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Fall 1977

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Repository Citation

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The Impact of the New Basis Rules on Post-Mortem Income Tax Planning

EDITOR'S NOTE: This is the second *Journal* article by Prof. Donaldson concerning the effects of the Tax Reform Act of 1976. His first article "The Role of Inter Vivos Giving in Estate Planning Under the Tax Reform Act of 1976," appeared in Volume III, Number 2, Spring, 1977.

THE modifications in the basis rules enacted as part of the Tax Reform Act of 1976 requires the estate planner to place a much stronger focus on post-mortem income tax planning than in the past. Prior to 1977 the basis of an item acquired from a decedent was the value for estate tax purposes of that item unless the item was income in respect of a decedent. As a result, unrealized appreciation reflected in an asset held by a decedent until death escaped taxation and the asset experienced in the hands of the fiduciary or legatee "tax free step-up in basis." Accordingly, an executor choosing to sell some or all of the estate assets need be concerned only with post-mortem appreciation during the period of administration prior to sale in evaluating the capital gains impact of the asset disposition. Because in the typical estate asset appreciation during the period of administration was relatively slight, the executor enjoyed considerable latitude in determining to liquidate the estate and distribute cash or instead to distribute assets in kind.

New Section 1023 of the Internal Revenue Code added by the Tax Reform Act of 1976 has severely curtailed latitude as to whether to liquidate or distribute in kind and has brought added miseries to the executor, his advisors and the legatees of the decedent. The mere reading of Section 1023 is misery *per se*. The section occupies four pages in the standard editions of the Internal Revenue Code and is incredibly complex, requiring numerous cross references to other sections for its understanding. No attempt will be made here to outline the detailed provisions of the statute.¹

In its more salient features Section 1023 provides

that the basis of assets acquired from decedents dying after 1976 is "carryover basis," that is, the basis of the decedent the moment before death modified by four possible adjustments. The first adjustment, which is allowed for purposes of gain but not loss, is the "fresh start" adjustment applicable to assets acquired by the decedent prior to 1977. In the case of marketable securities the adjustment may increase basis to market value as of December 31, 1976. As to other property acquired before 1977 the adjustment is an imputed basis as of December 31, 1976 and employs the assumption that appreciation between date of acquisition and date of death occurred ratably on a daily basis. The appreciation so determined to be applicable to the period prior to December 31, 1976 is then added to decedent's basis.

The second possible adjustment is designed to mitigate the effects of double taxation of post-1976 appreciation. Such appreciation is reflected in the value of the gross estate and is subject to estate taxation and is also subject to capital gains taxation on the sale of the asset. Under this adjustment basis is increased for purposes of gain or loss but not above fair market value by estate taxes attributable to post-1976 appreciation contained in assets subject to estate tax. For this purpose estate taxes include state estate and inheritance taxes for which the estate is liable and which are paid by the estate. To the extent that appreciation is reflected in assets used to fund the marital and charitable deductions, the appreciation is not subject to estate tax and no adjustment is made.

The third and fourth adjustments will occur with less frequency. The third adjustment is designed to assure that when an estate has assets of a value of \$60,000 or more and basis would otherwise be less

¹An excellent, concise interpretation of section 1023 is contained in Internal Revenue Publication 559, "Federal Tax Guide for Survivors, Executors and Administrators, 1977 Edition."



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Professor Donaldson joined the faculty of the Marshall-Wythe School of Law in 1966 and was named professor of law in 1970. From 1968 to 1970 he served as assistant vice-president of the College of William & Mary, and from 1970 to 1972 was associate dean of the Marshall-Wythe School of Law. He is a member of the Virginia State Bar, The Virginia Bar Association, and the Williamsburg Bar Association.

After practicing law in Williamsburg, Professor Donaldson served as attorney with the Internal Revenue Service. He was consultant for the IRS from 1968 to 1969, and consultant for the Virginia Income Tax Conformity Statute Study Commission from 1970 to 1971.

Professor Donaldson has served as lecturer and seminar leader for various CPA, tax, and estate planning groups, as well as for the State Bar and The Virginia Bar Association. He also served as associate editor of the *Tax Executive Quarterly* and has published several articles on taxation and land use law.

to pay state or local succession taxes attributable to post-1976 appreciation.

