Why DOESN'T a Reserved Life Estate Get a Step-up in Basis under Internal Revenue Code Section 1022?

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I've seen several blog posts in early 2010 that state the conclusion that a life estate is not entitled to obtain a step-up in basis upon the life tenant's death in 2010, but I have yet to see any analysis on how those lawyers got to their conclusion. Congress is well aware of the existence of life estates, as Internal Revenue Code Section 2036 specifically addresses them; if Congress intended to exclude life estates from receiving a step-up in basis under Internal Revenue Code Section 1022, it seems that Congress would have specifically mentioned them, as it did with several other common estate planning techniques.

To qualify for the step-up in basis under 2010 tax law, an asset must be considered to be owned by the decedent under Section 1022(d) and considered to be acquired from the decedent under Section 1022(e). To determine whether a reserved life estate is entitled to a step-up in basis, the issue needs to be broken down into 2 questions.

Question 1: At the time of death, does a decedent "own" the property which is the subject of a reserved life estate?

It is true that Section 1022(d) does not include life estates in its description of special rules on what is considered owned by the decedent, but life estates could be covered by the general rule. Reserved powers of appointment are less commonly utilized and not as well-known, but were expressly excluded under Section 1022(d)(1)(B)(iii), so Congress knew how to exclude certain planning techniques when it wanted to do so. If life estates were intended to be excluded, why were they not specifically mentioned? A power of appointment is not a possessory interest, yet Congress took pains to exclude it from the possibility of a step-up in basis. It seems illogical for Congress to have specifically excluded a nonpossessory interest but to be silent if it also intended to exclude a possessory interest such as a life estate. Further, it is possible that the phrase "at the time of death" could be interpreted to exclude a life estate, because death terminates the interest, but since a reserved power of appointment was specifically mentioned and would also terminate at death, it doesn't appear that the "at the time of death" phrase was intended by Congress to mean "after" death. I therefore conclude that Congress must not have intended to exclude reserved life estates from the definition of what is owned by a decedent at the time of death.

I cannot speak for all 50 states, but under Massachusetts law, the life tenant has exclusive possession of the entire property during the life tenant's lifetime. The life tenant is entitled to all the rents and profits from the property and pays all current real estate taxes. Remainderpersons do not have the right to petition for partition because they do not have a present possessory interest in the premises. At the time of the life tenant's death, the life tenant has an ownership interest to the exclusion of the remainderpersons, and a reserved life estate may therefore fit the ownership test in Section 1022(d).

Question 2: Does a remainderperson “acquire” from the decedent the property which is the subject of a reserved life estate?

If you agree with the analysis in Question 1, then this question probably poses little obstacle to the step-up in basis. The language in Section 1022(e)(3) includes “property passing from the decedent by reason of death to the extent that such property passed without consideration,” and where the property passes to the remainderpersons without consideration upon the life tenant’s death, that description could easily include a reserved life estate. A question could arise on whether they received it "from" the decedent, but the possession does transfer based on the decedent's actions. The open issue on the step-up in basis would be whether, since the remainder interest was already vested, it was the entire value of the property that was "acquired," or merely the actuarial value of the life estate at death; still, since the entire possession transfers upon the life tenant's death, a strong argument could be made for the full step-up in basis (subject to the other limitations in the law of a total of $1,300,000 for most estates).

Conclusion: It’s not an absolute slam dunk that life estates are entitled to a step-up in basis under Internal Revenue Code Section 1022, but there is at least a solid argument that they weren’t excluded and that they fit the definition of what is entitled to a step-up.