

## **RECEIPT OF A BEQUEST OR DEVISE: BASIS, HOLDING PERIOD AND CHARACTER**

Although a devise is generally not included in gross income under Section 102 of the Internal Revenue Code (the “Code”), the subsequent disposition of the devised property could result in tax consequences. As a result, it is critical that a devisee determine the following information when accepting an inheritance: (1) the basis of the property received; (2) the holding period of the property received; and (3) the nature of the property received. This information will be required for calculating future gain or loss upon a subsequent disposition of the property.

*A. Basis of Property: Application of the Unitary Basis Rules of Section 1014.* Whenever an interest in property is transferred, including if the transfer is by gift or inheritance, the basis of the transferred property must be determined for purposes of calculating gain or loss on a subsequent transaction. Code Section 1011 states the adjusted basis for determining the gain or from the sale or disposition of property, whenever acquired, shall be the basis as determined under Subchapter O or the applicable sections in Subchapters C, K, or P of the Code, with adjustments as provided in section 1016.<sup>1</sup> Under Section 1014 of the Code, which prescribes the calculation of basis in property received as an inheritance, the basis of property in the hands of a person acquiring the property from a decedent or to whom such property passed from a decedent shall be the fair market value of the property at the date of the decedent’s death so long as the property is not sold, exchanged, or otherwise disposed of prior to the decedent’s death.<sup>2</sup> If an election was made regarding valuation under Code Sections 2032, 2032A, or 811(j), then those provisions will govern the determination of the basis.<sup>3</sup> This section is applicable to “property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.”<sup>4</sup>

As a result of these rules, a life tenant and remainderman will take a basis in property received by bequest that is equal to the fair market value of such property at the time of the decedent’s passing. Despite the existence of two distinct interests when a decedent devises a life estate in property, the basis of such property will remain uniform in the hands of each person having possession or enjoyment of the property at any time under the decedent's will.<sup>5</sup> The principle of uniform basis means that the basis of the property will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee.<sup>6</sup> The sale, exchange, or other disposition by a life tenant or a remainderman of his interest in property will, for purposes of Section 1014 of the Code, have no effect upon the uniform basis of the property in the hands of those who acquired it from the decedent.<sup>7</sup> All titles in property acquired by bequest, devise, or inheritance relate back to the death of the decedent despite the nature of the interest of the person taking the title on the date of the decedent’s

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<sup>1</sup> I.R.C. § 1011 (1969).

<sup>2</sup> I.R.C. § 1014 (1997). However, section 1022 of the Code governs the basis determination for decedents passing 2010. *See id.* § 1022 (2001). Under this carry-over basis regime, transferees generally take a basis in property equal to the lesser of the decedent’s adjusted basis or the fair market value of the property. *See id.*

<sup>3</sup> *Id.* § 1014(a).

<sup>4</sup> *Id.* § 1014(b)(1).

<sup>5</sup> Treas. Reg. § 1.1014-4(a)(1) (1957).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

death.<sup>8</sup> Accordingly, there is a common acquisition date for all titles to property acquired from a decedent within the meaning of Code Section 1014, and, for this reason, a common or uniform basis for all such interests, including life estates and remainders.<sup>9</sup>

The purpose of this uniform basis is to tax the gain, with respect to property acquired by bequest, devise, or inheritance, to the party who actually realizes the gain.<sup>10</sup> Moreover, the rule protects donees from recognizing gain simply because there is value resulting solely from the circumstance that the possession or enjoyment of the donee was postponed.<sup>11</sup> Such postponement includes circumstances, such as life estates, in which the period of the possession or enjoyment of a remainderman is postponed until after the period of enjoyment of another has terminated, or until an uncertain event has happened.<sup>12</sup>

If more than one person has an interest in property acquired from a decedent, such as when a decedent devises a life estate interest and an estate in remainder, the basis of such property shall be determined and adjusted without regard to the multiple interests. Thus, the sale, exchange, or other disposition by a life tenant or remainderman of the life interest or remainder has no effect on the property's uniform basis in the hands of those who acquired it from the decedent.

