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Carryover Basis for Gifts & Joint Tenancies

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CARRYOVER BASIS AND TAXATION

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This section discusses basis issues in several common situations that occur in an Elder Law practice.

Basis of Property Acquired by Gift

When a taxpayer makes a gift of appreciated property, IRC § 1015(a), known as the carryover basis rule,[1] requires the donor's tax basis in the property to transfer to the donee. As a result, the recipient, or donee, of the property will take the same adjusted basis as the donor had immediately prior to the gift.

For example, a father transfers rental property to his daughter. The father originally purchased the rental property for $50,000. He made a $5,000 capital improvement to the property and took a depreciation deduction in amount of $10,000. The father calculates his adjusted basis in the rental property as follows:

$ 50,000 cost of purchase
- 10,000 allowable depreciation
<u>+ 5,000</u> capital improvements
$ 45,000[2]

While the daughter owns the property, she may continue to claim depreciation, but she must use her father's basis of $45,000.[3] When the

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1. I.R.C. § 1015(a).
2. I.R.C. §§ 1012, 1011(a).
3. Treas. Reg. § 1.1014-8(a)(1).

daughter sells the property, she will pay tax on the difference between her adjusted sale price and her adjusted basis.[4] If she sells the property for $100,000 with costs of sale of $5,000, and having taken an additional $5,000 in depreciation, she will calculate her recognized gain as follows:

$100,000 sale price
- 5,000 cost of sale
$ 95,000 adjusted sale price

$ 45,000 carryover basis
- 5,000 depreciation
$ 40,000 adjusted basis

$ 95,000 adjusted sale price
- 40,000 adjusted basis
$ 45,000 taxable gain

One of the exceptions to the carryover basis rule occurs when the value of the property at the time of the gift is less than the donor's adjusted basis. If the fair market value (FMV) of the property at the time of the gift is less than the donor's adjusted basis, the donee must take the fair market value as her substituted basis.[5] Consider the example above, except at the time the father made the gift of the rental property to the daughter, the fair market value of the property was $40,000. If the daughter sold the property immediately, she could not claim a $5,000 loss, even though she sold it for less than the father's $45,000 adjusted basis. The daughter will not recognize any gain or loss, because she was required to take the fair market value as her substituted basis.

If the father did not purchase the property himself, but acquired it as a gift from his brother, the father's initial basis will be the same as his brother's adjusted basis at the time of the gift.[6] If the basis of the donor cannot be determined, the IRS will estimate the fair market value of the property on the date that the donor brother acquired the property, based on the best information that can be obtained.[7] Additionally, the father's holding period, for the purpose of determining short or long-

4. I.R.C. § 1001(a).
5. Treas. Reg. § 1.1014-8(a)(1).
6. *Id.*
7. I.R.C. § 1915(a).

term gain or loss, is "tacked" on to his brother's holding period.[8]

Another exception to the carryover basis rule occurs when the donor pays gift tax. When the donor pays gift tax, the donee will acquire a substituted basis. For example, if the father transfers property worth $100,000 to his daughter and pays $37,000 in gift tax for such transfer, the daughter's basis is the father's adjusted basis in the property increased by a portion of the gift tax paid.[9] If the father's adjusted basis is $45,000, the net appreciation of the property is $55,000.[10] The increase in basis is the portion of the gift tax paid in relation to the net appreciation compared to the value of the gift.

$$\frac{\text{Increase in basis}}{\text{Total gift tax paid}} \quad \frac{\text{Net appreciation}}{\text{Value of gift}}$$

$$\frac{x}{37{,}000} = \frac{55{,}000}{100{,}000}$$

$$x = 20{,}350$$

Daughter's basis is $ 45,000 carryover basis
+ 20,350 increase due to gift tax
$65,350 substituted basis

A taxpayer who makes a taxable gift must file a gift tax return. IRC § 1016 imposes a three-year statute of limitations for the IRS to challenge the value reported on the gift tax return.[11] If the donor does not file a gift tax return, there is no statute of limitations that will bar the IRS from challenging the value of the gift. For transfers after December 31, 1996, the IRS requires that the donor disclose the value of the gift on the gift tax return, as well as provide a description of the property interests, the relationship of the donee to the donor, and the method used for determining the value of the interest of each party.[12] Thus, when the donor makes a taxable gift, a qualified appraiser should appraise the property. If a taxpayer fails to adequately disclose the details of the gift, the statute of limitations does not apply.[13]

What if the father transfers the entire property to the daughter but

8. I.R.C. § 1223(2).
9. I.R.C. § 1015(d)(6).
10. I.R.C. § 1015(d)(6)(B).
11. I.R.C. § 6501(a).
12. Treas. Reg. § 301.6501(c)-1(f)(2).
13. Treas. Reg. § 301.6501(c)-1(f)(1).

continues to live in the property with an explicit or implicit home occupancy agreement? The IRS considers this transfer a completed gift, because the daughter now holds full title. Therefore, if she sells the property, her carryover basis is the father's basis, and if the property has appreciated, she will recognize gain on the sale.[14] However, if the father continues to live in the property until his death, he has retained a right of enjoyment in the property, which is sufficient to cause the entire property to be included in his taxable estate at his death.[15] A case decided by the United States Tax Court held that occupancy by a donor after he had transferred the house by gift to his three sons was a continued enjoyment of the property sufficient to include the value of the property in his estate.[16] Continued occupancy by donors may cause estate tax to be paid on the value of the property, depending on the size of the father's (decedent's) estate. Because it is includable in the father's estate, if she inherits the home, the daughter will receive a new basis equal to the fair market value at the date of the father's death.[17]

