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*ESTATE WISE PLANNING*TM

SINCE 1979

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Vol. VI, No. 2. February 2010

2010 Transfer Tax Update

Corrections: The January 2010 issue of *ESTATE WISE PLANNING*TM contains two technical errors. The first is found in the topic “**Step-up (Step-down) in Basis Repealed**,” last sentence of the incomplete paragraph at top of page 3 of 7, which reads “Nowhere in the 2001 Tax Act is it provided that IRC Section 1022 applies only to estates of decedents dying after December 31, 2009, and before January 1, 2011.” The sentence should read, “By authority of the 2001 Tax Act, modified carry-over basis does not apply to the estates of decedents dying after December 31, 2010” [§901(a)(1) 2001 Tax Act]. The second is found in the topic “**Community Property Step-Up Basis Repealed**,” last sentence of that paragraph on page 4 of 7. The sentence should read, “Thus, upon the death of the first spouse to die, only one-half the fair market value of the decedent spouse’s community property interest is includable in his or her gross estate (as it was prior to 2010); but, now, the basis of such property in the hands of the surviving spouse is equal to the lower of the decedent spouse’s adjusted basis or the fair market value of 100 percent of the entire value (i.e., both halves) of the community property on the date of the decedent spouse’s death (not the alternate valuation date) [IRC §1022(a)(2) and (d)(1)(B)(iv)]. *ESTATE WISE PLANNING*TM regrets the errors.

Reporting Large Transfers at Death: For estates of decedents dying **after** December 31, 2009, and **before** January 1, 2011, the federal estate tax is repealed. Accordingly, no United States Estate (and Generation-Skipping Transfer) Tax Return (“Form 706”) will be required for estates of decedents dying during that period. Does this mean, then, that no information return is required to be filed with the IRS for the value of decedent’s estate? The answer is *NO!*

The decedent’s personal representative (“PR”) must “make a return” [IRC §6018(a) for decedents dying **after** December 31, 2009] of all property (other than cash) acquired from a decedent, if the fair market value of such property exceeds \$1.3 million [IRC §6018(b)(1)] or if the fair market value of any appreciated property less than \$1.3 million was required to be included on a United States Gift (and Generation-Skipping Transfer) Tax Return (“Form 709”) and was transferred by the decedent within three years of death [IRC §6018(b)(2)]. The provisions of IRC Section 1022(e) apply regarding “[p]roperty acquired from a decedent” [IRC §6018(d)]. With respect to nonresidents not citizens of the United States (*i.e.*, “nonresident aliens”), the term “large transfer” means taking into account only tangible property situated in the United States, and other property acquired from the decedent by a United States person, having a fair market value of \$60,000 [IRC §6018(b)(3)]. If the PR is unable to make a complete return as to any property acquired

from or passing from the decedent, the PR must include in the return a description of such property and the name of every person holding a legal or beneficial interest in such property. “Upon notice from the Secretary [of the Treasury], such person shall in like manner make a return as to such property.” [IRC §6018(b)(4)] In effect, the burden of making the return would then shift to the beneficiary or recipient of such “acquired” property.

The following information is to be included on the return: (1) the name and TIN of the recipient of such property; (2) an accurate description of such property; (3) the adjusted basis of such property in the hands of the decedent and its fair market value at the time of death; (4) the decedent’s holding period for such property; (5) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income; (6) the amount of basis increase allocated to the property under IRC Section 1022(b) or (c); and (7) such other information as the Secretary may by regulations prescribe [IRC §6018(c)]. To date, no regulations have been proposed; and no return form number has been released upon which to report large transfers at death.

Every person required to make a return of all property (other than cash) acquired from a decedent must furnish to each person whose name is required to be set forth in such return (other than the person required to make such return) a written statement showing: (1) the name, address and phone number of the person required to make such return; and (2) the information specified in the preceding paragraph with respect to property acquired from, or passing from, the decedent to the person required to receive such statement. This written statement must be furnished not later than thirty (30) days after the date that the required return is filed [IRC §6018(e)]. Unlike the due date for filing Form 706, the due date for filing the return for large transfers at death must be filed with the decedent’s income tax return for the decedent’s last taxable year or such later date specified in regulations prescribed by the Secretary [IRC §6075(a) for decedents dying **after** December 31, 2009].