Section 1023 also provides an opportunity to exclude certain assets from carryover basis treatment. The executor by filing a timely election is permitted to designate up to \$10,000 in value of personal and household effects as non-carryover basis property. Property so designated will have a basis for purposes of gain equal to estate tax value.

The new rules compound the income tax compliance problems of the fiduciary. A particularly onerous aspect is that the fiduciary has been made the agent of the Internal Revenue Service in assuring compliance with the income tax law by heirs and legatees. Subject to substantial penalties and pursuant to regulations yet to be issued the executor must notify the Internal Revenue Service and each heir or legatee of the basis for gain and basis for loss of each asset distributed. To properly discharge his duty the fiduciary must establish the decedent's basis for all assets in the estate, the date of death and alternate valuation of all such assets, the post-1976 appreciation reflected in each such asset, the December 31, 1976 value of marketable securities owned by the decedent on that date and state and federal death taxes attributable to unrealized appreciation pursuant to an asset by asset computation. Once carryover basis with adjustments has been computed any change in state or federal estate tax liability as a result of audit or mistake will require a recomputation of the basis of each asset that has post-1976 appreciation.

The new rules make it very difficult for the fiduciary to file correct fiduciary income tax returns for income received during the period of administration of the estate. Gains on the sale of assets sold during the period of administration are reportable on the fiduciary income tax return. However, the gain cannot be properly reported unless basis is known and basis cannot be known with certainty until estate tax liability pursuant to audit is finally ascertained. The same observation is applicable to income tax returns of legatees who sell distributed assets prior to a final determination of estate tax liability. In practice fiduciaries and legatees will frequently find it necessary to request extensions of time to file income tax returns and will often find it expedient to file protective refund claims where the income tax return has been filed and estate liability remains unsettled. The new basis rules provide an added reason why the fiduciary should consider filing a request for prompt assessment of estate tax liability. A further consequence is that in the

than \$60,000 carryover basis in the aggregate will be at least \$60,000. The fourth adjustment provides an increase in basis to the heir or legatee who is required

valuation disputes that often attend the determination of estate tax liability pursuant to audit, the fiduciary in formulaing offers of compromise should be mindful that upward adjustments in federal estate tax can generate income tax refunds with respect to reported gains on assets sold during the period of administration.

As has been noted, a major consequence of the new basis rules is the curtailment of the latitude previously enjoyed by the fiduciary in determining whether to liquidate and distribute cash or instead to distribute in kind. Where assets in the estate are heavily appreciated the executor is truly caught between a rock and a hard place. A decision to liquidate and distribute cash is in effect a decision to incur significant capital gains tax and a decision to distribute in kind is in effect an undertaking to assign to various legatees in various income tax brackets the potential capital gains liability reflecting in varying amounts in the individual assets to be distributed. Where there are substantial pecuniary legacies and no discretion to satisfy them with distributions in kind there will frequently be no choice but to liquidate substantial portions of the estate portfolio thereby generating potentially high capital gains taxes that will reduce the take of residuary legatees. No analysis of the liquidity of an estate is complete which fails to consider the capital gains cost to the fiduciary in administering the estate.

Even if there is authority to satisfy pecuniary bequests with distributions in kind the executor, absent an exoneration clause in the will, may in practice frequently feel constrained in the selection of assets for distribution if he is to avoid potential liability for alleged partiality shown among the legatees. Only the selection of high basis assets is likely to satisfy the unfriendly pecuniary legatee insistent upon impartiality.

It should be noted that the previous rule that distributions in satisfaction of pecuniary bequests are realization events for purposes of gain and loss is continued. However, new Section 1040 requires that gain be recognized to the fiduciary only in the amount of appreciation occurring during the administration of the estate prior to the distribution of the asset, and provides further that the distributee who receives assets in satisfaction of a pecuniary legacy succeeds to the carryover basis as defined, but with an upward adjustment for the gain recognized to the fiduciary. Section 1040 was enacted to prevent the estate from recognizing gain attributable to pre-death appreciation

where distributions satisfy pecuniary legacies. As a result the "pecuniary amount" formula marital deduction clause remains as viable in relation to the "fractional share of the residue" formula as before 1977. Distributions under the "fractional share" formula result in no gain to the estate and distributions in kind in satisfaction of the "pecuniary amount" formula bequest result in gain to the estate only in the amount of post-death appreciation.