What if the father transfers the property to an irrevocable trust of which the daughter is the beneficiary? IRC § 1015(b) states that an irrevocable trust will take the father's carryover basis.[18] If, at the father's death, the trust is not included in his estate for federal estate tax purposes, and the trust distributes the property to the daughter, she will receive the same basis in the property as the trust received. Any adjustments to the basis of the property while in the hands of the trustee will be carried over to the daughter as well.[19]

If the father transfers the property to a revocable trust, it is not a completed gift, because he has not relinquished dominion or control over the property.[20] For that reason, the property continues to retain the father's basis. If, at the father's death, the daughter receives the property as the beneficiary of the trust, the daughter will receive a stepped-up basis equal to the fair market value of the property as of the father's date of death.[21]

What if the father transfers real property to himself and the daughter as joint tenants with the right of survivorship? The IRS

14. Treas. Reg. § 1.1014-8(a)(1).
15. I.R.C. § 2036(a)(1). *See* Rev. Rul. 78-409, 1978-2 C.B. 234, Rev. Rul. 70-155, 1970-a C.B. 189.
16. Estate of Emil Linderme, Sr., 52 T.C. 305, 309 (1969).
17. I.R.C. § 1014. Section 1014 will not apply after December 31, 2009.
18. I.R.C. § 1015(b).
19. Treas. Reg. § 1.1015-2(a).
20. Treas. Reg. § 25-2511-2(c).
21. I.R.C § 1014.

considers this a completed gift from father to daughter equal to one-half of the property. The gift is completed because once the father executes the deed and delivers it to the daughter, the father cannot sell the property without her permission.[22] The daughter's carryover basis in her one-half of the property is equal to one-half of father's basis. When the father dies, the daughter will receive a stepped-up basis in the one-half interest that passed to her as a result of her father's death.

For example, if the property has a fair market value of $100,000 at the time of the gift as well as on the father's date of death, and the father's adjusted basis was $45,000 at the time of the gift, and there were no subsequent adjustments to basis during his lifetime, the daughter's new basis in the property after her father's death is calculated as follows:

$45,000 ÷ 2 $22,500 daughter's basis in one-half of property
<u>50,000</u> value of father's one-half interest at death
$72,500 daughter's basis in property after father's death

If, instead of real property, the father adds the daughter's name to a bank account or a brokerage account, in most circumstances, the IRS considers this a revocable gift.[23] Because the donor retains the ability to access and spend the entire account without requiring the other joint tenant's approval or permission, no completed gift will occur. However, when the daughter makes a withdrawal from the account, the father will be deemed to have made a completed gift to the daughter. If the account holds appreciated assets, such as stock, the daughter's basis in stock that she withdraws will equal the father's adjusted basis in that stock.[24]

Joint tenancy is the most common form of ownership between spouses. The same tax basis rules apply to spouses when one spouse makes a gift of property to the other spouse, or retitles property in joint tenancy. If the joint tenancy is severed or terminated, each spouse has one-half of the basis that the donor spouse had when the donor spouse created the joint tenancy. If the termination of the joint tenancy was incident to a divorce, the property retains the basis that it had, even if the property is transferred with consideration.[25] Transfers incident to divorce are not subject to gift tax, nor are they subject to the rules of IRC § 1015 regarding substituting the fair market value if the basis is

22. Treas. Reg. § 25.2511-1(h)(5).
23. Treas. Reg. § 25.2511-1(h)(4).
24. I.R.C. § 1915(a).
25. I.R.C. § 1041(a).

lower than the value at the time of the transfer.

The federal estate tax system has evolved in its treatment of basis for transfers of joint interests at the death of a spouse. Before 1977, when a spouse died owning property jointly with his or her spouse, the IRS calculated the deceased spouse's share included in the taxable estate by determining how much of the value of the property the deceased spouse had contributed. Therefore, if a husband died, and he had provided all of the money for the family, his estate included the entire value of the jointly owned property. The widow, therefore, obtained a full step-up in basis in the property.

In 1976, Congress changed the estate tax law to provide that regardless of who contributed the funds for the purchase of property, when a spouse dies, the decedent spouse's estate excludes one-half of the value of property owned jointly with the surviving spouse.[26] The basis of this "qualified joint interest" steps up to the fair market value of the property on the date of death.[27] The surviving spouse obtained the entire interest in the property, with a basis of one-half of the fair market value added to one-half of the adjusted basis immediately before the death of the deceased spouse. However, this new rule does not apply to joint tenancies created before 1977. (This rule also does not apply to married couples in community property states, where the surviving spouse obtains a full step-up in basis.[28])

Elder law practitioners should be aware of the important case, *Gallenstein v. United States*.[29] Mr. and Mrs. Gallenstein purchased their home in 1955. Mr. Gallenstein provided all of the consideration, because he was the sole source of income for the family. The title of the property was in their joint names. Mr. Gallenstein died in 1987. Under the IRC that existed at that time, Mr. Gallenstein's estate reported that a qualified joint interest in the property passed to Mrs. Gallenstein. Later, however, when she sold the house, Mrs. Gallenstein reported on her income tax return that she did not have to pay capital gain on her one-half, because she had received a full step-up in value. And she was right.[30] The new law passed in 1976 excluded property that was purchased jointly before January 1, 1977. Therefore, because Mr. Gallenstein provided all of the consideration, because they had purchased the property before January 1, 1977, and

26. I.R.C. § 2040(b)(1).

27. 2d.

28. Treas. Reg. § 1.1014-2(a)(5). Community property states are: New Mexico, Washington, Texas, California, Arizona, Idaho, Louisiana, Nevada, Wisconsin.

29. Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992).

30. *Id.* at 292.

because the Gallenstein's had titled the property jointly, the "qualified joint interest" rule did not apply. These facts are likely to appear among clients who are elderly today.