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Along Route 12  
towards Rimrock  
Lake, 2010

## **Estate Taxes v. Income Taxes (Capital Gains) for Decedents of 2010**

So, in 2010, Congress has refused to fix the problem of the Estate Tax Repeal. This leaves us with some interesting work to do. While there is no estate tax in 2010, there is also no longer a true unlimited “step-up” in basis. And this impacts the beneficiary’s income tax return. Any property inherited is inherited tax free, but if you ever sell that property, you will have to pay a capital gain on the difference between the basis (purchase price) and the sales price.

The purchase price is what the deceased paid for the item. In the old system, and that system comes back in 2011, you received a gift from the government called a “step-up” in basis. You inherited property at the date of death value, regardless of what the deceased paid for the item.

Now, there is no unlimited step up in basis. What there is, is an allocation amongst the non-spouse beneficiaries of up to \$1.3 Million of step-up in basis and a further \$3 Million of step-up for a spouse. So a spouse has a total of \$4.3 Million of step-up available.

But how do you get the step up? Read further for a puzzling catch 22.

To obtain a step-up in basis for appreciated assets, it appears that a Federal Estate Tax Return must be filed for any decedent who dies during 2010. Internal Revenue Code Section 1022(d)(3) states that basis increases must be allocated “on the return required by Section 6018.” Internal Revenue Code Section 6018 pertains to the filing of Federal Estate Tax Returns, but, unfortunately, no such return is actually required for anybody who dies during 2010.

A Federal Estate Tax Return is due 9 months after a decedent’s death, and can normally be placed on extension for no more than 6 months, but a temporary amendment to Internal Revenue Code Section 6075 provides that the Federal Estate Tax Return will normally be due (unless Internal Revenue regulations provide otherwise) when the decedent’s final federal income tax return is due. The requirement in Internal Revenue Code Section 1022 that basis increases be allocated on a Federal Estate Tax Return poses a potentially huge tax trap for the unwary, as Section 1022 does not state whether a basis increase can be allocated on a late-filed return. Unfortunately, many persons may not even become aware of this basis issue until they have sold appreciated assets that they inherited and are preparing to file their income tax returns, and, if assets had been inherited in any year before the sale, the deadline for the executor of the decedent’s estate to allocate the basis increase may well have passed by then.

Reportedly, the Internal Revenue Service is working on a new version of the Federal Estate Tax Return. Estate planning professionals should soon begin the process of informing the executors of the estates of all 2010 decedents about the need to file this return, and accountants should revise their annual questionnaires to ask about assets that were inherited during 2010.

## Estate Tax v. Income Tax 2010 (continued).



Mount Rainier  
Looking from the  
south side north.  
2010

Only an “executor” can allocate the basis increase, and that term is not defined within Section 1022, but under Treasury Regulation 20.2203-1, the term “executor” includes an executor or administrator, but if there is no executor or administrator, the term means “any person in actual or constructive possession of any property of the decedent,” and the term can actually include “the decedent’s agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding, as collateral, securities belonging to the decedent; and debtors of the decedent in this country.” Thus, the lack of an executor or administrator being appointed for a decedent’s estate can mean the possibility exists for different persons or entities to file competing Federal Estate Tax Returns with different basis adjustments.

Internal Revenue Code Section 1022 causes a giant paperwork headache. For example, my experience has been that many persons who sell their homes or vacation homes later find themselves searching their records for proof of their expenditures on capital improvements that add to the basis for capital gains tax purposes, and now the executor of a person’s estate is placed in the difficult position of attempting to locate all of those records. The 2001 Republican Congress that passed this law may have created a perverse incentive for everybody to become paper hoarders, and the executor of a decedent’s estate will now have potential liability for getting rid of any of the decedent’s paperwork without having reviewed it thoroughly.

### Costs of service animals used for mental health deductible as medical expenses

**Information Letter 2010-0129** (<http://www.irs.gov/pub/irs-wd/10-0129.pdf>)

An IRS Information Letter (IL) to a member of Congress makes it clear that the costs of buying, training, and maintaining a service animal to assist an individual with mental disabilities may qualify as a deductible medical expense if the taxpayer can establish that he is using the service animal primarily for medical care to alleviate a mental defect or illness and that he would not have paid the expenses but for the disease or illness.

Service animals have long been used to assist individuals with physical disabilities, such as sight or hearing impairments. More recently, these animals are being used to help an increasing number of individuals with mental impairments. As the IRS letter notes, these individuals may be able to deduct the costs of acquiring, training and maintaining the animal.

**Background.** Code Sec. 213(a) allows an itemized deduction for expenses paid during the tax year, not compensated for by insurance or otherwise, for medical care of the taxpayer, spouse, or dependent, to the extent that they exceed 7.5% of adjusted gross income. Medical care includes amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. (Code Sec. 213(d)(1)(A)) Allowable deductions for medical care are limited to expenses paid primarily for the prevention or alleviation of a physical or mental defect or illness. An expense that is merely beneficial to the general health of an individual is not an expense for medical care. (Reg. § 1.213-1(e)(1)(ii))



Peanut Butter is  
very sticky.

## Service Animals (continued)

The IL notes that a taxpayer who claims that an expense of a peculiarly personal nature is primarily for medical care must establish that fact. The courts have looked toward objective factors to determine whether an otherwise personal expense is for medical care: the taxpayer's motive or purpose for making the expenditure, whether a physician has diagnosed a medical condition and recommended the item as treatment or mitigation, linkage between the treatment and the illness, treatment effectiveness, and proximity in time to the onset or recurrence of a disease. (Havey, (1949) 12 TC 409) The taxpayer also must establish that the expense would not have been paid "but for" the disease or illness. A personal expense is not deductible as medical care if the taxpayer would have paid the expense even in the absence of a medical condition. (Jacobs, (1974) 62 TC 813)

**Expenses of service animal may qualify.** Against this backdrop, the IL concluded that the costs of buying, training, and maintaining a service animal to assist an individual with mental disabilities may qualify as medical care if the taxpayer can establish that the taxpayer is using the service animal primarily for medical care to alleviate a mental defect or illness and that the taxpayer would not have paid the expenses but for the disease or illness.

