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2010 - NO ESTATE TAX AND CARRYOVER BASIS

The estate tax laws that have been in effect since 1976 have been repealed for 2010. In 2001, Congress increased the estate tax and generation skipping transfer (GST) tax exemption amounts to $3,500,000 and lowered the top estate and gift tax rate transfer tax to 45%. For the past 10 years, everyone had expected that Congress would extend the 2001 law beyond 2009. Congress did not.[1]

Starting January 1, 2010, for the first time since 1915, the United States has no federal estate or generation skipping transfer tax,[2] and starting January 1, 2011, the estate and generation skipping transfer tax is reinstated at the pre-2001 rates. Thus, starting in 2011, the federal estate tax exemption equivalent amount will be $1,000,000 and the tax rate will 55%. Because many have estates greater than $1,000,000, a substantial number of people will be subject to estate taxes on death occurring after 2010.

January 1, 2010 also brings the introduction of new law regarding adjustment of income tax basis for assets on the death of the owner. The new law is called "carryover" basis.[3]

Prior to 2010, the tax law provided that all assets owned by a person received an "adjustment basis" equal to the fair market value of that asset as of the date of death. Thus, the asset's new income tax basis could be increased or decreased depending on the value of the asset on the date

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[1] On December 3, 2009, the House passed a very short bill that would have extended the current tax law for two years. On December 17, the Senate failed to pass that bill.

[2] The federal gift tax law was not repealed and stays in effect after 2009. Thus, the annual gift tax exclusion amount will be $13,000, and the life-time gift tax exemption amount will remain $1,000,000.

[3] IRC §1022.

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of death. This was a significant benefit given that most assets appreciated and thus all the income tax gain was eliminated because most assets received a step-up in basis to fair market value on death.

Starting January 1, 2010, all assets owned by a person dying in 2010 will receive an adjustment in income tax basis equal to the lesser of the assets income tax basis or the assets fair market value on date of death.[4] In most cases, this will result in a "carryover" of the asset's income tax basis on date of death. The impact of the carryover regime is that beneficiaries are more likely to inherit assets that when sold, will result in significant income tax liability.[5]

There are two exceptions to the new carryover basis law:

First, the personal representative[6] of an estate may elect to allocate up to $1,300,000 to increase the income tax basis of assets to an amount not exceeding the asset's fair market value on date of death.[7] This amount will be adjusted for inflation.

Second, the personal representative of an estate may elect to allocate an additional $3,000,000 to increase the income tax basis of assets that is "Qualified Spousal Property" -- meaning assets received by the surviving spouse or transferred to a qualifying marital trust.[8] This amount will also be adjusted for inflation.

[4] IRC §1022(a).

[5] For example: Assume that Tom owns a duplex that was purchased for $150,000 in 1985, and has been depreciated down to $20,000; and that when Tom dies, the fair market value of the duplex is $300,000. If Tom dies in 2009, the new adjusted income tax basis will the duplex will be $300,000, and if Son sells the duplex for $350,000, he will have a taxable capital gain of $50,000 and will pay $7,500 in capital gains tax (15%). In the alternative, if H dies in 2010, the income tax basis will be $20,000, and if Son sells the duplex for $350,000, he will pay taxes as high as $68,000. [This assumes no exceptions apply].

[6] IRC §1022 authorizes only the "executor" to make the allocations allowed by §1022. Presumably, a trustee of a revocable living trust cannot not make the election.

[7] IRC §1022(b).

[8] IRC §1022(c).

A couple of comments and planning points need to be made regarding the new carryover basis rules:

1. It is very important that the estate planning documents specifically authorize the personal representative to make the elections to allocate income tax basis increases authorized by IRC §1022. The authority to make adjustments applies to both probate and non-probate assets.

2. Estate planning documents should also consider waiving any claim of self-dealing against the personal representative when the personal representative is a related-party and/or may benefit from the allocation of income tax basis under §1022.

3. It should be noted that the $1,300,000 and the $3,000,000 allocation are separate, and with planning can result in a total increase in basis to assets of $4.3 million.

4. The increased basis authorized by §1022 of $1,300,000 and $3,000,000 is based not on assets having a value of $1.3 million and $3.0 million, but rather on assets having income tax basis adjustments equal to those amounts. Thus, the post-death allocation process may get very complicated, especially when choosing between assets that pass to different people.

Because of the new carryover basis rules, it is very important that one establish and maintain detailed historical records establishing the current income tax basis[9] on all assets – especially those of significant value (real estate, art, investments, planes, etc.). This means that you should go back through your records now to establish the current income tax basis of your assets to make it easier to establish basis on your death.

At this time, no one knows or can predict what Congress may do in 2010 regarding carryover basis or the estate tax law. Congress could: (i) re-enact the 2009 federal estate tax law starting in 2011; (ii) re-enact the 2009 federal estate tax law retroactively to January 1, 2010; (iii) re-enact

[9] Current income tax basis is normally referred to as an asset's "adjusted income tax basis." Adjusted basis is equal to: (i) the asset's original purchase price; plus (ii) the actual cost of improvements; minus (iii) income tax depreciation. For example: you purchase a duplex for $200,000, spend $100,000 substantially remodel it [doors, deck, roof, kitchen, etc], and depreciate it for a number of years, the "adjusted basis" would be $200,000 + $100,000 - accumulated income tax depreciation.

some new or revised form of the federal estate tax, either increasing or decreasing the exemption amounts from $3.5 million, to some other amount; or, (iv) do nothing.

So with the repeal of the federal estate tax law and enactment of carryover basis, it is important that you carefully consider the impact to you and your family should death occur in 2010. Although there is some possibility that Congress may change the law, the potential tax consequences and costs to your family may be very significant.

If you would like additional information about this topic or would like to discuss estate planning in light of the new changes in the law, please contact our office to schedule an appointment.

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