A person required to furnish any information under IRC Section 6018 [*i.e.*, relative to reporting large transfers at death and gifts on the date due (determined with regard to any extension of time for filing such return)] who fails to furnish such information shall pay a penalty of \$10,000 (\$500 in the case of information required to be furnished under IRC Section 6018(b)(2) (Transfers of certain gifts received by decedent within 3 years of death) for each such failure [IRC §6716(a)]. Any person required to furnish in writing to each person whose name is required to be reported on a return of large transfers at death [IRC Sections 6018(e) and 6019(b)] who fails to furnish such information shall pay a penalty of \$50 for each such failure [IRC §6716(b)]. If any failure to make a return of large transfers at death is due to intentional disregard of the requirements under IRC Sections 6018 and 6019(b), the penalty shall be 5 percent of the fair market value (as of the date of death, or, in the case of IRC Section 6019(b), the date of the gift) of the property with respect to which the information is required [IRC §6716(d)].

Modified Carryover Basis Step-up: Questions are beginning to be asked regarding the application of the modified carryover basis rules under new code section 1022. For example, a reader posited the following situation: The decedent died in January 2010. The only major asset comprising the decedent’s gross estate is the decedent’s principal residence acquired at a cost of \$10,000, having a fair market value of \$400,000 as of the date of the decedent’s death. What is the basis for income tax reporting purposes in the hands of the recipient of the real property? IRC Section 1022(b)(1) provides: “In General.--In the case of property to which this subsection applies, the basis of such property under subsection (a) shall be increased by its ***basis increase*** under this subsection.” [Emphasis added] IRC Section 1022(b)(2) provides: “***Basis Increase***.--For purposes of this subsection--(A) In General.--The ***basis increase*** under this subsection **for any property** is the portion of the ***aggregate basis increase*** which is allocated to the property pursuant to this section. (B) ***Aggregate Basis Increase***.--In the case of **any estate**, the ***aggregate basis increase*** under this subsection is \$1,300,000.” [Emphasis added] Accordingly, of the total aggregate ***basis increase*** of \$1,300,000, the personal representative would allocate \$390,000 to the \$10,000 cost basis of the home for a total ***basis increase*** of \$400,000. Thus, the basis for income tax reporting purposes in the hands of the decedent’s beneficiary(ies) would be \$400,000. The reader also posited, “Based upon what I read, it appears to me that the PR can ‘step-up’ basis any individual or group of assets....” If the beneficiary of the decedent is not the decedent’s spouse, then, the maximum ***basis increase*** in the hands of the beneficiary is \$1,300,000. If, on the other hand, the beneficiary is the decedent’s surviving spouse, the maximum ***basis increase*** in the hands of the surviving spouse is \$4.3 million [IRC §1022(c)(2)(B)]; however, to be eligible for the \$3.0 million portion of the total

amount of \$4.3 million of **basis increase**, the surviving spouse must receive the property interest outright or as the beneficiary of a QTIP marital deduction trust [IRC §1022(c)(3) and (5)]. It is not required that the property eligible for the \$1.3 million **basis increase** of the total \$4.3 million passing to the surviving spouse be distributed to a QTIP marital deduction trust—only the \$3.0 million portion [IRC §1022(c)(3) and (5)].