In so concluding, the IL did not mention that Rev Rul 55-261, 1955-1 CB 307, and Rev Rul 68-295, 1968-1 CB 92, specifically provide that amounts paid to acquire, train, and maintain a dog to assist a blind or deaf taxpayer are eligible for the itemized deduction for medical expenses.

## Court paves the way to joint filing by same sex married couples

### **Nancy Gill, et al. v. Office of Personnel Management, et al., (DC MA 07/08/2010)**

A Federal district court in the State of Massachusetts, which allows same-sex couples to marry, has held that Section 3 of the Defense of Marriage Act violates equal protection principles embodied in the Fifth Amendment to the U.S. constitution. The decision paves the way for those individuals who brought the suit to file Federal income tax returns jointly with their spouses to do so.

The suit was brought by seven same-sex couples and three survivors of same-sex couples married in Massachusetts. The individuals sought various Federal benefits available to spouses in heterosexual marriages, such as, social security retirement and survivor benefits. Some individuals also sought the right to file jointly. Various Federal officials and agencies, not including IRS or IRS's commissioner, were named as defendants. Presumably, pending an appeal by the government, the affected individuals will attempt to amend their open returns to file jointly. How IRS will proceed with them or other same-sex married couples who weren't parties to the case but who attempt to file jointly on the strength of the case remains to be seen.

**Background.** In '96, Congress enacted, and President Clinton signed into law, the Defense of Marriage Act (DOMA). Section 3 of DOMA defines marriage for purposes of administering Federal law as the "legal union between one man and one woman as husband and wife." It further defines "spouse" as "a person of the opposite sex who is a husband or wife."

**Individuals sought joint filing status.** A number of individuals who brought the case sought the ability to file Federal income taxes jointly with their spouses. A married individual who files jointly generally is subject to a lower tax than an unmarried individual or head of household. (Code Sec. 1) If an individual has filed a separate return for a tax year for which a joint return could have been made by him and his spouse, the couple may file a joint return within three years after the filing of the original returns. (Code Sec. 6013(b)) Should the amended return call for a lower tax due than the original return, the taxpayer may also file an administrative request for a refund of the difference. (Code Sec. 6511(a))

**Equal protection analysis and result.** The Court observed that the House Report on DOMA identifies

## Federal Income Taxes for All (continued)

four interests which Congress sought to advance through its enactment: (1) encouraging responsible procreation and child-bearing, (2) defending and nurturing the institution of traditional heterosexual marriage, (3) defending traditional notions of morality, and (4) preserving scarce resources.

The court readily disposed of the notion that denying federal recognition to same-sex marriages might encourage responsible procreation, because the government conceded that this objective bears no rational relationship to the operation of DOMA. Also, the court observed that, since DOMA's enactment, a consensus has developed among the medical, psychological, and social welfare communities that children raised by same-sex parents are just as likely to be well-adjusted as those raised by heterosexual parents.

The court said that Congress' asserted interest in defending and nurturing heterosexual marriage was not grounded in sufficient factual context for the court to ascertain some relation between it and the classification DOMA effects.

According to the court, what remained, therefore, was the possibility that Congress sought to deny recognition to same-sex marriages in order to make heterosexual marriage appear more valuable or desirable. But to the extent that this was the goal, Congress achieved it only by punishing same-sex couples who exercise their rights under state law. The court stressed that the Constitution does not permit this.

Congress also attempted to justify DOMA by asserting its interest in the preservation of scarce government resources. While the court recognized that conserving the public fisc can be a legitimate government interest, it said that it could discern no principled reason to cut government expenditures at the particular expense of the individuals who brought the case, apart from Congress' desire to express its disapprobation of same-sex marriage.

The government entities (government) being sued in this case disavowed Congress's stated justifications for DOMA and instead offered different justifications for DOMA. In essence, the government argued that the Constitution permitted Congress to enact DOMA as a means to preserve the status quo, pending the resolution of a socially contentious debate taking place in the states over whether to sanction same-sex marriage. Had Congress not done so, according to the argument, the definitions of "marriage" and "spouse" under Federal law would have changed along with each alteration in the status of same-sex marriage in any given state because, before DOMA, Federal law simply incorporated each state's marital status determinations.

The Court, however, found that the government's current justifications for DOMA failed to ground a rational relationship between the classification employed and a legitimate governmental objective. The government conceded that Congress does not have the authority to place restrictions on the states' power to issue marriage licenses. But its argument assumes that Congress has some interest in a uniform definition of marriage for purposes of determining federal rights, benefits, and privileges. The court said there is no such interest. It noted that the Federal government has fully embraced variations and inconsistencies in state marriage laws by recognizing as valid for Federal purposes any heterosexual marriage which has been declared valid pursuant to state law.

The court noted that the passage of DOMA marked the first time that the federal government ever attempted to legislatively mandate a uniform federal definition of marriage. The court said that the states alone have the authority to set forth eligibility requirements as to familial relationships and the federal government cannot, therefore, have a legitimate interest in disregarding those family status determinations properly made by the states.

Accordingly, the court found that DOMA lacks a rational basis to support it. Indeed, according to the Court, Congress undertook this classification for the one purpose that lies entirely outside of legislative bounds, to disadvantage a group of which it disapproves. And such a classification, the Constitution clearly will not permit, said the court.