

WILLMS, S.C.



MEMORANDUM

TO: Clients and Friends of Willms, S.C.

FROM: Maureen L. O'Leary

DATE: September 27, 2010

RE: What is "Basis" and How Does it Affect Me in 2010?

Introduction

It has always been important to understand basis and track the basis of your assets, since you need to know the basis of any asset you sell or gift during your lifetime. However, changes to 2010 estate tax laws now require you to also ascertain the basis of assets you inherit from a decedent who dies in 2010.

What is Basis?

"Basis" (also called "Cost Basis" or "Tax Basis") represents your investment in an asset (such as real estate or stock). Generally, the basis of an asset is the amount you paid for it, adjusted to reflect events that occur after the asset was purchased.

For example, the basis of real estate is generally its original purchase price, plus the cost of any additions and improvements, minus any damages and depreciation. Similarly, the basis of stock is generally its original purchase price, plus acquisition fees, reinvested dividends and capital gains distributions, minus nontaxable distributions and adjustments for nontaxable stock dividends and stock splits.

If you receive an asset as a gift during the donor's lifetime, your basis in the asset becomes the lesser of either the fair market value of the property or the donor's basis in the property (this is known as "carryover basis").

Why Does Basis Matter?

Basis is significantly important for income tax purposes. When you sell an asset, the difference between the sales price and the asset's basis is subject to income taxes. If the sales price is greater than the basis, you have a taxable gain. If the sales price is less than the basis, you have a loss for income tax purposes.

For example, if you sell a parcel of land for \$300,000 and its basis is \$200,000, you have a \$100,000 taxable gain (\$300,000 sales price - \$200,000 basis = \$100,000 gain). Your income tax liability will be calculated based on the amount of taxable

gain. In contrast, if you sell a parcel of land for \$200,000 and its basis is \$300,000, you have a \$100,000 loss ($\$300,000 \text{ basis} - \$200,000 \text{ sales price} = \$100,000 \text{ loss}$). As you can see, in most instances, it is desirable to have a high basis, so as to minimize or avoid tax upon sale of the property.

Pre-2010 Estate Rules

If you inherited an asset from a decedent who died before 2010, your basis became the fair market value of the asset as of the date of the decedent's death (this is known as "step-up basis"). This meant that if you immediately sold the asset for its fair market value, there would be no taxable gain. (Ex. $\$300,000 \text{ fair market value sales price} - \$300,000 \text{ fair market value basis} = \$0 \text{ taxable gain or loss}$). This also meant that when someone died before 2010, the Personal Representative of the decedent's estate did not necessarily need to track down the decedent's basis in his or her assets. Instead, it was usually more important to just determine the fair market value of all the decedent's assets as of the date of death.

2010 Estate Rules

Beginning January 1, 2010, along with the temporary repeal of the estate tax came a significant change to the basis rules for inherited assets. For the estates of persons who die in 2010, the federal estate tax is replaced by a new set of rules providing for a "carryover" basis for property acquired from a decedent. Under these rules, the basis of property received from a person who dies on or after January 1, 2010 will be the lesser of the income tax basis that the decedent had in the property or the fair market value of the property at the decedent's date of death (similar to the lifetime gifting basis rules). This means that upon death, it is important for the beneficiaries to ascertain not only the fair market value of the assets as of the date of death, but also the decedent's basis in the assets.

There are two exceptions to the above "carryover" basis rules. First, a decedent's estate is entitled to an aggregate basis increase of \$1,300,000. Second, and in addition to the \$1,300,000 basis increase, a decedent's surviving spouse is entitled to a \$3,000,000 basis increase. Thus, the basis of property acquired by a surviving spouse from the decedent is eligible for a basis increase of up to \$4,300,000 (plus any amounts related to unused loss carryovers and unused losses).

For estates of persons who die in 2010 that exceed \$1.3 million of non-cash assets, a special tax return will need to be filed to report the fair market value and basis of the decedent's assets, and to report the allocation of the \$1.3 million and \$3 million basis increase (if applicable). This special tax return will use a new form that the IRS has not yet released and it will be due at the same time as the deceased person's final income tax return (i.e. April 15, 2011). In addition, no later than 30 days after filing the special tax return, the Personal Representative must provide a written statement to each recipient of property that contains the information that was reported on the return.

Summary

It's arguably more important than ever to keep good records tracking the basis of your assets, in case you sell or gift an asset during your lifetime, or in case your heirs need to determine the basis of your assets upon your death. It is also important to speak with your family and nominated Personal Representatives to make sure they are aware of where you keep your important records. Consider sitting down for a conversation with your loved ones to be sure they know where to find your records if necessary.

If you have questions regarding basis and the reporting requirements for 2010 estates, please feel free to call us. You can also reference the following information found on the IRS Website:

<http://www.irs.gov/businesses/small/article/0,,id=224519,00.html>