable to the property." Rev. Proc. 2011-41, § 4.06(3). Therefore, depreciation would continue in the same manner and over the remaining period that was being used by the decedent.

However, the portion of the recipient's basis that exceeds the decedent's adjusted basis (for example, attributable to Basis Increase allocated to the property) is treated as a separate asset placed in service by the recipient after the date of death. The depreciation method, recovery period and convention applicable to the property on its placed-in-service date would apply to that portion of the recipient's basis, but if the property is not held by the recipient as depreciable property on that date, the allowable depreciation would be determined on the date the property is converted to depreciable property.

D. *Passive Activity Loss Provisions.*

1. *Background.* Section 469 has two possible methods of dealing with suspended losses that might apply to an estate that makes the Section 1022 Election. Revenue Procedure 2011-41 says to use the method that applies to gifts, which is not taxpayer-friendly.

Observation: Section 469 limits the ability of a taxpayer to deduct losses incurred in the conduct of a trade or business if the taxpayer does not “materially participate” in the business. Nondeductible losses may be carried over to offset passive gains in future years. The first possible method of dealing with suspended passive losses for an estates making the Section 1022 Election is that suspended losses are deductible on a decedent’s final income tax return under § 469(g)(2) to the extent that they exceed the difference between the basis in the hands of the estate recipient and the decedent's basis. When the basis of property is stepped up under § 1014, this limits the amount of suspended losses that can be deducted on the final return. Under a modified carryover basis situation, there would be no such limitation and the full amount of the suspended losses could be deducted on the decedent’s final return. The second possible method of dealing with suspended passive losses for an estate making the Section 1022 Election is to apply § 469(j)(2), which has a different rule that applies when there is a gift of an interest in a passive activity. Section 469(j)(2) increases the basis of the interest immediately before the transfer by the amount of suspended passive activity losses, rather than allowing a current deduction of the suspended losses.

2. *Suspended Losses Are Added to Basis, Not Deducted on Decedent’s Final Return.* The Revenue Procedure takes the position that because property owned by the decedent at death is treated under § 1022(a)(1) as having been transferred by gift, the gift treatment described in § 469(j)(2), adding suspended losses to basis, should apply rather than the transfer-at-death treatment in § 469(g)(2), which would have allowed a deduction for the suspended losses on the decedent’s final return. Rev. Proc. 2011-41, § 4.06(4). (**Observation:** This is a significant taxpayer-unfriendly position, converting a current deduction on the decedent’s final return [possibly at a 35% rate] to basis that might offset future capital gain [possibly at a 15% rate]. Bear in mind that Rev. Proc. 2011-41 merely creates safe harbors and does not necessarily preclude a taxpayer from taking the position that other methods could apply.)
3. *Addition of Suspended Losses to Basis Either Increases Basis of the Passive Loss Asset or Increases Unrealized Losses That Are Added To General Basis Increase That Can Be Allocated to Other Appreciated Assets.* If the fair market value of the passive loss asset is large enough to absorb all of the addition of suspended loss to basis, it is all utilized with that particular asset. However, if the fair market value of that asset is not large enough to absorb all of the addition of suspended losses to basis, the excess that cannot be absorbed into the basis of that asset will become an unrealized loss that is added to the Carryovers/Unrealized Losses Increase and can be added to the basis of other appreciated assets.

That is because suspended losses are added to basis before the amount of the additional Basis Increase for unrealized losses is calculated. This increases the amount of unrealized losses that may be added in determining the General Basis Increase.

Example 10 is an example of a situation in which the addition to basis of the amount of the suspended losses can be absorbed into the basis of the passive activity asset. Rev. Proc. 2011-41, § 4.06(4) Ex. 10.

Example 11 illustrates a situation in which part of the suspended loss basis addition is reflected in Basis Increase that can be added to *other* assets that are appreciated. Rev. Proc. 2011-41, § 4.06(4) Ex. 11. The decedent's basis in property is \$10,000, the FMV of the property is \$100,000, and suspended passive losses are \$200,000. The property is distributed to C. The suspended losses are added to the decedent's basis immediately prior to death under § 469(j)(2).

