Rhode Island & Massachusetts
Lawyers Weekly
www.lawyersweekly.com
November 1, 2010
The Dolan Company

# Trusts & Estates Special Feature

# Estate taxes: clock is ticking and time is running out

By David J. Correira and Eric D. Correira

DAVID CORREIRA

ERIC CORREIRA

While some practitioners still believe that Congress will retroactively reinstate the federal estate tax for 2010, as the months go by without any action, it is becoming increasingly likely that there will not be a federal estate tax this year.

Many felt that action by Congress to reinstate the estate tax prior to Oct. 1, 2010, would withstand a constitutional challenge because that would be the due date for an estate tax return for a person who died on Jan. 1, 2010. However, at this late hour it seems time may have run out.

Many have equated "no estate tax" to mean no tax on estates whatsoever, but that conclusion is incorrect. In fact, although the estate tax, and as the additional generation skipping tax, has been removed for 2010, it is replaced with a temporary succession tax regime that shifts the tax burden from a decedent's estate to the decedent's beneficiaries.

Under existing law, if left unchanged, the federal estate tax will return in 2011 in its pre-2001 form. Estates will receive a $1 million exemption and may be taxed at a rate of up to 55 percent.

In addition, the return of the federal estate tax will have a direct effect in several states with systems tied to the federal regime. For instance, Florida's estate tax was eliminated in 2005 because of the manner in which it was linked to the federal estate tax. Under the Florida system, the state would "pick up" all, or a portion of, the federal credit for state death taxes. In 2005, the federal credit was changed to a deduction for state death tax and because Florida's law only referenced a credit, th state's estate tax automatically vanished.

However, because of that same connection, Floric estate tax will likewise return in 2011, with a $1 milli exemption when it will again "pick up" the reinstated federal credit for death taxes.

In comparison to Florida, states like Massachusetts and Rhode Island, which still have an estate tax this year under the pre-existing rules, will continue into 2011 unaltered. The current Massachusetts estate tax exemption is $1 million. The Rhode Island exemption is $850,000.

If the estate tax is not reinstated for 2010, estate planners and tax practitioners will have to grapple with its replacement, which can best be characterized as a "carryover basis system." Many known, anc still yet unknown, problems will arise for decedents with estate plans designed under the pre-2010 estat tax system, who die this year. Practitioners must no familiarize themselves with the new replacement sy tem, as at this point it is most likely here to stay.

Obviously, in order to gain a full understanding of the federal estate tax system's replacement, an in-depth analysis is needed. The purpose of this article is to instead give a brief overview of the main characteristics of the new system and the most important changes that it brings.

### Carry-over basis rule

Under the pre-2010 system, the tax basis (or tax value) in property acquired from a decedent was adjusted (usually upward) to the fair market value of the property on the date of the decedent's death without limitation.

That adjustment is often referred to as a "step-up in basis." Depending on the type of property in the estate, the tax savings from the rule could be tremendous, because a subsequent sale at date of death value resulted in no capital gains tax.

To illustrate step-up in basis, suppose dad bought a house for $50,000 several decades ago. At the time of his death, the property had increased in value to $400,000. If son inherits the property from dad, his basis in the property would be its value at the time of dad's death, or $400,000. If son immediately sold the property for its present value, he would not realize any gain and, in turn, would not recognize or be taxed on any gain.

However, pursuant to Internal Revenue Code section 1014(f), as the law currently exists, section 1022 is now applicable to property acquired from a decedent. Section 1022 removes the step-up in basis and treats inherited property in the same way as if it were acquired by gift — that is, the beneficiary's basis in the newly acquired property is the lesser of the decedent's original basis (as may be adjusted for improvements or depreciation) or the fair market value of the property on the date of the decedent's death.

This means that most beneficiaries will have a basis in inherited property equal to the decedent's original basis (unless the property has decreased in value, a growing possibility given the current depressed housing market, creating the unfortunate scenario of a property's fair market value being less than its original purchase price). If the beneficiary immediately sells the property, the lower basis will result in a much higher gain and, in turn, a much higher capital gains tax.

