US TAX BASIS INHERITED FROM FOREIGN DECEDENT

Andrew Besch
Canadian Tax Highlights
May 15, 2019

This article was originally published in Volume 27, Number 5 of the May, 2019 issue of *Canadian Tax Highlights*, a publication of the Canadian Tax Foundation. Reprinted with permission.

Under IRC section 1014, the cost basis of a property received from a decedent is generally stepped up (or down) to the property's FMV on the date of death. This basis adjustment can yield a substantial tax benefit for the recipient, particularly for appreciated property, because all appreciation during the decedent's life escapes income taxation on a subsequent sale. Most commentators view this benefit as a tradeoff: property received from a decedent was already included in the decedent's taxable estate, and theoretically it is subject to the 40 percent estate tax. However, if the decedent is not a US person and the property is not included in a US estate, the rationale for the application of section 1014 is blurred.

Section 1014(a) generally provides that a property's basis in the hands of a person "acquiring the property from a decedent or to whom the property passed from a decedent shall . . . be the fair market value of the property at the date of the decedent's death." Section 1014(b) specifically defines the property "acquired from a decedent"; of note, such property includes property received by "bequest, devise, or inheritance" under section 1014(b)(1). Section 1014(b)(9) is a catch-all for property acquired "by reason of death, form of ownership, or other conditions" from a decedent and includes property transferred during the decedent's life that is included in his or her gross estate for US tax purposes.

Two scenarios commonly arise in which property is received on death from a non-resident alien (NRA). Section 1014 must be analyzed to determine whether a basis adjustment is available (1) when property owned on death by an NRA is passed to a US person under a will or equivalent estate-planning document and (2) when an NRA and a US person jointly own property and the NRA predeceases the US person.

In the first scenario, the property inherited from an NRA decedent receives a cost-basis adjustment in the recipient's hands under section 1014. If the property in question is US- situs property, it attracts US estate tax. In such a situation, a basis adjustment appears consistent with the rule's spirit. The IRS has also determined,

Attorneys

Andrew Besch

Practices & Industries

Canada-U.S. Cross-Border

International Tax

however, that even if the property in question is foreign property, the recipient enjoys a basis step- up to the FMV on death. Rev. rul. 84-139 (1984-2 CB 168) provides that foreign real property inherited by a US person from an NRA is entitled to a basis adjustment under section 1014(b)(1), despite the fact that such property is not subject to US estate tax. The decision turned on the determination that property owned by the decedent on death that passed under that person's will is property received by "bequest, devise, or inheritance," as described under section 1014(b)(1).

Turning to the second scenario, if property is owned jointly by a US person and an NRA, ownership of the property fully vests in the US person on the death of the NRA. As described above, section 1014(b)(9) provides that property received "by form of ownership" that is "required to be included in determining the value of the decedent's gross estate" is entitled to a step-up in basis. Under US estate tax principles, the full value of jointly owned property is included in the taxable estate of the first joint tenant to die, unless it can be shown that the surviving tenant contributed to the purchase of the property. Spouses are presumed to each have contributed 50 percent to the purchase, and thus only 50 percent of the value is included in the taxable estate of the first to die. Applying these rules to the situation in which the first-to-die tenant is the NRA, there appears to be no basis adjustment available. It seems clear that jointly owned property passes by "form of ownership" on death as described by section 1014(b)(9) and not by the "bequest, devise, or inheritance" referred to under section 1014(b)(1). In addition, the property is not included in the decedent's gross US estate (there is no gross US estate for the NRA). Thus, such jointly owned property does not receive a basis adjustment under the clear language of section 1014. Furthermore, for additional clarity, Treas. reg. section 1.1014- 2(b)(2) provides that the language of section 1014(b)(9) does "not include property not includible in the decedent's gross estate such as property not situated in the United States acquired from a nonresident who is not a citizen of the United States."

However, if jointly owned property is US-situs property and thus includible in the NRA's gross US estate, a surviving joint tenant receives a basis step-up for the portion of the property includible in the decedent's US estate. Furthermore, if property is jointly owned without a right of survivorship (such as a tenancy in common) so that an undivided one-half interest passes under the NRA decedent's estate plan, there is a strong argument that such interest is an outright ownership interest such as described in Rev. rul. 84-139 and is thus entitled to a basis adjustment under section 1014(b)(1).

Although a decedent's property on death is generally entitled to a basis adjustment under section 1014, this benefit is typically understood to be a tradeoff for the property's being included in a gross estate for US estate tax purposes. However, if the decedent is an NRA, this view of the rules under section 1014 seemingly breaks down, as discussed above. Property that is inherited outright from an NRA decedent is clearly entitled to a basis adjustment; on the other hand, property held jointly by an NRA and a US person appears to fall outside section 1014, unless such property is included in a US gross estate (US-situs property) or is held by tenancy in common so that the interest passes by "bequest, devise, or inheritance" rather than through a form of ownership.

For a Canadian who is not a US citizen or a US tax resident, it is important to be aware of these rules when crafting his or her estate plan, particularly if property is passing to a US person or to someone who may become a US person in the future.