THE BASICS OF BASIS

By

Kenneth P. Brier, Esq., CPA, TEP, AEP®

BRIER MARANDETT & ROSSETTI LLP
160 Gould Street, Suite 320
Needham, MA 02494-2300
781.453.0030
kbrier@brierlaw.com
www.brierlaw.com

New England Fellows Institute
Of The American College of Trust and Estate Counsel

September 15, 2022

I. TAX BASIS GENERAL CONCEPTS

A. Role in Trust and Estate Practice

1. Taxation – both transfer taxation (estate, gift and generation-skipping transfer taxes) and income taxation permeate almost everything we do as trust and estate lawyers.

2. And tax basis is one of the core concepts in income taxation. The word "basis" appears in about one of every two sections of the Internal Revenue Code. J. Maule, 560-3rd T.M.*, Income Tax Basis: Overview and Conceptual Aspects* II.A.

B. Basic Concepts

1. Tax basis is one of the two essential elements in determining gain or loss on the disposition of a tax item. Basic formula (IRC §1001):

Net Proceeds	+ $xxxxxxx
Adjusted Tax Basis	- $yyyyyyy
Gain or Loss Realized	$zzzzzzzz

2. Basis is a term of art in tax practice, assigning the amount which is credited to the taxpayer as the tax investment in property. Basic idea is to permit the taxpayer to recover his investment tax-free (or sometimes the investment of a preceding person). It binds together tax events that occur in multiple years. It serves to define the portion of a person's wealth that is exempt from future income taxation, and to harmonize treatment when property is transferred from person to person or when one kind of property is substituted for another. The general idea is to insure that gain is taxed once, but only once, and loss is allowed once, but only once.

3. Original (or Unadjusted) Basis

   a. Generally the taxpayer's cost, including acquisition expenses (brokers' commissions and legal fees, etc.) – but there are lots of exceptions. IRC §1012.

   b. Property exchange (barter) transactions – Basis is set equal to value of property received, not the value of property transferred, if there is any disparity in values or the latter is not discernable. *Philadelphia Park Amusement Co. v.*

United States, 126 F. Supp. 184 (Ct. Cl. 1954) (exchange of interest in a bridge for a 10-year extension of right to maintain a railroad to amusement park); Rev. Rul. 55-757, 1955-2 C.B. 557.

c. Property received in taxable transaction

(1) examples: compensation for services or as a corporate dividend.

(2) basis is set equal to fair market value of the property, as that is what is taxed to the recipient.

4. Adjusted Basis

a. Basic formula: original basis + additional investments – adjustments (including depreciation, amortization, and depletion). IRC §§1011 and 1016.

b. Formula is more involved for particular assets, notably interests in partnerships (including LLCs taxed as partnerships) where basis is adjusted periodically to reflect ongoing economic activity attributed to each partner: original basis + taxable income allocated + tax-exempt income allocated + depletion adjustment – losses allocated – nondeductible expenditures allocated – distributions. IRC § 705. There are additional adjustments for a partner's share of partnership liabilities. IRC §752.

c. The formula for shares in S corporations is similar, but not identical. IRC §1367.

5. Substituted Basis – Nontaxable Transactions

a. The bedrock idea of "cost" constituting the basis of an asset cannot apply when then asset is acquired in one of the transactions treated as nontaxable under the tax laws. A like-kind exchange under IRC §1031 is one of innumerable examples.

b. The tax laws apply instead a "substituted basis," which can involve either (1) the transfer of the basis of the property surrendered to the property received (an "exchanged basis") or (2) the assumption of the basis of the previous owner (a "transferred basis").

c. Suitable adjustments are made in the substituted basis, for example to subtract the amount of any cash received in the transaction (cash effectively always having a basis equal to face) or to add in any (partial) gain that is recognized in the transaction.

II. TAX BASIS ISSUES INVOLVING MULTIPLE ASSETS

A. Combined Purchase of Multiple Assets – Allocation of Basis

1. Purchase of multiple assets for a lump-sum amount necessitates an allocation of the purchase price among the items purchased if they may later become subject to separate tax treatment, such as:

   a. Sale of only part of the holding, or

   b. Different depreciation life or method for different assets.