*David J. Correira, Esq., MPA, is managing partner of Correira LLP Law Partners and Associates in Boston and Providence, R.I., and a member of the adjunct faculty at New England Law|Boston where he teaches estate and gift tax and estate planning. Eric D. Correira, Esq, LLM is an associate junior partner at the firm.*

Turning back to the original illustration, where dad had purchased a house for $50,000 several decades ago that was worth $400,000 at the time of his death, now, under the new system, son may only take as his basis the lesser of dad's original basis ($50,000) or the property's current value ($400,000).

Thus, son's basis will be $50,000. If son then sells the property for its fair market value of $400,000, he will recognize a capital gain of $350,000. At present, capital gains rates are scheduled to increase from the current 15 percent level to 20 percent.

**General basis allocation**

Similar to the estate tax exemption available under the pre-2010 system, Congress has carved out an exception to the carryover basis rule, allowing every estate a basis adjustment equal to $1.3 million plus the rest of the decedent's unused section 172 net operating loss carryover, unused section 1212(b) capital loss carryover, and section 165 losses that would have been otherwise allowable had the decedent sold the property immediately before his death.

Thus, given the huge amount of possible basis allocation, only large estates will be faced with gains (estates with property with a built in gain in excess of $1.3 million).

One important point worth mentioning is that, understandably, under section 1022(d)(2), these upward basis adjustments are allowed only to the extent of the fair market value of the property.

In other words, if the estate's only property has a basis of $50,000 and fair market value of $400,000, a $350,000 allocation can be made, increasing the property's basis to $400,000 (however, a $1.3 million allocation, increasing the basis to $1.35 million, is not permitted).

Building once more on the original illustration, assume dad owned three properties, the house with a basis of $50,000 and fair market value of $400,000, and also two rental properties, each with a basis of $100,000 and fair market value of $500,000. If son inherited all three properties, he would have a total basis of $250,000, while the total value of the properties on the date of dad's death was $1.4 million.

If son wishes to sell all three properties at their present value, he will not realize any gain on the sale because dad's estate has the $1.3 million basis allocation to be applied. Of the total $1.3 million allocation available, $350,000 will be applied to the house (increasing the basis from $50,000 to $400,000) and $400,000 will be applied to each of the two rental properties (increasing the basis in those two properties from $100,000 up to $500,000 each). The remaining $150,000 allocation is unused.

Next, if son immediately sells all three properties at the value each had on the date of dad's death, he will not recognize any gain from the sales.

One final note, while the $1.3 million basis allocation is the general rule, non-resident aliens are limited to only a $60,000 basis allocation. In addition, non-resident aliens are unable to take advantage of the additional adjustments for unused net operating loss and capital loss carryovers and section 165 losses.

**Marital basis allocation**

In addition to the general basis allocation, a second basis allocation of $3 million is allowed for property left outright to a spouse or in a trust from which a spouse is entitled to all the income from the property, and no other person can appoint the property to anyone other than the surviving spouse. That allows for a much greater adjustment for property left to a spouse.

**Possible trust planning**

In states like Massachusetts, which will have a $1 million state estate tax exemption, the executor of a $4 million estate might want to make an election to fund a family trust with $1 million and thereby receive a full step-up in basis using the general basis allocations. The other $3 million could pass to a marital trust, which would also receive a full step-up in basis using the marital basis allocation.

Similarly, in a state with a different state estate tax exemption, the trust could be funded with an alternate sum equal to that state's exemption. For example, in Rhode Island, the family trust would be funded with $850,000 (Rhode Island's exemption).

Beyond the analysis of this discussion is whether it would be wise under these rules to take a different course of action with a $4.3 million estate, and fund the family trust with $1.3 million and make a state QTIP election (where at least net income goes to the surviving spouse) over the additional $300,000 (or $450,000 in Rhode Island). That would allow a step-up in basis for everything over the $3 million marital basis allocation.

