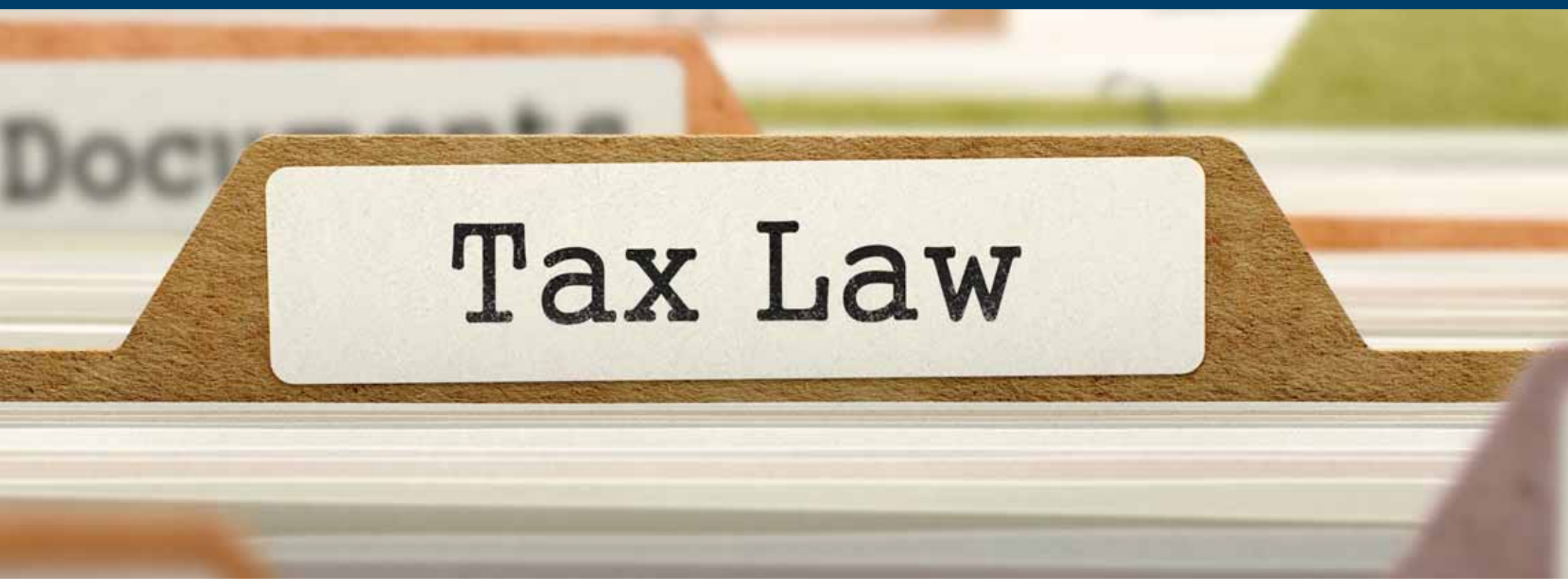

Basis Adjustments at Death for Personal Residences:

Don't Forget the Gallenstein Rule

By Matthew E. Rappaport, Esq., LL.M. and Louis J. Kesselbrenner, Esq.

Most practitioners in real estate law and trusts and estates understand the basis adjustment rule in § 1014 of the Internal Revenue Code of 1986, as amended (the "Code"). This rule provides that the basis of an asset owned by a decedent and includible in her gross estate for federal estate tax receive an adjustment to its income tax basis; the "new" basis is equal to the asset's fair market value (FMV) at the time of the decedent's death. This concept is referred to as a "step-up" in basis. In most situations, the application of the basis adjustment is simple; but not for some decedents owning personal residences as a married couple.

Under § 2040, spouses own a "qualified joint interest" (QJI) if, at the time of a spouse's death, a surviving spouse owned property with the decedent as either (i) tenants by the entirety or (ii) joint tenants with rights of survivorship (JTWROS). When a QJI exists between a married couple, one-half the FMV of the QJI property—at the time of death—is included in the decedent's gross estate.

The Gallenstein Rule derives from a Sixth Circuit case where a married couple purchased real estate in 1955 as JTWROS and owned it through the husband's death in 1987. At first, the decedent's estate tax return included one-half of the real estate in accordance with the current § 2040(b); however, when the real estate was sold in 1988, the estate filed an amended return to include the full value of the real estate and claim the basis adjustment. The surviving spouse initially reported all the net proceeds from the sale as gain on her 1988 tax return, but after amending her tax return twice, she took the same position as the decedent's estate and reported no gain from the sale.

In the ensuing litigation, the surviving spouse argued for applying the "consideration-furnished test" under § 2040 as it existed upon purchase, not the version existing at the time of the husband's death. The "consideration-furnished test" included the full value of QJI property in a decedent's estate of the first joint tenant to die unless the decedent's estate could establish that the surviving joint tenant contributed consideration to acquire the property.

Ultimately, the Sixth Circuit agreed with the taxpayer pursuant to technical construction of the original § 2040. The Sixth Circuit concluded that the old "consideration-furnished test" would apply to the Gallensteins' residence because the property was purchased prior to 1977. And since the husband was the only joint tenant to furnish consideration, 100% of the QJI was includible in his estate, qualifying the residence for a full step-up in basis.

Following the Gallenstein decision, its holding has been solidified. The Tax Court adopted Gallenstein in Hahn v. Commissioner, and the IRS acquiesced to the Hahn decision in 2001.Tax professionals working with elderly clients should consider whether the Gallenstein Rule applies, because the benefits could prove significant.

Matthew E. Rappaport, Esq., LL.M

Matthew is the Vice Managing Partner of Falcon Rappaport & Berkman PLLC in Rockville Centre, and chairs its Taxation Group.

Louis J. Kesselbrenner, Esq.

Louis is an Associate in Falcon Rappaport & Berkman PLLC's Taxation group.