California basis differences for 2010 estates

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California does not conform to the inherited basis rules for 2010 estates that elect out of the estate tax. For California purposes, the pre-2010 basis rules still apply.1 This means you will have some interesting basis differences to keep track of for your clients who inherited property in 2010 from estates that elect pre-2010 Tax Relief Act provisions.

Rules for 2010 deaths

The 2010 Tax Relief Act reinstated the estate tax for deaths on or after January 1, 2010, and before January 1, 2013.2 Under the new law, the maximum estate tax rate is 35% with an exclusion amount of $5 million.3 However, for decedents dying in 2010, the executor may elect out of the estate tax and opt to use the no estate tax and carryover

basis provisions under EGTRRA (P.L. 107-16).4 In these cases, the inherited assets will not receive the automatic step-up in basis that we are traditionally used to.

The beneficiary's basis in property received from these 2010 decedents generally will be the lower of:

- The FMV on the date of the decedent's death; or The changes to the federal rules for deaths in 2010 have created new California nonconformity.

EXAMPLE 10-3: Mom died in 2010. Her home had a basis of $50,000 and a FMV of $2 million, and her stock had a basis of $10,000,000 and a FMV of $20,000,000.
Mom's will leaves all her assets to her son, who is her executor. He elects pre-2010 Tax Relief Act provisions so he doesn't have to pay estate tax.
For federal purposes, the son's basis in the assets is $11,350,000 ($50,000 house + $10,000,000 stock + $1,300,000 §1022(b) basis addition). He may allocate the $1.3 million to the house, the stock, or a combination of the two. For California purposes, the son's basis in the home is $2 million and his basis in the stock is $20,000,000.

- The adjusted basis of the property immediately before the death of the decedent, plus certain additions.5
  Each estate will receive potential basis additions, including:

EXAMPLE 10-4: Dad dies and leaves his home to his son at his death, on February 1, 2010. The executor of Dad's estate elects out of the estate tax, so the son inherits the property with modified carryover basis for federal purposes and a full step-up for California purposes. The FMV of the home is $500,000 at the date of Dad's death, and Dad's basis was $400,000. For federal purposes, the son's basis is $400,000; for California purposes, it is $500,000.
On January 2, 2011, the son sold the home for $550,000. For federal purposes, he may exclude the $150,000 gain ($550,000 - $400,000) using Dad's §121 exclusion under IRC §121(d)(11).
For California purposes, the son will have a $50,000 taxable gain ($550,000 - $500,000), because he may not uses Dad's §121 exclusion on the California return.

- $1.3 million basis step-up; $3 million for assets passed to the surviving spouse; and
- Other basis additions equal to the decedent's capital loss carryovers, NOLs, and built-in losses.

California nonconformity

For California purposes, the inherited basis is the FMV on the date of death, even if the executor elects out of the estate tax.6 This means beneficiaries may have two separate basis numbers to keep track of for their inherited assets.

121 exclusion

For estates electing out of the estate tax, the estate or beneficiary will be entitled to a $250,000 principal residence gain exclusion under IRC §121 if the property is sold by:

- The estate of a decedent;
- Any individual who acquired the property from the decedent (within the meaning of the modified carryover basis rules of IRC §1022); or ! A trust which, immediately before the death of the decedent, was a qualified revocable trust.7 California also does not conform to this provision. They do get the full step-up in basis to the date of death FMV for California purposes. However, any post-death appreciation would not qualify for the 121 exclusion.

1 R&TC §18035.62 Act §301; IRC §2056A