Death in 2010: Federal Estate Tax Election

By Robert Katz and Neil D. Katz

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The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made a number of changes to the estate and gift tax rules that previously applied (i.e. increased the exemption amounts, reduced the rates, etc.) It also provided that there would be no estate tax in 2010 and that on January 1, 2011 the provisions of EGTRRA would sunset and the law would revert to the 2001 levels. Very few professionals, if any, believed that Congress would allow a year in which there would be no estate tax.

In fact, they were right. As a result of the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010 (the 2010 Tax Relief Act) the estate tax was retroactively reinstated as of January 1, 2010. The 2010 Tax Relief Act was signed into law on December 17, 2010.

A. Summary of the Changes

The 2010 Tax Relief Act sets the estate tax and generation skipping tax exemptions at $5 million for 2010, 2011 and 2012 with a maximum tax rate of 35%. For 2011 and 2012 the $5 million exemption and the 35% maximum rate applies to the gift tax as well.

Unless a future Congress acts, these provisions will sunset on January 1, 2013 and we will return to the 2001 levels.

B. 2010 Election

The enactment of the 2010 Tax Relief Act two weeks before the end of 2010 caused Congress to consider the large number of individuals who died during 2010 (many of them with large estates). Therefore, Congress enacted a special provision for executors of estates of individuals who died on or after January 1, 2010 and before December 17, 2010. In effect, this provision allows the executor to elect out of the estate tax and into the carry-over basis regime that would have applied had EGTRRA been in effect in 2010.

The determination of whether to elect out of the estate tax, for estates of individuals of substantial wealth (for example, George Steinbrenner) is a relatively simple decision. However, the mere fact that an estate exceeds the $5 million exemption is not the sole determining factor to be considered by an executor. By choosing the no estate tax regime, the assets of the estate will pass to the beneficiaries of the estate with carry-over basis which could cause substantial income taxes to be paid by the beneficiaries in the future.

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Among the factors that an executor should consider in deciding whether or not to elect to have no estate tax apply are:

1. The current estate tax payable vs. the present value of the future income taxes payable.
2. The character of the future income that will be recognized (capital gain vs. ordinary income).
3. How soon after death the assets may be sold.
4. The use of depreciation that would be available if an asset's basis is increased to fair market value rather than carry-over basis.
5. The additional basis adjustments available if carry-over basis is used.

C. Extension of Time

For individuals who died on or after January 1, 2010 and before the effective date of the new law, the due date for the filing of the federal estate tax return and the payment of the estate tax is extended to a date no earlier than nine months from the date of the enactment. Since the date of enactment is December 17, 2010, the filing of the estate tax return and the date for the payment of the estate tax is extended to September 19, 2011 (since September 17 is a Saturday). It is important to note that the time for filing the New York State estate tax return and the payment of the New York estate tax has not been extended.

For estates that elect to not have the estate tax apply and thus have carry-over basis applicable to the estate's assets, a report is required to be filed. The law originally required this report to be attached to the decedent's final income tax return. However, the IRS has announced that it should not be filed with that return. The IRS has also stated that it would be issuing **Publication 4895, Tax Treatment of Property Acquired From a Decedent Dying in 2010**. That publication will set forth the when to file and where to file this report.

The IRS has issued a draft Form 8939, the carry-over basis form. The draft does not include instructions nor does it deal with the election that is now required. We will have to wait to see the final form and Publication 4895, when it is issued, for further guidance.

D. Carry-over Basis

If the executor elects out of the estate tax, carry-over basis and holding period issues arise. Under the carry-over basis regime the starting point is the lesser of the basis of the asset in the hands of the decedent or the asset's fair market value on the date of death. I.R.C. § 1022 then contains several modifications to carry-over basis.

1. Every estate is entitled to a $1.3 million basis increase, other than an estate of a non-resident alien for which only a $60,000 increase is available.
2. An additional $3 million basis increase is available for property passing to the decedent's spouse directly or through a QTIP trust.
3. In addition, I.R.C. § 1022 allows an extra basis increase for any unused net operating loss under I.R.C. § 172 or capital loss under I.R.C. § 1212(b).
4. Finally, an increase is allowed for built-in losses, existing on the date of the decedent's death, relative to business or investment property. For example, if on the taxpayer's date of death he owned business property that cost $5,000 but was worth $1,000, there exists a built-in loss on this property in the amount of $4,000. This $4,000 built-in loss can be added to the date of death basis of that asset.

The code contains a limitation on the applicability of the $1.3 million and the $3 million basis increases. Neither of those amounts can increase the basis of an asset to an amount in excess of the asset's fair market value.

Certain property is ineligible for the basis increase:

1. Income in respect of a decedent property under I.R.C. § 691.
2. Property acquired by the decedent by gift within three years of death.
3. Property over which the decedent had a general power of appointment.
4. Certain foreign stock.

The election also affects the holding period of the assets inherited. If the estate is subject to estate tax then each asset inherited by a beneficiary is treated as if it has been held long-term. However, if the executor has elected out of the estate tax, each asset's holding period must be determined with reference to the decedent's holding period. The holding period of the asset after the date of the decedent's death is then added to the decedent's holding period. For example, if the decedent had purchased an asset two months before her death and the beneficiary sold the asset nine months later, any gain would be considered a short-term gain because the holding period of the asset was 11 months. Had this been a taxable estate the gain would have been a long-term gain.

Since the enactment of EGTRRA, estate planning attorneys have been waiting for Congress to modify the rules that would apply in 2010. While it took Congress 11½ months into to the year to act, there is now a clearer understanding of what we have to deal with. Advising executors of estates of decedents that died during 2010 creates a new set of challenges and requires analysis different from those we faced in any other year in recent memory.

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