If it can be assumed, either by reason of express authorization in the will, an adequate exoneration clause in the will or the friendliness of the heirs, that the executor may exercise discretion in choosing to sell or distribute in kind and can do so to maximize aggregate income tax savings to the estate and the heirs a valuable opportunity for tax planning may be present. However, the executor's choices must reflect a careful evaluation of a number of factors. He must determine what to sell and what to distribute, when to sell, when to distribute and what to distribute to whom. Each of these decisions can be properly made only if based on a careful evaluation of the income tax posture of the estate and of each beneficiary of the estate, a careful comparison of marginal income tax brackets of each, due regard to the taxable years of each and an evaluation of the likelihood of sale or retention by the beneficiary if a distribution in kind is made. The status of the specific beneficiary as a pecuniary or specific legatee in contrast to that of a residuary legatee is also relevant. To properly make the decisions a thorough understanding of Section 1023 of the Internal Revenue Code is essential as is a knowledge of the principles of fiduciary income taxation.² In particular the fiduciary should be mindful that distributions during the period of administration to residuary legatees are generally regarded as out of current estate income to the extent of such income but that distributions to pecuniary legatees generally are not regarded as out of estate income. To the extent that the estate income is regarded as having been distributed the distributee is required to report that income and the estate claims a distribution deduction.

The following examples are illustrative of some of the techniques for income tax minimization that might be employed where the executor has the desired discretion:

² A very readable discussion of tax savings techniques in post-mortem administration is contained in Tax Management Portfolio No. 302, "After-death Tax Planning—Payments and Distributions" by Conway and Hale.

Example One

Residuary legatee X has a large capital loss carry-forward from an earlier year. A distribution to X of low basis assets may be advantageous since gain realized by X on the subsequent sale would be offset by previous year's capital losses.

Example Two

Estate is in the 30% marginal income tax bracket and beneficiary is in the 40% bracket. If sold by the estate the tax burden with respect to a low basis asset will be lower than if distributed to the beneficiary and then sold by him. Because the accumulation throwback rules do not apply to estates the gain, once taxed to the estate, will not again be taxed to the beneficiary. However, if it is likely that the beneficiary would not sell the asset but would retain it indefinitely a distribution to the beneficiary may be more advantageous than a sale by the estate. The sale would generate immediate tax liability and a decision to distribute would in effect enable a deferral of tax liability. The deferral of tax liability is often good money management even where the amount to be paid later is greater than the amount that would have been due earlier.

Example Three

An estate must unfortunately sell a substantial amount of low basis assets to pay debt taxes and satisfy cash legacies. It is anticipated that twelve months is required to administer the estate. Because it is better to have the same amount of income taxed over two taxable periods than entirely within one, the estate should select a short taxable year as its initial year, perhaps one ending in the six month after death and then sell in such a way as to spread the gain over two periods. Note however that capital gains incurred during the taxable year of the estate in which it terminates are usually taxable to the residuary legatees and not to the estate.

Example Four

An estate must sell both potential gain and potential loss assets to pay debts, taxes and pecuniary legacies. The estate is otherwise in a low income tax bracket and the residuary legatee is in a high income tax bracket with substantial year to year capital gains. The estate should sell the gain assets prior to the final year of administration and should sell the loss assets in the year in which administration terminates. As a consequence the gain is taxed at the lower estate

income rates and the losses are passed on to the residuary legatee who may use them in the year of termination to offset his capital gains.

Example Five

An estate's residuary assets are to be used to fund a "fractional share" marital deduction trust bequest and a family trust bequest. Included in the assets is a low basis block of stock and investment counsel is of the opinion it should be sold. If the stock is distributed to the marital deduction trust and then sold, gain will be greater than if distributed to the family trust and then sold. Appreciated assets used to fund the marital deduction do not qualify for the step-up in basis attributable to federal estate taxes because such property, being deductible, is not subject to estate taxes. A distribution to the family trust however would qualify the asset for the step-up in basis, thereby resulting in a lesser amount of gain when the asset is sold. However, if the marital trust is given the asset the tax burden as to the unrealized appreciation is shifted to the marital share and the economic value of the share going to the family trust is thereby enhanced. In short, distributing the low basis asset to the marital trust in effect enables enhancement of the worth of the family trust at marital trust expense without transfer tax liability, but at a cost of potentially greater income tax exposure to the marital share than would have existed for the family trust. The implied transfer tax saving must be weighed against the income tax costs to determine which distributee trust is to receive the low basis asset.

