To Elect or Not Elect Out of Estate Tax: More Complicated Than You Think

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Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1769

Date: 31-Jan-11
From: Steve Leimberg's Estate Planning Newsletter

Subject: **Jonathan Blattmachr: To Elect or Not to Elect (Carryover Basis): That Is the Question**

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 retroactively imposes the Federal estate tax with a $5 million exemption, but also permits the estate of someone who died last year to elect out of the estate tax regime and into the modified carryover basis regime of section 1022. In some cases, the decision on whether to elect out or stay in will appear very simple.

As **Jonathan Blattmachr** points out in his commentary below, if the estate is less than the decedent's exemption ($5 million for most and likely no less than $4 million for nearly everyone), staying in the estate tax system may seem like a "no brainer" decision. Similarly, if the estate is very large (say, over $10 million), electing out of estate tax seems like the absolutely perfect step to take. However, as Jonathan notes, at least in some cases, those may not be the best decisions.

Jonathan Blattmachr is a director of **Eagle River Associates**, a wealth management firm in New York City. He also, with Dallas Attorney **Mike Graham**, is a co-developer of Wealth Transfer Planning, a computer system for lawyers that offers specific client advice and automatically prepares wills, trusts and other estate planning documents using document assembly. In addition, he is the Director of Estate Planning for the **Alaska Trust Company**.
Here is his commentary:

EXECUTIVE SUMMARY:

One of the most important elections made available under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Act") is whether to elect out of the retroactively reinstated federal estate tax with a "stepped up" basis and into a carryover basis regime without estate tax for those who died in 2010. Although the decision as to whether to elect out or not might seem simply to be based upon whether the estate of a 2010 decedent is not more than the $5 million estate tax exemption allowed for last year (staying with the estate tax and stepped up basis in that case) or is greater than $5 million (opting into carryover basis in such a situation), the decision actually may be a very complicated one.

Several factors, from the timing of recognition of income to the nature of the gain inherent in property to fiduciary duty, need to be considered. In some cases, it will be preferable to pay a significant estate tax rather than electing into the carryover basis system.

FACTS:

Few, if any, would have thought just a few weeks ago that the United States would adopt legislation giving the estates of 2010 decedents a choice either to have no estate tax with carryover basis or estate tax with a automatic change in basis for most assets included in the decedent's gross estate. But that is exactly what the Congress passed and the President signed into law as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Act").

Many other changes were made to the estate, gift and generation-skipping transfer ("GST") tax provisions of the Internal Revenue Code ("Code"). Those other changes will have a much longer shelf life, barring further legislation. The opportunity for estates of 2010 decedents to stay in the estate tax system with the automatic basis change or to elect into the modified carryover basis system will end much sooner—perhaps, as early as September 17, 2011, which is nine months after the Act was passed and when most estate tax returns for 2010 decedents will be due (unless placed on extension for up to six months).

COMMENT:

The Basic Decision

The 2010 Act retroactively imposes the Federal estate tax with a $5 million exemption (which on account of prior lifetime gifts could be $4 million or slightly less in some cases where the decedent used part or all of the old $30,000 gift tax exemption in the latter part of 1976) with an essentially constant 35% rate on those who died in 2010. However, the Act permits the estate of someone who died last year to elect out of the estate tax regime and into the modified carryover basis regime of section 1022. In some cases, the decision on whether to elect out or stay in will appear very simple. If the estate is less than the decedent's exemption ($5 million for most and likely no less than $4 million for nearly everyone), staying in the estate tax system seems like a "no brainer" decision. Similarly, if the estate is very large (say, over $10 million), electing out of estate tax seems like the absolutely perfect step to take. However, at least in some cases, those may not be the best decisions.

Impact on the Beneficiaries

Obviously, how much estate tax is paid and the income tax basis of inherited property will affect at least some beneficiaries. But the impact will not

necessarily be the same across the board. For example, a beneficiary of a specific dollar cash bequest to which estate tax is not apportioned may be indifferent as to whether the estate chooses to stay in the estate tax regime or elect out of it.