A careful reading of IRC Section 1022 does not evidence any requirement that the **basis increase** takes into account relative appreciation or depreciation in the assets to which the **basis increase** is allocated. Thus, the reader is probably correct when he posited that there could be “circumstances where the PR may choose to value certain assets that have decreased in value since the death with a step-up (certain stocks/bonds needing to be sold to raise cash for any estate taxes or administrative expenses, for example) to create a loss and those (such as an apartment building not to be sold in the near term) as maintaining adjusted basis. If this is correct, I foresee lots of arguments with the IRS over which assets should get the step-up.” Certainly, this could be an area of litigation over allocation of the **basis increase**. Such circumstances may be possible if the federal estate tax is reinstated for the year 2010 or if Congress would legislate the continuance of modified carryover basis for estates of decedents dying after December 31, 2010, when the federal estate tax is reinstated on January 1, 2011, as in effect on June 6, 2001 [§901(b) 2001 Tax Act: “(b) Application of Certain Laws.—The **Internal Revenue Code of 1986** and the *Employee Retirement Income Security Act of 1974* shall be applied and administered to **years, estates, gifts, and transfers** described in subsection (a) **as if the provisions and amendments described in subsection (a) had never been enacted.**” (Emphasis added) *The Economic Growth and Tax Relief Reconciliation Act of 2001 was enacted on June 7, 2001.*]

Moreover, the decedent’s PR may be challenged in allocating **basis increase** with respect to the individual needs of the decedent’s beneficiaries; *i.e.*, the PR may be pressured to allocate a disproportionate amount of basis to assets depending on the beneficiaries’ respective income tax brackets. Of course, the biggest and most challenging aspect of valuing the decedent’s assets will be in determining adjusted basis, particularly, if the decedent did not keep accurate records of expenditures for assets that are subject to capital gain tax. Beneficiaries of property in which the decedent used IRC Section 1031 to, in effect, defer capital gain on investment real property could be adversely impacted in situations where the **aggregate basis increase** amount is insufficient to obtain a 100 percent step-up to, in effect, the fair market value of the property in the hands of the decedent’s beneficiary.

Trust Income Tax Return: Is a trust having only “income of \$45 in interest income” required to file a U.S. Income Tax Return for Trusts and Estates (“Form 1041”)? After making the necessary allocations provided in the trust instrument, the following five steps are taken in arriving at **taxable income** of a trust: (1) Start with **fiduciary accounting income**; (2) make all necessary adjustments to arrive at **taxable income before distributions deduction**; (3) adjust this figure back to **distributable net income** (“DNI”); (4) eliminate **tax-exempt income** to arrive at **distribution deduction**; and (5) go back to **taxable income** before **distributions deduction** [step (2)] and subtract the **distribution deduction** to arrive at **taxable income** of the trust [J.G. Denhart, Jr., CPA with James W. Denhart, J.D., *Trust Accounting and Trust Income Taxation*, Prentice-Hall, Inc., Englewood Cliffs, NJ, 1977, at 114].

Line 22 of Form 1041 would be the **taxable income** of the trust. Line 18 would be the deduction for DNI. Accordingly, the definition of **taxable income** is “subtract line 21 from line 17” of Form 1041.

Now, then, let’s review the rules in perspective:

(1) IRC Section 6012(a) provides that, “Returns with respect to income taxes under subtitle A shall be made by the following: “(4) **Every** trust having for the taxable year **any taxable income**, or having **gross income of \$600 or over, regardless of the amount of taxable income**” [IRC §6012(a)(4)]. [Emphasis added]

(2) Treas. Reg. Sec. 1.6012-3(a)(1) provides: “(1) In general. Every fiduciary, or at least one of joint fiduciaries, **must make a return of income** on Form 1041 (or by use of a composite return pursuant to section 1.6012-5) and attach the required form if the estate or trust has items of tax preference (as defined in section 57 and the regulations thereunder) in any amount... (ii) For each trust for which he acts, except a trust exempt under section

501(a), if such trust has for the taxable year **any taxable income**, or has for the taxable year **gross income of \$600 or more regardless of the amount of taxable income....**” [Emphasis added]

The “**any taxable income**” language has, without exception, been enunciated in Rev. Ruls. 75-278, 1975-2 C.B. 461 and 55-287, 1955-1 C.B. 130. In Rev. Ruling 75-278, the IRS ruled that, “...if the trust has **any taxable income** or has gross income of \$600 or over, **it is required to file a Form 1041.**” [Emphasis added] In Rev. Rul. 55-287, the IRS ruled that, “A trust continues in existence for Federal income tax purposes during the period within which the trustee is allowed by the laws of the State in which the trust is being administered to distribute the assets of the trust to the distributees upon the termination of the trust. Form 1041, United States Fiduciary Income Tax Return, **should be filed for each year that the trust so continues in existence and has taxable income**, or gross income of \$600 or over, **regardless of the amount of taxable income.**” [Emphasis added]

Further, the “**any taxable income**” language was earlier enunciated in *Glenn E. Edgar v. Comm’r* 56 T.C. 717, 762 (July 8, 1971). Clearly, revenue rulings and case law do not mention an exception to the “**any taxable income**” language requiring the filing of a Form 1041 by the trustee.

