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Obtaining a Full Step-up in Basis for Jointly Held Property Between Spouses

By William P. LaPiana and Marc S. Bekerman

Holding property together as joint tenants with right of survivorship has numerous advantages to spouses. Among the advantages are asset protection, disability planning, and possible avoidance of a probate or administration proceeding on the death of the first spouse. Because most assets can be held in this manner, many married couples own a substantial portion of their property in this form. This article will review a possible additional advantage that may be available to a surviving spouse of jointly owned property in jurisdictions that have favorable law and when proper planning is done both before and after the death of the first spouse.

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Tax Consequences of Jointly Held Interests

The estate tax treatment of jointly held interests is governed by section 2040 of the Internal Revenue Code ("Code"). The general estate tax treatment for property interests held jointly by spouses, usually referred to as qualified joint interests, is that each spouse is treated as having owned a one-half interest in the assets at the time of the first spouse's death (that is, contributions between spouses are not traced for estate tax purposes). Code § 2040(a). As a result, the estate of the first spouse to die will include one-half of these qualified joint interests and will report such holdings on Schedule E(1) of the federal estate tax return (assuming that a return is required to be filed). The inclusion of these assets for estate tax purposes will not increase the estate's potential estate tax liability because the qualified joint interests will qualify for the marital deduction as passing to the surviving spouse by operation of law. Code § 2056. (Assume that both spouses are U.S. citizens for purpose of this article.)

The income tax treatment of the qualified joint interests in the hands of the surviving spouse is also fairly simple in most cases. At the death of the first spouse to die, the surviving spouse will not recognize income on receipt of these assets. Code § 102. In addition, the basis of the qualified joint interests will be adjusted to the fair market value of the property at the time of death to the extent that such interests are included in the estate of the deceased spouse for estate tax purposes. (Assume for purposes of this article that no elections are made regarding potential alternate valuations of assets.) Code § 1014. (The basis adjustments under Code § 1014, often referred to as a step-up in basis, may be a disadvantage if the decedent's basis in the property exceeds the fair market value of the property at the time of death because then a step-down in basis would result.) This basis adjustment is mandated by the Code and is applicable even when no estate tax return is required to be filed.

Only the one-half portion of the qualified joint interest included in the gross estate under Code § 2040 will receive a basis adjustment under Code § 1014. There will be no adjustment to the basis of the other one-half of the qualified joint interest.

Example—H and W own their residence as tenants by the entirety. Their basis in the residence is $100,000. At the time of H's death, the fair market value of the residence was $400,000. Even if no estate tax return is required to be filed, W's basis in the residence will be $250,000 (one-half at the original basis of $100,000 divided by 2 and one-half at the fair market value of $400,000 divided by 2).

For joint tenancies created by spouses before 1977, there is an interesting twist on the general rule set forth in Code § 2040(a). In *Gallenstein v. United States*, 975 F.2d 286 (6th Cir. 1992), the Sixth Circuit held that such joint interests are governed by the contribution tracing rule in effect before the passage of the Economic Recovery Tax Act (ERTA) in 1981 and still in effect for joint tenancies involving other than married couples. Inclusion of the jointly held property in the estate of the spouse first to die, therefore, is determined by which spouse contributed how much of the consideration for the acquisition of the jointly held property. Although the IRS did not accept the result in *Gallenstein*, in 2001 it conceded the point by acquiescing in the result in *Hahn v. Commissioner*, 110 T.C. 140 (1998), which followed *Gallenstein*. Therefore, joint interests created by spouses before 1977 are taxed on the death of the first spouse under the rules of Code § 2040(b).

Code § 2040(b) creates a rebuttable presumption that the first owner to die contributed 100% to the acquisition of the joint property and that the entire property is includable in that owner's gross estate. To rebut the presumption, a tracing rule is available to taxpayers who can demonstrate that the surviving joint tenant contributed to the acquisition of the property, which allows for an allocation of the property between the two joint tenants based on their respective contributions.

In many cases this rule is to the government's advantage in that it maximizes the value of the estate of the first owner to die, while placing the burden of challenging the default rule on the surviving joint tenant, who may be unable to provide sufficient proof to rebut the presumption. Further, assuming that the surviving joint tenant lives more than two years, the property will be at least partially taxable in that survivor's estate. See Code § 2013 (Credit for Tax on Prior Transfers). If the property passes to a surviving *spouse*, however, the marital deduction will completely offset the increased value, resulting in no additional estate tax liability.

As the entire property passes through the estate of the first spouse to die under *Gallenstein*, Code § 1014 mandates a corresponding effect on the basis adjustment. Specifically, the entire interest in the property will receive a basis adjustment to fair market value because the entire interest was included in the estate of the first spouse to die. Code § 1014.

Example—Assume that the residence in the prior example was purchased in 1970. Because the *Gallenstein* rule applies, the entire residence will be included in H's estate for estate tax purposes and W would take a basis of $400,000 (the fair market value of the entire property at the time of H's death). The entire $400,000 reportable on the estate tax return, however, will also generate a marital deduction of $400,000, resulting in no estate tax liability on account of this asset.