Example Six

The estate's taxable year ends at the end of November and the executor is preparing to terminate the estate. The executor wishes to sell a carryover basis asset that is subject to Section 1245 depreciation recapture as to gain a \$45,000, to pay himself a commission of \$15,000 and to distribute the residue to the residuary legatee, who is in a higher income tax bracket. If the executor sells the asset in November and pays the commission in December and then terminates, maximum savings will result. The recapture income will be taxed at a lower rate to the estate and the commission paid in December will in all likelihood exceed estate income in December and will, on the assumption that the estate tax deduction for administrative expenses has been waived, generate an "excess deduction" which can be claimed as an itemized deduction on the residuary legatee's income

tax return for the year of termination. Had the recapture asset been sold in December followed by distribution to the residuary legatee the gain would have been ordinary income to the legatee and the beneficiary would have lost the benefit of the excess deduction.

Example Seven

Decedent died leaving a stamp collection with a value of \$10,000 and a carryover basis of \$1,000 and an antique car with a value of \$10,000 and a carryover basis of \$6,000. If both are to be sold executor should designate the stamp collection as household or personal effects which are excluded from the carryover basis rules. If both assets are to be distributed to legatees, executor should carefully consider whether the particular legatee will retain or sell the specific legacy before determining which to designate under the personal and household effects exclusion.

Example Eight

An estate will take several years to administer. In the second year of administration it has \$20,000 of income from dividends and wishes to satisfy a \$20,000 cash bequest to beneficiary A and to give \$20,000 to residuary legatee B. The estate also has a block of stock valued at \$20,000 at time of proposed distribution and having an estate tax value of \$16,000 and a carryover basis of \$10,000. The executor is free to distribute either the stock or the cash to either A or B. If the estate distributes the stock to A it will realize a gain of \$4,000 and A on selling the stock will have a basis of \$14,000 and a gain of \$6,000. If residuary legatee is given \$20,000 in cash he will realize \$20,000 of income and the estate will have a distribution deduction of \$20,000. This is because distributions to residuary legatees are regarded as out of the taxable income of an estate to the extent of its current taxable income. If on the other hand the estate had distributed the \$20,000 in cash to A and the stock to B no capital gains would be realized to anyone on the facts stated. B will realize \$20,000 in ordinary income because distributions to residuary legatees are regarded as out of estate income, thereby being deductible by the estate and taxable to the distributee. However, inasmuch as B has realized \$20,000 in income on the distribution he takes the stock with a basis of \$20,000 and its subsequent sale by him would produce no gain.

The new basis rules require a reexamination of techniques frequently employed in the past to enable effective administration of estates. A number of these techniques either are no longer valid or are of less utility. For example, the use of "flower bonds" to pay death taxes is of considerably less value after 1976. Such bonds carry a low rate of interest and now, unlike before, the difference between the decedent's purchase price and par at redemption will constitute taxable gain. Also, the funded buy-sell agreement technique under which a surviving business associate would purchase the decedent's interest in a closely held business with cash shortly after death may now, unlike before, result in the generation of substantial taxable gain. The draftsman should now consider using the installment sale approach rather than outright cash purchase to enable spreading the gain over several tax years.

From the foregoing discussion of the effect of the new basis rules on post-mortem income tax planning, certain conclusions clearly emerge. Firstly, it is imperative that the fiduciary's legal and tax advisors possess a thorough knowledge of the new rules and a mastery of the complex statutes and regulations governing fiduciary income taxation. Secondly, potential capital gains tax exposure adds a new element to liquidity problems that should be carefully examined, particularly in relation to a client's desire to make large cash bequests. Thirdly, from the standpoint of tax compliance difficulty and tax savings opportunities, estates are likely to require longer periods for effective administration with attendant increases in administration costs and legatee frustration. Fourthly, immediately following the death of a decedent the tax posture of the estate and the legatee should be carefully diagnosed and a plan for the administration of the estate formulated under which sales, payments and distributions will be carefully made and timed. Fifth, wills drafted in the past should be carefully examined and those drawn in the future written with due regard to the potential need for the fiduciary to enjoy considerable latitude in the selection of assets for sale and distribution. Clauses empowering the executor to act with a view to the aggregate income tax advantage of the estate and legatees and exonerating the executor for decisions involving in-kind distributions may be appropriate. Finally, as a result of the new basis rules, post-mortem estate planning is truly a new ball game.