2. Allocation for fungible items is self-evident: each share of stock of a lot of 100 shares is assigned 1/100 of the basis.

3. Examples involving non-fungible assets

   a. Improved real estate consisting of land and building(s);

   b. Residence including a depreciable home office and nondepreciable living quarters;

   c. Developer's tract of land divided into separately saleable lots;

   d. Purchase of a going business, potentially including inventory, depreciable assets (of varying lives), and intangible assets (some potentially amortizable).

4. When only a portion of an asset or grouping of assets is sold, the basis is to be determined by an equitable apportionment of the overall basis. Reg. §1.61-6(a).

5. Equitable apportionment typically would be determined in accordance with the fair market values of component assets at the time of acquisition. This principle is specifically prescribed for acquisitions of combined depreciable and nondepreciable property. Reg. §1.167(a)-5.

6. But since taxpayer typically would not have obtained a formal appraisal of the constituent assets, the taxpayer often must determine the relative values of those assets by other reasonable means (e.g., values of land and building as assessed for local real estate tax purposes).

7. Purchases of business assets are subject to special rules under IRC §1060:

    a. These rules are intended to strengthen the IRS's hand relative allocations of proceeds among the assets bought and sold as between the buyer and seller, who commonly have conflicting interests in how the aggregate price is allocated among the different classes of assets.

    b. The regulations prescribe how the allocation is to be made among five classes of assets.

    c. Though the buyer and seller need not agree on the allocation, each is required to report the allocation to the IRS on Form 8594.

    d. The reporting obviously gives the IRS a "head's up" if the allocations are inconsistent, and the resulting risk of audit provides an incentive for buyer and seller to reach an agreement.

    e. To the extent that the buyer and seller agree to the allocations, they are each bound by them, except if the IRS determines that the allocation is not appropriate.

B. <u>Sales of Fungible Assets – Identification of Assets Sold</u>

1. The issue of identification of the asset sold arises when the taxpayer holds a collection of identical (or fungible) items – like merchandise or securities – and the buyer is indifferent as to which particular item is delivered.

2. Though the buyer might be indifferent, the seller might not be, if various items or lots were acquired at different times and bear different tax bases.

3. In principle, a taxpayer could be compelled to maintain adequate records and to means of identifying each otherwise undifferentiated unit or lot, or a taxpayer could be compelled to use some other accounting convention to track basis.

4. Items subject to inventory rules (manufacturing input items and merchandise held for sale) fall into the latter category and are subject to inventory accounting rules, under which the cost of goods sold is a residual component of a calculation for the accounting period subtracting ending inventory from the sum of beginning inventory and purchases. This still requires an identification of the ending inventory under some accounting convention (e.g., first-in first-out (FIFO) or last-in first-out (LIFO)).

5. The rules for sales of securities held for investment encompass a hybrid approach, permitting either a specific identification of the lot of securities sold or the application of an accounting convention.

   a. If the lot of securities is "adequately identified," then the basis and holding period of that lot controls for the sale.

   b. Otherwise the FIFO convention prevails.

   c. Securities represented by an individual certificate (now rare for publicly-traded companies) can be identified by the particular certificate delivered to the buyer.

   d. For securities held in the custody of a broker or other agent, the "adequate identification" standard is met by notifying the agent of the lot being sold before the sale or by the settlement date for the sale.

   e. As a practical matter, the "adequate identification" standard can permit the broker to adopt, on the taxpayer's behalf, a tax strategy based on some other convention besides FIFO – including LIFO or sales first of highest basis lots or first of long-term holdings.

   f. Shares in a regulated investment company (mutual funds) are subject to special rules which permit application of an average cost method.