However, even that beneficiary may be affected by the decision. The reason is that under the law of many jurisdictions (or the terms of the instrument making the bequest) a dollar bequest may be funded with a non-cash asset as long as the asset has a fair market value on the date the bequest is satisfied has a fair market value equal to the amount of the bequest.

Although, as a general rule, gain or loss is realized when a non-cash asset is used to satisfy a fixed sum (pecuniary) bequest with the beneficiary receiving a basis in the asset equal to the amount of the bequest, section 1040 of the Code provides that the inherent gain in a carryover asset as of the decedent's death is not recognized by the estate and that the beneficiary takes over the fiduciary's modified carryover basis which may be lower than the estate's fair market value. Perhaps, the beneficiary could complain to a court that her bequest was not really satisfied in full on account of the inherent income tax liability in the asset used to fund the legacy. Whether the beneficiary would be successful seems quite uncertain.

But there may be much bigger fish to fry. As has been discussed by many lawyers, there is considerable uncertainty as to what passes under a bequest described in terms of tax concepts such as the "minimum amount as the federal estate tax marital deduction necessary to reduce my federal estate tax to zero", "the applicable exclusion amount in effect at my death" or similar tax driven formula disposition.

Several states passed legislation last year providing that, if a decedent domiciled in one of those jurisdictions died making such a formula disposition, he or she would be treated as having died during 2009 when the federal estate tax exemption was $3.5 million. It seems clear that some 2010 decedents would not want that result.

For example, a wealthy 2010 married decedent, who created as so-called "credit shelter trust" equal to his or her estate tax exemption under which his or her spouse was the principal beneficiary (perhaps, entitled to all income for life) with the balance passing outright to his or her spouse, almost certainly would want his or her entire estate (not just $3.5 million of it) to pass to the credit shelter trust if there were no estate tax. But the legislation, on its face, seems to prevent that.

The 2010 Act, in some ways, has made the situation even worse. At the time the decedent died (at least before December 17 when the 2010 Act was signed into law), there was no federal estate tax. Does the fact that it has been

retroactively reinstated change the application of those state statutes or the meaning of a disposition premised upon a statement in the governing instrument such as "If I died when there is no federal estate tax in effect, I leave my entire estate as follows..."?

A rational case can be made that courts (and legislatures) should not literally interpret such instruments. In any case, even if it is clear that the disposition will be different if the estate is not subject to federal estate tax than if it were, does the failure to elect out of estate tax mean that the disposition, based upon there being a federal estate tax, will apply? If so, staying in or electing out of estate tax could have enormous impact on the beneficiaries.

Here is an actual case:

> A man died in early 2010 survived by his second wife and children of his first marriage naming his oldest son as executor of his will and bequeathing to his children "an amount equal to the Federal applicable exclusion amount in effect at the time of my death" and the balance of his estate outright to his wife. Decedent wrote his will when the federal estate tax exemption was $1 million and his wealth declined in his later years. His estate, at death, was approximately $4 million. The children (all of whom are from the first marriage) claim that they are entitled to the entire estate and the eldest son is refusing to elect out of estate tax. Hence, the children claim that, because the applicable exclusion amount (the estate tax exemption) is $5 million for 2010 decedents, they take it all. The widow sees it otherwise. She claims the son is so conflicted that he should be removed as executor at least for purposes of deciding whether to stay in or elect out of estate tax. She points out that the carryover basis of the assets (after the adjustments permitted under sections 1022(b) and (c)) will be just as high as the "step up" in basis under section 1014 if the estate stayed in the Federal estate tax system. She also points out that the applicable exclusion amount was actually zero when her husband died so the children should get nothing.

