

Section 1022, instituting a modified carryover basis system that partly offset the tax benefits of eliminating the estate tax.

Unfortunately, the “hour upon the stage”¹ of Sections 2210 and 1022 passed quickly. On Dec. 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA) retroactively reinstated the estate tax for those dying in 2010. Yet, even as TRUIRJCA repealed the modified basis rules of Section 1022 and reinstated the estate tax, it allowed the executor of an estate for a decedent who died in 2010 to elect for the modified basis rules of Section 1022—rather than the estate tax—to apply. Thus, Section 1022’s modified basis rules were used only in the fairly specific situation in which: (1) a decedent died in 2010, (2) with an estate valued in excess of the retroactively instated \$5 million exemption,² (3) the assets and overall situation rendered the modified basis rules more favorable than paying the estate tax and benefitting from a full step-up in basis, and (4) the executor made a timely Section 1022 election (1022 election”) on IRS Form 8939.

New Regulations

Despite the seemingly fleeting, long-expired, application of Sections 2210 and 1022, the IRS released new regulations relating to the repealed Section 1022 (“new regulations”) on Jan. 19, 2017.³ The new regulations emphasize that while the 1022 election may only have been available for property of those dying in 2010, the modified basis of that property continues to affect transactions and property owners.⁴ As the IRS emphasized in the Background to the New Regulations, the repealed Section 1022 will continue to be relevant until the last of the property inherited or bequeathed from a decedent who died in 2010, and whose executor made a 1022 election, is sold or otherwise disposed of.⁵

Modified Basis Rules of Section 1022

In general, IRC Section 1014 governs the basis of property acquired from a decedent. Under Section 1014(a), the recipient receives such property with an adjusted basis of its fair market value (FMV) on the decedent’s date of death (the asset’s “stepped up”

or “stepped down” basis). Thus, under Section 1014, an individual who sold inherited stock, originally purchased for \$1 million, immediately after the decedent’s death for its FMV of \$2 million, would report no taxable gain.

In contrast, under Section 1022, such property is treated as a gift and is received with a basis of “the lesser of” the decedent’s adjusted basis or the property’s fair market value on the decedent’s date of death.⁶ The “lesser of” rule is mitigated by an aggregate \$1.3 million basis increase that the estate’s executor may allocate among estate assets that were both “owned” by the decedent at the time of death and “acquired from” the decedent.⁷ The aggregate basis increase may be increased by the sum of the decedent’s unused capital loss carryover, net operating loss carryover and unrealized losses at death that would have been deductible under IRC Section 165 if the decedent had sold the property.⁸ Furthermore, the executor may allocate an additional basis increase of \$3 million among assets received by the decedent’s surviving spouse, outright or as qualified terminable interest property.⁹ However, the total basis of any one asset, including any increase attributable to an allocation of the aggregate basis increase, may not exceed the asset’s FMV on the decedent’s date of death.¹⁰

Thus, if the stock in the example above had been received from the estate of a decedent who died in 2010 and whose executor made a 1022 election, a very different overall result might well emerge depending on the aggregate basis increase available, the estate’s value, the selection of assets in the estate and the original basis of each of those assets in the hands of the decedent. If the stock was the only asset in the estate, the executor would choose to increase the stock’s basis to the maximum available level (its FMV on the decedent’s date of death) by allocating a \$1 million basis increase to the stock on IRS Form 8939. However, if the decedent’s estate was valued at \$10 million, with a combined original basis across the assets of \$3 million and a total of \$1.3 million aggregate basis increase was available, the executor would be forced to choose how to allocate the aggregate basis increase. In that situation, the recipient might receive the stock with a basis of \$1 million and be forced to report \$1 million in taxable gain on its sale, or might receive the stock with an allocation of some of the aggregate basis increase and a commensurate decrease in

reportable taxable gain. Whether or not part of the aggregate basis increase was allocated to the stock, the rules of Section 1022 will be relevant at the stock's ultimate disposition, even decades later.

The Newly Adopted Regulations

In revising the language of the regulations, the IRS intended “solely to conform the existing regulations to the provisions of section 1022.”¹¹ The new regulations incorporate references to Section 1022 into the existing regulations wherever basis is referenced. Many of the changes simply involve inserting a reference, such as “or section 1022” or “and section 1022.”¹² Others include an example or more detailed explanation addressing proper application of Section 1022 in a specific context. For example, Section 1.742-1(a) of the new regulations specifically addresses the basis of a partnership interest acquired from a decedent who died in 2010 and whose executor made a 1022 election. Section 1.742-1(a) provides that the basis is the lower of the decedent's adjusted basis or the interest's FMV at the decedent's death, but the basis may be increased up to the interest's FMV at the decedent's date of death under Subsections 1022(b) (addressing aggregate basis increase) and/or 1022(c) (addressing additional surviving spousal basis increase).

Endnotes

1. Macbeth, Act V, Scene 5.
2. Intuitively, an estate valued at less than the \$5 million exemption benefits more from receiving a full step-up in basis for all its assets under the estate tax regime, while still paying no estate tax, than from making a Internal Revenue Code Section 1022 election.
3. Internal Revenue Service, RIN 1545-BK09, “Application of Modified Carryover Basis to General Basis Rules.”
4. IRS, RIN 1545-BK09, “Background.”

5. 5. *Ibid.*
6. Internal Revenue Code Section 1022 (a).
7. IRC Section 1022 (a)(1), (b)(2)(B), and (d)(1).
8. IRC Section 1022(b)(2)(C).
9. IRC Section 1022(c)(2).
10. IRC Section 1022(d)(2).
11. Proposed regulations published in Internal Revenue Bulletin, REG-107595-11 (May 26, 2015), adopted as final regulations without modification by IRS, RIN 1545-BK09.
12. For example, Section 1.48-12(b)(2)(vii)(B) of 26 CFR part 1 is amended by inserting “or section 1022” after the phrase “if a transferee’s basis is determined under section 1014.”

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