The basis for computing gain or loss on the sale of any one of such multiple interests is determined under Treasury Regulation § 1.1014-5.<sup>13</sup> This regulation prescribes that the “factors set forth in the tables contained in §20.2031-7 or, for certain prior periods, §20.2031-7A, of Part 20 of this chapter (Estate Tax Regulations)” shall be used for purposes of determining the basis of the life interest, the remainder interest, or the term certain interest in the property on the date such interest is sold.<sup>14</sup> The basis of the life interest, the remainder interest, or the term certain interest is computed by multiplying the uniform basis, which is adjusted to the time of the sale, by the appropriate factor from the prescribed tables.<sup>15</sup> For sales of a remainder interest or life interest, the factor used is the factor, adjusted where appropriate, which appears in the remainder interest or life interest column of the table opposite the age, on the date of the sale, of the person at whose death the life interest will terminate.<sup>16</sup> Notwithstanding the uniform basis rules requiring an allocation of basis between interest holders in the same property, if a life tenant sells his or her interest, that part of the adjusted basis is disregarded.<sup>17</sup> Accordingly, the life tenant treats the entire amount received on such a disposition as gain. This rule does not apply, however, where the entire interest in the property is transferred to another person and the sales proceeds are to be divided between the life tenant and the remainder beneficiary.<sup>18</sup> Under such

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<sup>8</sup> Treas. Reg. § 1.1014-4(a)(2).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* § 1.1014-4(b). *See* Treas. Reg. § 1.1014-5 (1994).

<sup>14</sup> *Id.* § 1.1014-5(a)(3).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *See* I.R.C. § 1001(e), *see also* Treas. Reg. § 1.1014-5(b). This rule applies where the basis is attributable to section 1014 (stepped-up basis at death) or a transferred basis by reason of a gift under section 1015.

<sup>18</sup> I.R.C. § 1001(e).

circumstances, the uniform basis rules are available to determine the allocable basis available to the life tenant and the remainder beneficiary.

The following examples illustrate this concept: A decedent, D, died, leaving dividend-paying stock in trust, income to L, for life, and a remainder to R. The stock had a fair market value of \$100,000 at D's death, and no special valuation rules applied to D's estate. When D died, L was 58 years of age. The uniform basis in the stock is \$100,000. Using the treasury regulations and assuming that the appropriate section 7520 interest rate is 5%, the factor for L's life estate is .60318 and for R's remainder is .39682. Ten years later, when the stock has a fair market value of \$300,000, L sells her life estate for \$140,853 ( $\$300,000 \times .46951$ , the factor for someone age 68, assuming a 5% interest rate). The portion of the uniform basis allocable to L's life interest is \$46,591 ( $\$100,000 \times .46951$ ), but L must recognize \$140,853 on the sale because section 1001(e) of the Code requires that the basis be disregarded. However, if R, rather than L, had sold his remainder interest 5 years after D's death, when the stock had a fair market value of \$220,000, for \$101,642 ( $\$220,000 \times .46201$ , the remainder factor applicable when the life tenant is age 63, assuming a 5% interest rate), then the portion of the uniform basis allocable to R's remainder interest would have been \$46,201 ( $\$100,000 \times .46201$ ). R would have recognized gain of \$55,441 ( $\$101,642 - \$46,201$ ).

When the uniform basis rule applies, the life tenant must maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by sections 1016 and 1017 of the Code.<sup>19</sup>

*B. Holding Period of the Property Received by Bequest or Devise.* Although the determination of basis is critical for subsequent transfers of inherited property, the holding period for such property is as equally important. A taxpayer's holding period for property is necessary for determining the nature of any gains or losses associated with a subsequent disposition. Under Section 1223(9) of the Code, if a person acquires property from a decedent within the meaning of Code Section 1014(b) and the basis for such property is determined under Code Section 1014, then the person will be treated as having held the property for more than one year even if the property is disposed of within one year of the decedent's passing.<sup>20</sup> This section applies to the sales of property included in the decedent's gross estate for the purposes of the estate tax by the executor or administrator of the estate and to sales of property by other persons who have acquired property from the decedent.<sup>21</sup>

*C. Nature of the Property Received as a Bequest or Devise.* The final requirement that must be determined by the devisee is the nature of the property received. According to Code Section 1221, property held by a taxpayer is a capital asset unless it falls within one of the listed exceptions.<sup>22</sup> These exceptions generally relate to business assets, such as merchandise, accounts receivable, depreciable property, land used in a trade or business, assets of a literary or artistic nature, and certain financial transactions that are inherently related to a trade or

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<sup>19</sup> *Id.* § 1.1014-4(c).

<sup>20</sup> I.R.C. § 1223(9) (2005). Although Congress has passed subsequent amendments to this Code section since the passing of the Decedent in 1992, none of these changes have impacted subsection (9) of this Code section.

<sup>21</sup> Treas. Reg. § 1.1223-1(j)(2)(flush language) (1980).

<sup>22</sup> I.R.C. § 1221 (2001).

business.<sup>23</sup> In determining whether property is a “capital asset”, the holding period of such property is immaterial.<sup>24</sup> Thus, the term “capital assets” includes all classes of property not specifically excluded by section 1221.

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<sup>23</sup> *Id.* § 1221(a).

<sup>24</sup> Treas. Reg. § 1.1221-1(a) (1975).