How this matter will be resolved is unclear at this time. It seems likely that, unless a settlement is reached, no final court decision of whether the executor may choose to stay in the estate tax system will have been reached by the time election out would have to be made (which the Congress has left up to the Treasury Department but does provide it may be revoked with its consent). The key point is that, if having the federal estate tax apply will cause a significant swing in how much a particular beneficiary will receive, the estate tax/no estate tax decision, perhaps, should not be based solely on what will produce the lowest overall tax. Nevertheless, it might be appropriate to choose what will produce the smallest tax and then make an "equitable adjustment" to make all beneficiaries whole. See, Matter of Rappaport, 121 Misc. 2d 447 (Surr. Ct. Nassau County 1983). Even then, two other factors should be considered. First the IRS will not be bound by a settlement agreement or by a court decision

other than by the highest court of the state. Commissioner v. Estate of Bosch, 387 US 456 (1967).

For example, the family elects out of estate tax so the whole estate can pass to a credit shelter trust and so none of the property of the 2010 decedent will be included in the gross estate of the surviving spouse. The IRS might argue that construction of the governing instrument by the family and the local court that the entire estate passes into the credit shelter trust is incorrect and all (or a significant portion) of the estate passes to the surviving spouse and will be included in the survivor's gross estate at death. Second, the equitable adjustment itself may have tax consequences. See, generally, Blattmachr, "The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey," 18th University of Miami Estate Planning Institute ¶1400 (1984).

Running the Numbers: Not Always Easy

It seems clear that if the disposition is not certain (e.g., all to a credit shelter trust or all to a QTIP trust or partially to each), it may not be possible to determine with certainty whether estate tax or carryover basis will produce the smallest tax. But even if the disposition is certain, there will be complexities in many cases.

Basis Higher Before Death for Non-Carryover Basis Property

For example, it may seem obvious if the decedent's taxable estate would be under his or her estate tax exemption ($5 million in most cases), then staying with the federal estate tax and the step-up in basis provisions of section 1014 is the way to go. However, it may be that an asset that would not fall under the modified carryover basis provisions but would be in the decedent's gross estate would have a higher basis if carryover basis is elected.

Although not absolutely certain, its seems a QTIP trust that was created for the decedent by his or her spouse and that would be included in his or her estate under section 2044 is not carryover basis property. If the trust is included in the decedent's gross estate, the basis of its assets will be adjusted to their date of death fair market values (assuming no special rule applies such, as for the right to income in respect of a decedent ("IRD")).

However, it may be that the basis of the assets in the trust just before the decedent's death is greater than fair market value at death. Because the QTIP trust does not appear to carryover basis property, the basis of its assets will not be limited to the lower of the decedent's basis in them or their fair market value at death as section 1022 directs. Hence, it would seem better to elect into carryover basis, all other things being equal (but, of course, they will not be). The same is true for property over which the decedent held a general power of appointment described in section 2041. That property seems to be excluded

from the being carryover basis property and, therefore, it appears that the property's income tax basis immediately before the decedent's death would continue when the property is transferred to the successor beneficiaries. What this means, of course, is that the basis of assets in a QTIP trust or subject to a general power of appointment held by the decedent should be checked before a decision on electing out of estate tax or not is made.

Young Surviving Spouse or Charity

As mentioned above, if the estate is large, the knee jerk reaction is to elect out of estate tax and into carryover basis. However, if the property will pass to a much younger surviving spouse under the protection of the estate tax marital deduction, obtaining a stepped up basis may be preferable if the surviving spouse will live a long time and have opportunities for significant estate planning to avoid the estate tax that may be due when he or she later dies with respect to the assets he or she has inherited from the deceased spouse who died in 2010. Similarly, if a significant portion of the estate will be protected from tax by reason of a charitable estate tax deduction, that too should be considered in making the decision whether to opt into carryover basis.

