

on the \$88,000 of gain is a major advantage. If fair market value at death is less than the basis, the decedent's estate receives a step down (rather than a step up) in basis. Thus, if property acquired for \$200,000 (no improvements and no depreciation) had dropped to \$120,000 at death, the potential \$80,000 loss is eliminated.

There is an exception to the general rule of a new income tax basis at death. If appreciated property is given away within one year of death and then inherited back by the donor or the spouse of the donor, or the property is sold and the proceeds are inherited by the donor or spouse of the donor, the property does not receive a new income tax basis at death.

For deaths in 2010, property will no longer receive a new income tax basis. The decedent's basis will carry over to the estate and to the heirs or beneficiaries (subject to an increase of \$1,300,000 for each estate and \$3,000,000 for the surviving spouse). However, the 2001 act provisions "sunset" after 2001, returning estates to a new basis at death beginning in 2011 (unless further legislation is enacted).

Advantages to holding assets

One of the major advantages of holding property until death (through at least 2009) has just been shown. For those with gains in assets, the advantage of receiving a new income tax basis may overshadow the potential estate or inheritance tax liability, or at least a significant part of it.

If the property is land, the land held until death may be valued under the special use valuation rules. That is a second major advantage. But special use valuation does not apply to transactions by sale or gift.

There is one type of asset that does not receive a new income tax basis at death, however. This is what is called "income in respect of decedent." This is a category of income that is so close to being earned income that a new basis is not permitted.

If the decedent has been renting out farmland under a non-material participation crop share lease,

the stored crops and growing crops are income in respect of decedent and the gain is not eliminated. Accrued interest on Series E U.S. Savings Bonds is another example that continues to be taxable after death.

Installment sales, or installment contracts for the sale of assets such as land, produce income in respect of decedent, also.

Sale of residence

There is an income tax exclusion available on the sale of a residence. This treatment applies to urban residences, or to the sale of the farm residence either as part of the farm or if sold independently.

A taxpayer is allowed a \$250,000 exclusion for gain on the principal residence (\$500,000 on a joint federal income tax return) no more frequently than once every two years. To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as the principal residence for at least two of the last five years before sale or exchange. To be eligible for the \$500,000 exclusion, either spouse can meet the ownership test, both spouses must meet the use test and neither spouse can have sold or exchanged a residence within the past two years. A taxpayer's period of ownership of a residence includes the period during which the taxpayer's deceased spouse owned the residence. For transfers of residences incident to a divorce, the time the taxpayer's spouse or former spouse owned the residence is added to the taxpayer's own period of ownership.