- C's Basis: Lesser of (i) \$210,000 decedent's basis (\$10,000 + \$200,000), or (ii) \$100,000 FMV, or \$100,000. (Observe that C's basis reflects \$90,000 of suspended losses [i.e., \$100,000 (C's basis) - \$10,000 (decedent's basis)].)
- Unrealized loss added to General Basis Increase: \$100,000 FMV - \$210,000 basis after adding suspended losses to basis, or \$110,000 unrealized loss, which can be allocated to other appreciated assets.
- Summary: Of the \$200,000 of suspended losses that are added to basis, \$90,000 is reflected in C's basis in this property, and \$110,000 is reflected in General Basis Increase that can be allocated to other assets.

4. *Community Property Passive Losses.* For community property passive losses, the surviving spouse's portion can be added to the \$1.3 million General Basis Increase, but is deemed to be used last. To the extent that the spouse's share of passive losses is not added to the \$1.3 million General Basis Increase, it is available to the spouse to offset future passive gains.

E. *Rule Limiting Gain Recognition on Funding Pecuniary Bequest to Post-Death Appreciation Is Extended to Qualified Revocable Trusts and § 2036, 2037, and 2038 Trusts.* Under § 1040, as applicable for estates making the Section 1022 Election, distributions of appreciated property in satisfaction of a pecuniary bequest generate gain only to the extent of post-death appreciation. Section 1040(b) also extends this rule to the satisfaction of pecuniary transfers from a trust, "to the extent provided in regulations." The Revenue Procedure applies the rule limiting gain recognition to post-death appreciation to qualified revocable trusts (defined in § 645(b)(1)) "as well as to trusts that would have been included in the decedent's gross estate for federal estate tax purposes under section 2036, 2037, or 2038 had the decedent's executor not made the Section 1022 Election." However, the provisions of § 1040, limiting gain recognition to post-death appreciation, do not apply to the distribution of a right to receive an item of income in respect of a decedent in satisfaction of a pecuniary bequest. Rev. Proc. 2011-41, § 4.06(5).

F. *Gain Recognition Under § 684 On Transfers to Nonresident Aliens Is Determined After Applying Basis Increase Allocations.* For estates that make the Section 1022 Election, § 684 requires gain recognition at the time that property is transferred by a United States person to a nonresident alien. (Section 684 has an exception for transfers by reason of the death of the transferor *if* the recipient's basis is determined under § 1014(a), which of course it would not be if the Section 1022 Election is made.) The Revenue Procedure takes the taxpayer-friendly position that the executor's allocation of Basis Increase will be deemed to occur prior to the computation of gain under § 684. "Thus, the amount of gain recognized under section 684 on the transfer may be reduced or even eliminated if sufficient Basis Increase is allocated to such property." Rev. Proc. 2011-41, § 4.06(6).

If property is not owned by the decedent at death, no Basis Increase can be allocated to the property, and if § 684 requires the recognition of realized gain at the decedent's death, the

decedent will have to recognize all unrealized gain for that property. Example 14 in Revenue Procedure 2011-41 clarifies this treatment. If a U.S. citizen or resident funds a foreign trust that has a U.S. beneficiary, § 679(a) treats the decedent as the owner for income tax purposes of the portion of the trust attributable to that contribution. Example 14 assumes that a U.S. citizen-decedent (D) funded a foreign trust that gave D a mandatory income interest but no other right or power. D is treated as the owner of the trust under § 679(a) for income tax purposes. If D's estate makes the Section 1022 Election, even though the decedent was treated as the owner of the trust for income tax purposes, the assets were not "acquired from the decedent" (because D merely had a beneficial interest in the trust but no other right or control over the trust, *see* Item VII.C.2-3) and no Basis Increase can be allocated to the property before the amount of § 684 gain recognition is determined.

- XIII. *Section 4.07 — Testamentary Charitable Remainder Trusts Are Recognized.* Regulation § 1.664-1(a)(1)(iii) provides that one of the requirements for a trust to be treated as a charitable remainder trust ("CRT") exempt entity is that a deduction is allowable when assets are contributed to the trust, including a deduction under § 2055. However, the estate tax charitable deduction under § 2055 does not apply to an estate that makes the Section 1022 Election. The Revenue Procedure clarifies that a testamentary CRT will not fail to qualify as a CRT solely because the decedent's executor makes the Section 1022 Election.