Family Tax Planning Forum

By Robert S. Keebler

2010 Tax Relief Act Sparks Both Relief and Anxiety

The 2010 tax year certainly proved to be one of the most interesting tax years, particularly in the area of estate planning. While there is now some clarity regarding the estate, gift and GST tax law for the next couple years, there still is a bit of uncertainty as to how to administer estates of decedents, especially those who passed away in 2010. In my October 2010 TAXES column,[1] we discussed the date-of-death basis step-up provisions of the prior tax law under Code Sec. 1014 and also discussed, in detail, the new "modified carryover basis" rules under Code Sec. 1022. In this column, we will briefly revisit the "modified carryover basis" rules again and compare these rules against the recently enacted estate, gift and GST tax law provisions of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("2010 Tax Relief Act") (P.L. 111-312).

When the "modified carryover basis" rules of Code Sec. 1022 were first enacted under Section 542(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (P.L. 107-16), few tax planners thought the day would come where they would be faced with the challenge of determining how to apportion the $1.3 million basis increase under Code Sec. 1022(b) or the basis increase of up to $4.3 million in the case of a married decedent (when using the $3 million spousal basis increase under Code Sec. 1022(c)). With the retroactive reinstatement of the estate,

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Table 1.

	Elect out	Elect in	Difference
Gross Estate	$5,000,000	$5,000,000	
Less: Exemption	- 5,000,000	- 5,000,000	
Taxable Estate	$0	$0	
Estate Tax @ 35%	**$0**	**$0**	**$0**
FMV of Assets	$5,000,000	$5,000,000	
Less: Original Basis	- 2,800,000	- 2,800,000	
Less: Basis Increase	- 1,300,000	- 2,200,000	
Capital Gain	$900,000	$0	
Capital Gains Tax @ 15%	**$135,000**	**$0**	**($135,000)**
TOTAL TAXES	**$135,000**	**$0**	**($135,000)**

Table 2.

	Elect out	Elect in	Difference
Gross Estate	$35,000,000	$35,000,000	
Less: Exemption	- 35,000,000	- 5,000,000	
Taxable Estate	$0	$30,000,000	
Estate Tax @ 35%	**$0**	**$10,500,000**	**$10,500,000**
FMV of Assets	$35,000,000	$35,000,000	
Less: Original Basis	- 25,000,000	- 25,000,000	
Less: Basis Increase	- 1,300,000	- 10,000,000	
Capital Gain	$8,700,000	$0	
Capital Gains Tax @ 15%	**$1,305,000**	**$0**	**($1,305,000)**
TOTAL TAXES	**$1,305,000**	**$10,500,000**	**$9,195,000**

gift and GST taxes for 2010 under 2010 Tax Relief Act, however, the decision-making becomes even more complicated.

Deciding whether to "elect out" of the estate tax in 2010, whereby the modified carryover basis rules of Code Sec. 1022 would apply, or "elect into" the estate tax, whereby the date-of-death basis step-up rules of Code Sec. 1014 would apply, will largely depend on both the size of the estate and the composition of the assets *(e.g.,* capital assets, depreciable assets, IRD, *etc.*) within the estate.

In general, for estates that are $5 million or less in 2010, electing into the estate tax will be advantageous in that (1) there will not be any estate tax (assuming no prior taxable gifts were made), and (2) the assets of the estate will receive a full basis step-up under Code Sec. 1014 (unless, of course, the original basis of an asset is greater than its date-of-death fair market value). For estates greater than $25 million, it will generally make more sense to elect out of the estate tax in 2010 because the estate tax savings will outweigh any income tax cost from the reduced basis step-up under Code. Sec. 1022. For those estates between $5 million and $25 million, the decision to elect into or out of the estate tax requires a more comprehensive mathematical analysis.

With these points in mind, it is possible to calculate a break-even point for just about any size estate. Because the "elect out" option becomes more favorable as the size of the estate increases, any estate larger than the break-even point would be better off electing out of the estate tax and falling under the modified carryover basis rules of Code Sec. 1022. On the other hand, any estate at or smaller than the break-even point would be better off electing into the estate tax and falling under the basis step-up rules of Code Sec. 1014.

This analysis can be generally summed up using the formula shown in Chart 1.

Chart 1.

Factors
X = Gross estate
X_b = Cost basis of gross estate
Y = Estate tax exemption
Z = Modified carryover basis increase
R_y = Estate tax rate
R_z = Income tax/capital gains tax rate

Formula
$(X - Y) \times R_y = ([X - X_b] - Z) \times R_z$

Example 1. John, age 80 and single, dies in 2010 with a $5 million gross estate. John's gross estate consists of a variety of assets with an aggregate cost basis of $2.8 million. Given these facts, John's estate would elect into the estate tax because the estate will not incur an estate tax and will get a full basis step-up. This is shown in Table 1.