One important note is that the *Gallenstein* rule applies whether or not an estate tax return is required to be filed. This is especially important given the increasing applicable exemption amount. The surviving spouse, therefore, should be made aware of the new, properly computed, basis in the formerly jointly held property. In addition, if an estate tax return is required to be filed for an estate when the taxpayer has determined that *Gallenstein* applies, it is appropriate usually to include the asset on Schedule E(2) of the estate tax returns because the joint interest is not a qualified joint interest under Code § 2040.

As one can imagine, a full step-up in basis with no additional estate tax liability is a highly desirable result because it will reduce the potential capital gains on the sale of the property by the surviving spouse. Further, if the property in question is depreciable (such as rental real estate), the increased basis will also increase the income tax deductions available to the surviving spouse on an annual basis. (Because of the extremely favorable tax treatment, estate planners should take care when considering the severance of a joint tenancy that would qualify for a full step-up in basis under *Gallenstein*.) Although this result cannot be obtained under *Gallenstein* if the joint tenancy was created after 1976, one question is whether the result can be replicated with proper planning. The authors propose that, with proper planning under fairly ordinary circumstances, it is possible to replicate the *Gallenstein* result in the majority of jurisdictions.

Use of Disclaimers for Jointly Held Property Interests

At the end of 1997, the Treasury promulgated new regulations under Code § 2518 governing disclaimers of jointly held property by surviving joint holders. These new regulations settled the questions surrounding such disclaimers in a way favorable to taxpayers. In short, beginning in 1998 surviving joint tenants with the right of survivorship and tenants by the entirety in property other than bank, brokerage, and other investment accounts can disclaim that portion of the jointly held property to which they succeed. In the case of joint tenancies between spouses and tenancies by the entirety involving other than bank, brokerage, and investment accounts, the surviving spouse can disclaim one-half of the property regardless of (1) the proportion of the consideration for the acquisition of the property furnished

by the surviving spouse, (2) the portion of the property included in the decedent's gross estate under Code § 2040, and (3) whether or not the interest could be unilaterally severed under local law. Treas. Reg. § 25.2518-2(c)(4)(i).

Example—W has significantly more resources than H. W acquires real property solely with her funds and takes title with H as joint tenants with right of survivorship or tenants by the entirety. At W's death, H can make a qualified disclaimer of one-half of the real property. (The rules governing disclaimers are contained in Code § 2518 and applicable state law. For purposes of this article, it is assumed that any disclaimer is properly executed under both federal and state law and that disclaimers of jointly held property are possible under state law.)

In this example, if H does not execute a disclaimer, H will receive the property with a one-half step-up in basis under Code § 2040(a). The disclaimer will not change that outcome, however, because the result of the disclaimer is that one-half of the property passes through W's probate estate. That one-half of the property will receive a new basis, but in the right circumstances (and perhaps with a further disclaimer by H) the property will pass to someone other than H, not qualify for the marital deduction, and use up part of the applicable exclusion amount that might otherwise be wasted. Indeed, most would assume that qualified disclaimers of jointly held property by a surviving spouse are usually made to mitigate overqualification of the marital deduction.

Obtaining the result of *Gallenstein* for some joint property arrangements created after 1977 is possible because of the special rule for disclaimers of joint bank, brokerage, and other investment accounts. Treas. Reg. § 25.2518-2(c)(4)(iii). Under this rule, if the transferor can unilaterally regain the transferor's own contributions to the jointly held property, a surviving joint holder may disclaim that portion of the property attributable to the decedent's contribution. The disclaimed property is included in the decedent's gross estate under Code § 2033 and receives a stepped-up basis.

Example—W has significantly more resources than H. W opens a brokerage account and deposits in the account her own funds, which then are used to purchase various securities. While H and W are both alive, W can regain sole ownership of the account without H's consent. At W's death, H may make a qualified disclaimer of the entire account.

In this example, if H does not execute a disclaimer, H will receive the property with a one-half step-up in basis under Code § 2040(a). But if H is the residuary beneficiary under W's will and there are sufficient other assets to pay all expenses and pre-residuary legacies, H's disclaimer will allow the entire property interest to pass to the estate and then to H as the residuary beneficiary. (Although H receives the disclaimed property as a result of the disclaimer, the disclaimer is qualified for tax purposes under Code § 2518(b)(4)(A).) The result from a property law perspective is identical whether or not the disclaimer is executed. Further, there is no additional estate tax because of the marital deduction available to the bequest to H. As the entire property interest passes through the estate, the entire interest will receive a step-up in basis. Thus, the result in *Gallenstein* has been replicated regardless of when the joint interest was established. Note that if H dies first, rather than W, W simply would forego a disclaimer and allow the property to be treated as a qualified joint interest under Code § 2040(a).