III. SPECIFIC BASIS RULES COMMONLY ENCOUNTERED IN T&E PRACTICE

A. Property Acquired by Gift

1. Under IRC §1015, the recipient of a gift (including an individual or a trust) generally takes a carryover basis (or a "transferred basis" as described in the discussion of "substituted basis" above). More specifically, the recipient takes a basis equal to

    a. The donor's adjusted basis, if the fair market value of the property equals exceeds such basis (gain property), or

    b. The fair market value, if such basis exceeds the FMV (loss property).

2. The general rule of carryover basis is consistent with the nonrecognition of gain on the transfer of a gift prescribed in IRC §102(a) and insures that the gain accrued while the donor held the property will eventually be taxed to someone (i.e., the recipient).

3. The exception for loss property is intended to prevent owners of such property from shifting the property to another family member who is in a better position to utilize the loss (apparently a common tactic after the stock crash of 1929). It means that the economic loss incurred by the donor might never be realized by anyone. The donor may avoid this detrimental result by selling the loss property and giving away the proceeds.

4. There is an additional adjustment for any gift tax paid by the donor attributable to the net appreciation on the gifted property at the time of the gift. IRC §1015(d). The idea is to avoid a double tax on the appreciation upon which the donee ultimately will bear an income tax. The adjustment cannot cause the basis to exceed the property's fair market value. The determination is more complicated if the donor has made multiple gifts over the tax year.

5. There is an analogous adjustment for any generation-skipping transfer tax paid with respect to a gift. IRC §2654(a)(1).

6. Practical Aspects -- Ascertaining the donor's basis

    a. Reporting of taxable gifts on Form 709 includes a column for reporting of the donor's adjusted basis of each gift. But under the instructions (and regulations) such reporting is

not required to satisfy the "adequate disclosure" rules, and this information seems to be omitted as often as it is provided.

b. If a donee lacks the information to adequately evidence the donor's basis, IRC §1015(a) relaxes the usual standard placing the burden on the taxpayer to provide "credible evidence" as to a tax item (as described in IRC §7491, related to burden of proof). IRC §1015(a) imposes a duty on the Treasury to obtain otherwise unknown basis information or to otherwise provide a finding based on best available FMV information with respect to the donor's acquisition.

B. Transfers Between Spouses or Incident to Divorce

1. Under IRC §1041, property transferred to a spouse or to a former spouse incident to divorce takes on a carryover basis – i.e., the adjusted basis of the property in the hands of the transferor spouse.

2. This rule is a corollary of §1041's treatment of the transfer as a gift for income tax purpose (i.e., as a nontaxable event), but without the loss-property exception otherwise applied to gifts.

C. Property Acquired from a Decedent

1. Under IRC §1014, basis in property acquired from a decedent is subject to a special rule assigning it a new basis at death equal to:

   a. Its fair market value at the date of the decedent's death, or

   b. If applicable, (1) its alternate valuation under IRC §2032, (2) its special estate-tax valuation as real property used in a farm or trade or business IRC §2032A, or (3) the decedent's basis for property that is subject to the exclusion of IRC §2031(c) for land subject to a qualified conservation easement.

2. The adjustment to basis at death is often referred to by the shorthand phrase "step-up" in basis, but it can also result in a "step-down."

3. The basis step-up rules have been subject to perennial criticism by academics and others as a piece of unwarranted legislative largesse that (a) allows taxpayers, particularly wealthy taxpayers, to avoid income tax on accrued gains (though also foisting on them a denial

of losses on property that has declined in value) and (b) creates a socially burdensome incentive for taxpayers to hold on to property that they might better dispose of during life (such as an oversize house).

4. Short-lived IRC §1022 was to have instituted a carryover basis regime starting in 2010. It remained as an option for decedents dying in 2010, exercisable by the executor electing it in place of the estate tax.

5. The basis step-up rules are sometimes defended on the basis that they avoid a double tax (estate tax and income tax) on the same property, but this defense seems weak in an era where only a minute fraction of decedents' estates pay any federal estate tax. It also neglects the substantial disparity in the bases of the two taxes (appreciation in value vs. entire fair market value).

6. The rules might still be defended on practical grounds, that many (and perhaps most) taxpayers keep poor records of their tax bases, and it may be particularly difficult for the successor to a decedent to obtain or reconstruct such records. Allowing a basis step-up provides an easily administrable fresh-start in record-keeping.