Example 2. Jane, age 85 and single, dies in 2010 with a $35 million gross estate. Jane's gross estate consists of a variety of assets with an aggregate cost basis of $25 million. Given these facts, Jane's estate would elect out of the estate tax because the estate will have an estate tax that is greater than any income tax liability it would incur upon the future sale of the assets. This is shown in Table 2.

The previous two examples are a bit simplified because they only assumed that all the assets held by each estate were capital assets subject to long-term capital gains tax treatment upon disposition. However, in many estates this will not be the case. When considering whether to elect into or out of the estate tax, the trustee and/or executor will need to look at the size of the estate as well as the composition of the estate's assets. In this case, the trustee and/or executor will need to ascertain if any of the assets are (1) considered "income in respect of a decedent" (IRD), (2) assets depreciated by the decedent, which are subject to depreciation recapture upon disposition, or (3) assets that may be used for future depreciation. This issue is illustrated in Example 3.

Table 3.

	Date-of-Death FMV	Adjusted Cost Basis	Unrealized Gain
Capital assets	$10,000,000	$3,000,000	$7,000,000
Depreciable assets (Code Sec. 1245)	5,000,000	500,000	4,500,000
Depreciable assets (Code Sec. 1250)	5,000,000	1,000,000	4,000,000
Total estate	**$20,000,000**	**$4,500,000**	**$15,500,000**

Table 4.

	Elect out	Elect in	Difference
Gross Estate	$20,000,000	$20,000,000	
Less: Exemption	- 20,000,000	- 5,000,000	
Taxable Estate	$0	$15,000,000	
Estate Tax @ 35%	**$0**	**$5,250,000**	**$5,250,000**
Capital Assets			
FMV of Assets	$9,000,000	$9,000,000	
Less: Original Basis	- 3,000,000	- 3,000,000	
Less: Basis Increase	- 0	- 6,000,000	
Capital Gain	$6,000,000	$0	
Capital Gains Tax @ 15%	**$900,000**	**$0**	**($900,000)**
Code Sec. 1245 Assets			
FMV of Assets	$5,000,000	$5,000,000	
Less: Original Basis	- 500,000	- 500,000	
Less: Basis Increase	- 1,300,000	- 4,500,000	
Net Gain (100% Recapture)	$3,200,000	$0	
Income Tax @ 35%	**$1,120,000**	**$0**	**($1,120,000)**
Code Sec. 1250 Assets			
FMV of Assets	$5,000,000	$5,000,000	
Less: Original Basis	- 1,000,000	- 1,000,000	
Less: Basis Increase	- 0	- 4,000,000	
Net Gain (100% Recapture)	$4,000,000	$0	
Income Tax @ 25%	**$1,000,000**	**$0**	**($1,000,000)**
TOTAL TAXES	**$3,020,000**	**$5,250,000**	**$2,230,000**

Example 3. Martha, age 75 and single, at the time of her death in 2010 had the assets shown in Table 3 in her taxable estate. Now assume that, for income tax purposes, the beneficiaries of Martha's estate are all at the highest marginal income tax rate (*i.e.,* 35 percent), and they liquidate all of the estate's assets immediately.

Based on these assumptions, Table 4 summarizes the tax liability under each scenario assuming

Martha's estate either elects into or out of the estate tax.

Keep in mind that when preparing a comparative analysis to determine which option is more advantageous, one must also take into consideration the present value of the tax liabilities. Example 3 was oversimplified in that it assumed that the beneficiaries were going to immediately sell all of the estate's assets. In most cases, though, the assets of the estate will not be disposed of for quite some time, thereby decreasing the present value of the future income tax liability. Finally, one must take into consideration the additional basis increase for future depreciation that would be allowed for the beneficiaries under the "elect into" scenario (under Code Sec. 1014). In this case, the present value of the future income tax benefit of any depreciation needs to be considered when determining whether to elect into or out of the estate tax.

Conclusion

The 2010 tax year certainly proved to be interesting, if not a little nerve-racking, from a tax planning perspective. While there is at least some short-term estate tax relief, there are still enough open issues for estates in 2010 that can cause considerable anxiety for trustees, executors and their advisors. Nevertheless, with careful planning and analysis, a prudent decision can still be made.

ENDNOTES

1 Robert S. Keebler, Family Tax Planning Forum, *Choosing Between Code Sec. 1022 Modified Basis Step-up and Applying the 2009 Estate Tax Rules for Decedents Dying in 2010*, TAXES, Oct. 2010, at 5.