Checking on State Death Tax Effects

Over a dozen states had "independent" death tax systems in effect in 2010. Those systems seem to apply whether the estate tax or carryover basis applies at the federal level. But the presence of a state death tax may complicate decision making. For example, if the disposition depends upon whether the estate stays in the federal estate tax system or elects into carryover basis (by reason of a tax driven formula bequest for example), that may affect how much state death tax is paid. For instance, assume that the estate stays in the federal estate tax system and, as a result, the entire estate passes to a credit shelter trust for the surviving spouse and descendants. In that case, it would appear to mean that there is no marital deduction for federal or state death tax purposes, which would cause greater state death tax.

Because the state death tax exemption may be smaller than the federal exemption (which may be as high as $5 million and likely will be at least $4 million), there may be state death tax due which could have been avoided if the estate had elected out of the federal estate tax system. Although electing out of estate tax means carryover basis, the $1.3 million basis increase under section 1022(b) for any carryover basis asset and the $3 million basis increase under section 1022(c) for qualified spousal property (carryover basis property that passes outright to the surviving spouse or a trust that would have qualified for QTIP treatment if there were a federal estate tax) may mean there is no benefit to the "step up" in basis adjustment under section 1014. It is also appropriate to keep in mind that the right to IRD under section 691 is denied a step up in basis under section 1014(c) even if included in the decedent's gross estate (and the

basis increases permitted under sections 1022(b) and (c) cannot be applied with respect to the right to IRD).

There are other factors in considering the impact of state death taxes on the decision whether to elect out of federal estate tax. First, if a federal estate tax is payable, a federal estate tax deduction for the state death tax will be allowed under section 2058 of the Code. Second, if there is the right to IRD passing at the decedent's death generates federal estate tax, the taxpayer who must include the IRD in gross income may be entitled to an income tax deduction under section 691(c). But forecasting the benefit of that deduction can be "tricky." It is not subject to the two percent floor rule of section 67 but is potentially subject to the cut back in itemized deductions under section 68.

Determining When the Tax Will Be Due

Essentially, the federal estate will be due on the earlier of September 17, 2011 or within nine months of the death of a 2010 decedent who died after December 17. State death taxes may be due at a different time. The payment of tax attributable to the failure to get a step up in basis by electing into the modified carryover basis system may be difficult to estimate. If the inheritor is the surviving spouse, the assets will be entitled to a step-up in basis when he or she later dies so, for an older surviving spouse, the carryover income tax liability may never be realized. Whether that is wise to count on is difficult to know. It depends upon many unknowns such as what the estate tax exemption will be when the surviving spouse dies.

It also may be difficult to determine when the carryover basis assets will be sold. There are numerous factors that an owner may consider in determining when to sell an investment. The estate tax normally will be due nine months after death but tax on gains may be due much later. Also, it is not entirely clear if the nature of the inherent gain, at least through date of death, in a carryover basis asset carried over to the inheritor. For example, if property was an ordinary income asset in the hands of the decedent (because, for example, the decedent was a dealer in the property or was the person, such as an artist, who created the property), it may be that the gain recognized by a sale by the inheritor also would be ordinary income at least through its date of death value if not gain thereafter experienced.

Costs of Administration and Local Law Effects

It may be that having to file an estate tax return will increase the costs of administration. Although there are many unanswered questions with respect to carryover basis, including the fact that there is no final form available on which the carryover basis information must be reported (see section 6018), it seems likely the IRS will spend little, if any, time auditing carryover basis matters. Unlike an estate tax return, a carryover basis return will not be accompanied by

the payment of any tax and the system ultimately will apply to fewer decedents. Therefore, it may be that the administrative costs of complying with the carryover basis system would be lower than the costs of complying with the estate tax system although a search for the decedent's basis in his or her assets may be challenging in some cases.

In some states or localities, filing or not filing a federal estate tax return may result in changes in court or other reporting. For example, under the New York Surrogate's Court Rules, the executor must make a special report to the Surrogate's Court if the estate is still "open" within two years if no federal estate tax return has been file or three years if such a return was filed. 22 NYCRR 207.42.