7. Specified categories of property are treated as property acquired from a decedent:

    a. Probate assets – property acquired by bequest, devise or inheritance or by the decedent's estate from the decedent:

    b. Nonprobate assets:

        (1) revocable trust property where the decedent retained income rights;

        (2) trust property where the decedent retained income rights along with the power to control the disposition;

        (3) property passing through the decedent's exercise of a general power of appointment;

        (4) property constituting a surviving spouse's one-half share of community property; and

(5) property includible in the decedent's gross estate under IRC §2044, related to qualified terminable interest property.

c. Catch-all provision – Any *other* property acquired from decedent by reason of death, form of ownership, or other condition if required to be included in the decedent's gross estate (but with new basis reduced by any depreciation, amortization or depletion previously claimed by decedent).

8. Categories of property specifically excluded from receiving new basis under IRC §1014:

a. Property sold or exchanged by the recipient prior to the decedent's death. IRC §1014(a). This exception apparently is to avoid the need, upon the decedent's later death, to recompute the gain or loss on includible property that had been gifted subject to some estate-tax "string" (e.g., a right of revocation or a retained life interest). Query whether this exclusion is superfluous, as the property acquired from the decedent should then be the *proceeds* of the sale or exchange, not the original property.

b. Income in respect of a decedent as described in IRC §691. IRC §1014(c). This perennially fuzzy category encompasses any item that would have constituted gross income in the hands of the decedent had the decedent collected it, including a final paycheck, uncollected fees, accrued interest and dividends, and the balances of pension and profit-sharing plans and IRAs.

c. Appreciated property acquired by the decedent by gift within one year of death and then transferred back to the original donor (or the donor's spouse):

(1) the original donor is often the spouse of the anticipated decedent but statutorily could be any person.

(2) the denial of a basis step-up here serves the self-evident purpose of preventing affirmative planning to obtain a step-up by giving low-basis property to a person likely to die in the near future, where the donor (or donor's spouse) is to receive the property back.

(3) planning to obtain a basis step-up may now shift to providing for a return of the gifted property to a trust from which the donor may benefit that is not treated as effectively the equivalent to the donor:

(a) passage to a family "spray" trust probably should not be treated as tantamount to passage back to the original donor, even if the donor is one of several permissible beneficiaries.

(b) passage to marital trust under which the decedent's spouse (the original donor) holds a general power of appointment is problematic.

(c) passage to a QTIP marital trust arguably avoids the one-year rule. *Cf. Estate of Bonner v. United States*, 96-2 USTC ¶60,237 (5th Cir. 1996), holding that a QTIP interest did not merge with the spouse's individual interest for purposes of determining the availability of a fractional interest discount.

9. Basis Consistency and Reporting Aspects

a. IRC §1014(f) provides a general duty of consistency limiting basis reported by the recipient of property to values reported for estate tax purposes where (1) the estate tax value has been finally determined for federal estate tax purposes or (2) the value has been furnished to the recipient under the relatively new basis reporting requirements of IRC §6035(a), as now implemented by filing and distribution of Form 8971.

b. That duty of consistency is subject to an exception that swallows most of the rule. It applies only to items of property that increase the estate tax. That exception substantially overlaps the limitation implicit in IRC §6035(a), applying the basis reporting obligation only on executors of estates required to file an estate tax return – i.e., estates exceeding the filing threshold.

c. Except where a recipient receives a copy of Form 8971, he or she may be prejudiced by lack of access to any estate tax

return or other estate filing, and in any case he or she may have reason to disagree with the valuation, as the recipient and executor often holding disparate interests in a higher or lower valuation.

d. The IRS accordingly has relaxed the standards for basis reporting, indicating that though the estate tax value is presumptive of the fair market value at death, it is not conclusive and may be rebutted by clear and convincing evidence, except where the taxpayer is estopped by previous actions or statements. Rev. Rul. 54-97, 154-1 CB. 113.