Of course, the question practitioners and trustees must ask themselves: “Does the trust have any ‘**net**’ **taxable income** (line 22 of Form 1041)?” If the trust is without “**net**” **taxable income** (arrived at by subtracting line 21 from line 17), then, filing a Form 1041 for the trust is **not** required, since the trust would not have **any taxable income**.

Question of the Month: If I direct the trustee of my revocable living trust to transfer back to me property comprising the trust estate, does such a transfer constitute a gift taxable event for purposes of the federal gift tax?
Answer: No. If the trustor (grantor) directs the trustee to convey legal title to property that comprises the trust estate back to the trustor in the same form of ownership in which it was titled before its conveyance to the trustee, no federal gift taxable event occurs. This is because a gift is incomplete in every instance in which the trustor (donor) reserves the power to revest the beneficial title to property in himself or herself or where the donor’s reserved power gives the donor the power to name new beneficiaries [Treas. Reg. § 25.2511-2(c); *see also* Tech. Adv. Mem. 9127008]. On the other hand, if the trustee conveys legal title to property comprising the trust estate to a beneficiary other than the trustor who did not initially transfer property to the revocable living trust, such a transfer constitutes a completed transfer subject to federal gift tax [Treas. Reg. §§ 25.2511-2(b) and 25.2511-2(f); *see discussion in* chapter eight, *Federal and State Transfer Taxes*, at 205, Doug H. Moy, *Living Trusts: Third Edition*, John Wiley & Sons, Inc., 2003. Copyright © 2003 by Doug H. Moy. All rights reserved].

AFR: The **February 2010** Applicable Federal Rate, under IRC Section 7520, for determining the present value of an annuity, an interest for life or a term of years or a remainder or reversionary interest is **3.4 percent** [Rev. Rul. 2010-06, 2010-6 I.R.B.1, Table 5]. The **March 2010** AFR is **3.2 percent** [Rev. Rul. 2010-08, 2010-10 I.R.B.1, Table 5]. This bodes well for the grantor retained annuity trust (GRAT), charitable lead annuity trust (CLAT), charitable transfer of remainder interest in residence or farm and private annuities but not well for the qualified personal residence trust (QPRT), grantor retained income trust (GRIT) and charitable remainder annuity trust (CRAT). Lower AFRs have no impact on grantor retained unitrust (GRUT), charitable remainder unitrust (CRUT), charitable lead trust (CLT) and pooled income funds. **Note:** In the case of transfers to a CRAT for which the *valuation date* is **after** April 30, 1999, if an election is made under IRC Section 7520 and Treasury Regulation Section 1.7520-2(b) to compute the present value of the charitable interest by use of the interest rate component for **either of the two months preceding the month** in which the transfer is made, the month so selected is the *valuation date* for purposes of determining the interest rate (*i.e.*, the AFR) and mortality tables [Treas. Reg. § 1.664-2(c) (Jan. 5, 2001)]. In other words, one may choose the lowest AFR of either of the two months preceding the month the CRAT is funded in order to obtain the maximum tax deduction for the present value of the remainder interest.

[**Note:** Section 6110(k)(3) of the Code provides that letter rulings may not be used or cited as precedent; however, they may be cited as authority].

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Nancy Shurtz, *Estate Planning*, July 2004, Vol. 31/No.7, p. 357.

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Doug H. Moy's article, "Income Taxation of Trusts and Estates: The Need to Amend § 1(e)," *TAXPRO Journal* 35 (Fall 2008) is available in electronic pdf format by request at dougmoym@msn.com. The *TAXPRO Journal* is the official journal of the National Association of Tax Professionals.