Negative Basis Property

For several reasons, property may have what is known as a "negative" income tax basis. That occurs when the income tax basis in an asset is less than the debt against it. Essentially, any transfer of the property during lifetime will trigger gain to the extent of the negative basis. See Commissioner v. Crane, 331 US 1(1947) and Commissioner v. Tufts, 461 US 300 (1983). Death, however, eliminates the negative basis if basis is changed under section 1014. See Reg. § 1.742-1. In addition, the negative basis may be taxed as ordinary income. Not infrequently, the fair market value of the negative basis property will be lower at the owner's death than the amount of negative basis. For example, the property might be worth $100,000 but have a $1,000,000 negative basis. In such a case the estate tax (at no more than a 35% rate) on the value of the negative basis property may be less than the income tax (possibly also 35%) that would be due if and when the negative basis property is transferred. But again, if the negative basis asset will be inherited by a surviving spouse who could hold the property until his or her later death, avoiding the estate tax may make greater sense. Moreover, all states, except seven, have income taxes which, if applicable, would increase the total income tax due on the negative basis property; far fewer have death taxes. Of course, all assets should be considered in determining if the election into carryover basis likely will reduce the overall tax bill.

The illustration of negative basis property is just an extreme example of the proposition that estate tax may be lower than inherent income tax for a particular asset. In fact, a careful analysis of whether step up in basis with a small estate tax will save more tax than carryover basis without estate tax should be made whenever the estate is slightly over the decedent's estate tax exemption. For example, the decedent died in 2010 with an estate of $5.5 million with assets that would have combined bases, even after adjustment, of $2 million under the carryover basis system. Assuming the estate tax exemption is $5 million, the total estate tax would be 35% of $500,000 or $175,000. The potential inherent gains tax on the $3.5 million is $525,000 at a 15% rate. That suggests that

paying estate tax would be desirable but timing of the recognition of gain must also be considered.

Fiduciary Duty

The decision whether to elect out of estate tax is made by the decedent's executor. If an executor is appointed, it may be that that fiduciary's principal loyalty is to the probate legatees. In such a case, the executor may be compelled by that duty of loyalty to elect or not elect depending upon what is in the best interests of the probate legatees even if overall taxation on all assets that are or would be in the decedent's gross estate would be reduced by a contrary decision. Moreover, the fiduciary may be required to allocate the basis increases under sections 1022(b) and (c) under the carryover basis rules to probate legatees even if more taxes would be saved by allocating it to non-probate property. The law with respect to the fiduciary's duty may be unclear and this also may complicate the decision of whether to elect out of estate tax. For a discussion on the limitations on a beneficiary-fiduciary being able to make certain tax elections, see, generally, **Gans**, **Blattmachr & Heilborn**, "Gifts By Fiduciaries By Tax Options and Elections", Probate & Property, November/December 2004, Vol. 18 No. 6; republished in Digest of Tax Articles (March 2005).

Apportionment of Tax; Apportionment of Basis

Different beneficiaries may be benefitted or burdened by the decision of whether to elect out of estate tax to a greater degree than the amount of potential tax saved. For example, even if overall taxation will be reduced by staying in the estate tax system even if some estate tax may be payable (consider, for example, a negative basis asset), the estate tax may be apportioned in a manner different than the income tax savings caused by the step up in basis under section 1014. If carryover basis is elected, different beneficiaries may receive assets with disproportionately lower bases. Equitable adjustments, even if available to "even out" benefits and burdens among the beneficiaries, may be challenging to make if carryover basis is elected on account of the difficulty in estimating when the gain in the property will be experienced by various legatees.

Summary and Conclusions

Although the knee jerk reaction to the decision of whether to elect out of estate tax and into the modified carryover basis system is simple: stay with estate tax if the estate is lower than the decedent's exemption and elect out of it and into carryover basis if it is greater than the exemption, there will be many circumstances where the decision should be made the other way around. The uncertainty of the law, facts, fiduciary obligations, the uneven allocation of benefits and burdens among the beneficiaries and other factors will make the

decision challenging in many circumstances.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jonathan Blattmachr

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