Conclusion

If state law allows for disclaimers of a jointly held property interest by a surviving spouse in accordance with his or her contributions to the property, a significant planning opportunity for jointly held financial assets may be available regardless of the size of the estate or when the joint interest was created. ■

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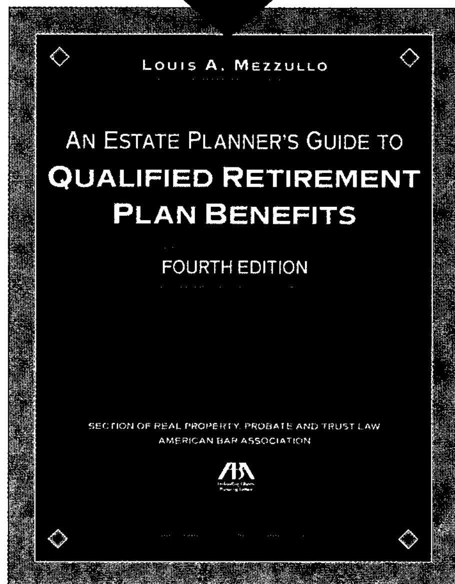

An Estate Planner's Guide to Qualified Retirement Plan Benefits, Fourth Edition

Louis A. Mezzullo

2007, 178 pages, 8 ½ x 11 + CD-ROM
Paper, ISBN: 978-1-59031-939-0
Product Code: 5430474
Regular Price: $139.95
Section of Real Property, Trust & Estate Law Member Price: $119.95

This clearly written guide, now completely revised and updated, provides practical advice for the non-ERISA specialist on how to structure benefits from qualified retirement plans and IRAs to achieve maximum benefits for your client. The new edition reflects changes made by the Pension Protection Act of 2006 and the final regulations issued in April 2002 dealing with the required minimum distribution rules under Code § 401(a)(9), as well as many administrative pronouncements made since publication of the previous edition. The new edition also includes appendices on an accompanying CD-ROM.

Written by nationally known author and speaker Louis A. Mezzullo, *An Estate Planner's Guide to Qualified Retirement Plan Benefits* relates key distribution issues to current estate planning practices. Mezzullo clarifies the current options available for distribution, alerts you to the dangers of some traditional estate planning techniques, and helps you meet clients' interests and needs. Along with summarizing defined benefit and defined contribution plans and the rules that affect each type of plan, it also discusses tax laws, rules, and regulations as well as the penalties related to these distributions. Income taxation of benefits, transfer tax issues and spousal rights are covered in detail. Where appropriate the author notes relevant estate and trust administration issues. A final chapter details practical planning strategies based on three key objectives:

- Achieving the client's personal goals when making decisions about benefits while considering restrictions in the plan that may limit the form and timing of the distributions
- Avoiding the two penalty taxes that may apply to distributions
- Incurring the lowest possible income tax on the distribution

Appendices include an illustration of tax consequences and hypothetical retirement plan scenarios, forms, tables and charts for estate planning purposes, and tables of cases, revenue rulings, private letter rulings, and IRS news releases, notices, and revenue procedures.

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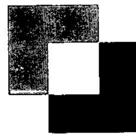

SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

A new Section Committee is active and looking forward to presenting its first CLE program at the Spring Symposia in May 2008. The **SPECIAL COMMITTEE ON IN-HOUSE COUNSEL**, formed in 2007, focuses on issues of particular concern to members of the Section who are employees of for-profit and not-for-profit corporations and federal, state, and local governmental departments and agencies. The Committee will work with other committees of the Section to design programs and arrange for articles that are of particular interest to in-house counsel and to promote opportunities for participation by in-house counsel in Section activities.

The Committee's CLE program on E-discovery and its effect on our profession, *Avoiding the Traps of Electronic Discovery and the Email Nightmare*, will be presented Friday, May 2, 1:45-3:15 p.m.

Program outline: Bob Karelitz, General Counsel for Fiduciary Trust (and Committee member), will read a mock set of e-discovery document requests that must be answered and produced for a specific litigation matter. Issues raised in the litigation include both real property and trust and estate controversies. After realizing how challenging it will be to comply (due to IT issues), he will review this document request with outside counsel he has "hired," Christine Braun of Kaye Scholer, who in turn will recommend bringing in an outside vendor, Maureen Attá of Huron Legal Consulting, to help reduce the workload and litigation costs. This approach will not only resolve Bob's "problem" but will also lead to a set of best practice tips from Christine and Maureen that can be applied by everyone in attendance. This hypothetical case study approach will allow for a lively give and take, with Bob playing the role of the "now what do I do...I need your help" in-house counsel, worried not about his corporate liability but about the cost to defend his company in this litigation. The issues raised are of concern not only to inside counsel but also to major law firms and corporate fiduciaries, since these firms often have thousands of computers and dozens of servers that need to be checked to be in compliance with an e-discovery document request.

The Committee is eager to hear from Section members who wish to participate by joining the Committee, writing an article on a topic of interest to in-house counsel, corporate fiduciaries, or governmental agencies, or participating in a future program. Please feel welcome to call or email **Dan Homick**, homick@earthlink.net, or **Jo Ann Engelhardt**, engelhardt@bessemer.com, co-Chairs of the Committee.

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