**Life estates and other types of property to which basis adjustments inapplicable**

First, although under the old regime life estates and property subject to a general power of appointment were includable in a decedent's estate and could receive a step-up in basis, under the new system such property is not given the benefit of a basis adjustment.

Similarly it remains unclear, and is now being debated among commentators, whether property held in an irrevocable grantor trust may receive a basis adjustment. It appears that unless the irrevocable trust is a "defective grantor trust" as to both income tax and estate tax, no step-up in basis allocation is allowed.

In addition, the basis adjustment is also inapplicable to property acquired by a decedent within three years of death for less than adequate consideration, unless the property was received from a spouse and that spouse did not receive the property for less than adequate consideration himself.

The purpose of this section is to avoid possible death-bed planning, in which property is transferred to a dying person in order to be able to include the property in that person's estate and receive a basis allocation, and then give the property, with a now increased basis, back to the original owner.

**Federal gift tax and the pre-2001 tax code**

Although the federal estate tax was repealed and replaced with the carryover basis regime, the federal gift tax system remains in place (in fact, as discussed, the new system in many ways resembles the already existing gift tax system).

The annual exclusion continues to apply to gifts of present interests (for 2010, the annual exclusion amount is $13,000). For gifts in excess of the annual exclusion, there is still the lifetime gift tax exemption, which presently allows tax-free gifts of up to $1 million over the course of a person's life, which will "reunify" at death with any federal exemption for estate taxes.

Furthermore, under section 901(b), at the end of 2010 the pre-2001 code will be reinstated and will be applicable to all estates, gifts and generation-skipping transfers made after Dec. 31, 2010. The estate tax system will include a $1 million exemption and rates of up to 55 percent, as already discussed.

**Effects of estate tax 'repeal' on existing planning**

Besides the nightmare of trying to determine the basis of an asset with poor record keeping, numerous other problems may now arise. Estate plans made under the old rules could now have less or no beneficial effect, or in some cases may actually work to the estate's detriment.

For instance, both martial deduction and charitable deduction formulas no longer serve a purpose in a carryover basis system (although these formulas still function in certain state death tax systems, such as Massachusetts and Rhode Island).

Likewise, many types of trusts (including Grantor Retained Annuity Trusts, Qualified Personal Residence Trusts and Irrevocable Insurance Trusts) have limited use in a system without a federal estate tax.

The failure of those formula provisions may result in a beneficiary being disinherited (for instance, because of an unfunded marital or charitable trust), or will force judges to interpret will or trust language by not applying the law in effect, but instead the law that the decedent anticipated would be in effect.

**Wills and trusts should include basis allocation provisions**

For large estates, the $1.3 million basis allocation is insufficient to increase the basis of all property. Thus, only some property, going to only some of the beneficiaries, will be able to be adjusted. That creates a new area of family conflict, as the executor will be left to determine how much of the overall allocation to give to each individual property.

Obviously, that may create a new ground for infighting and hostility between beneficiaries. Therefore, planners should consider including in wills and trusts a provision directing how to apply the basis allocation. Possible alternatives include applying it proportionally among the properties or in a sequential order.

Any practical allocation method will work. Without the inclusion of such a provision, the executor may be left having to make choices that may not necessarily please everyone.

**Conclusion**

Uncertainty still exists as to whether the estate tax will be retroactively reinstated for 2010 and, if so, what form it will take.

There has been some discussion that if Congress does act late in 2010, it might provide for an option by an executor to elect the "adjusted basis rules" for deaths in 2010 or any "reinstated estate tax rules."

The Democrats are generally in favor of reinstatement of a $3.5 million exemption level and a top rate of 45 percent, while the Republicans lean toward reinstatement of a $5 million exemption level and a top rate of 35 percent.

Finally, there has not been much discussion about reinstating any amount of exemption for qualified family owner business interests (QFOBI), which was eliminated in 2005 as the federal exemption level increased.

In the meantime, the clock continues to tick.

MLW

**Visit our website: www.cilaw.com 800-699-5040**

*Reprinted with permission from The Dolan Co., 10 Milk Street, Boston, MA 02108. (800) 444-5297 © 2010 #01350vw*