SPECIAL REPORT ON TAX CHANGES FOR 2010

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1.1.1.1. The corpus of the trust is taxable in the Settlor’s estate upon death under IRC Section 2036, which says that “[t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . under which he has retained for his life . . . the possession or enjoyment of, or the right to the income from, the property . . . .”1

1.1.1.2. If the Settlor retains a limited power of appointment in the trust corpus, the entire value of the estate is included in the settlor’s estate for estate-tax purposes.2

1.1.2. Step Up in Basis for Deaths Prior to 2009 and After 2010.

1.1.2.1. Because an income-only trust is designed so that assets are included in the estate of the Settlor, the trust beneficiaries will receive a step up in tax basis as to trust assets to the fair market value of the assets as of the Settlor’s death if the Settlor died prior to 2010 or after 2010.3

1.1.3. Step Up in Basis for Deaths During 2010.

1.1.3.1. Under the new IRC § 1022 modified carryover basis rules, the recipient of property “acquired from a decedent” receives a carryover basis equal to the lesser of the decedent’s adjusted basis or the fair market value of the property at the decedent’s date of death.4 Unlike 2009 and prior carryover basis rules that applied to gifts, the new rules allow the Executor to increase basis of property acquired from a decedent as follows:

1.1.3.1.1. The Executor can increase basis the by a total of $1,300,000.5 The $1,300,000 is increased by any capital loss carryover under § 1212(b), the amount of any net operating loss carryover under § 172 which would, but for the decedent’s death, be carried from the decedent’s last taxable year to a later taxable year plus the sum of any built in losses as determined under § 165.6

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1 IRC § 2036 and Treas. Reg. §20.2036-1
2 Begley, Jr. & Hook, supra at § 7.20[6][c]
3 IRC §1014(b)(9). See also IRC § 1014(b)(3), Treas. Reg. §§1.1014-2(a)(3), 1.1014-2(b)
4 2 I.R.C § 1022(a)
5 I.R.C § 1022(b)(2)(B). Any basis increase is allocated by the Executor on an asset by asset basis.
6 IRC § 1022(b)(2)(C)
1.1.3.1.2. In addition to the $1,300,000 basis increase, the Executor can increase the basis of property transferred to a surviving spouse ("qualified spousal property") by a total of $3,000,000. For a surviving spouse to receive the additional $3,000,000, the property must pass outright to the spouse or pass as qualified terminal interest property (QTIP).

1.1.3.2. Two requirements must be satisfied to receive a basis adjustment under IRC § 1022. First, the property must be "owned by the decedent" at the time of the decedent's death. Second, the property must be "acquired from a decedent" by reason of death, form of ownership, or by a reserved power for a transfer in trust.

1.1.3.2.1. The only mention of a trust in connection with property being "owned by a decedent" is that property will be deemed to have been owned by a decedent if it was "property that the decedent transferred to a qualified revocable trust as defined in Code § 645(b)(1)." Although there is no mention made of irrevocable grantor trusts, there is no reason to believe that Congress intended to eliminate the effect of IRC §§ 671-679. Specifically, under IRC §§ 671-679 and Rev. Rul. 85-13, if the decedent created a grantor trust, then for income tax purposes (and the § 1022 carryover basis rules are, of course, income tax provisions), it is "owned by the decedent."

1.1.3.2.2. Property will be deemed to have been "acquired from a decedent" if it is property transferred by the decedent during his or her lifetime to a qualified revocable trust or "to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust."

7 IRC § 1022(c). The Executor can allocate the entire $4,300,000 basis adjustment to the surviving spouse, or allocate all or part of the $1,300,000 basis increase to heirs receiving property other than the surviving spouse.

8 IRC § 1022(c)(3). Only a $60,000 basis increase will be allowed to nonresidents who are not U.S. citizens.

9 IRC § 1022(d). The term “owned by the decedent” is not defined. Although several examples of “rules relating to ownership” are provided, there are no examples given involving ownership of a life estate or “ownership” as determined under the grantor trust rules (IRC §§ 671-679).

10 IRC § 1022(e)

11 IRC § 1022(d)(1)(B)(ii)

12 IRC § 1022(e)(2)(A)

13 IRC § 1022(e)(2)(B)
1.1.3.2.2.1. An IOT can fall under IRC § 1022 (e)(2)(B) by being structured as a trust in which the decedent reserves the right to make a change in the enjoyment thereof through the exercise of a power to alter the trust, as follows:

1.1.3.2.2.1.1. The Settlor of the IOT should (1) serve as Trustee of the IOT; (2) reserve the right to alter the trust by changing the trustee of the trust; and (3) and reserve the right to distribute principal of the trust to the remainder beneficiaries, which in turn changes the Settlor’s beneficial interest in the trust insofar as distribution of principal reduces the amount of income that would otherwise be distributed to the Settlor.

1.1.4. Capital Gains Exclusion for Sale of Principal Residence.

1.1.4.1. This has not changed for 2010. If a taxpayer is considered the owner of the entire Trust (including the residence) under the Grantor Trust rules, the taxpayer will be treated as the owner of the residence for purposes of satisfying the ownership requirements of § 121 of the Internal Revenue Code.

1.1.4.2. Accordingly, by transferring a residence to an income-only trust in which the settlor retains a testamentary limited power of appointment, the exclusion from capital gains on the sale of a principal residence is maintained.

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14 IRC §§ 671-679

15 See Rev. Rul. 85-45 (1985) and PLR 199912026 .

16 Begley, Jr. & Hook, *supra* at § 7.20[6][e].