

WILLMS, S.C.

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LAW FIRM

MEMORANDUM

TO: Clients and Friends of Willms, S.C.
FROM: Maureen L. O'Leary
DATE: January 3, 2011
RE: Recent Developments Regarding the Administration of 2010 Estates

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "2010 Tax Act") that was signed into law on December 17, 2010 includes provisions that significantly affect the administration of estates of decedents who died in 2010.

Prior to the passage of the 2010 Tax Act, it was expected that all estates of decedents who died in 2010 with more than \$1.3 million of non-cash assets were going to be required to file an IRS Form 8939 "Allocation of Increase in Basis for Property Received from a Decedent" in order to allocate basis to assets inherited from a 2010 decedent. This requirement was a result of the temporary repeal of the estate tax that also repealed the automatic step up in basis upon death rules. However, the 2010 Tax Act changed the rules for 2010 estates. As a result, it may no longer be necessary for as many 2010 estates to file a Form 8939. It has been estimated that there could be as few as 3000 estates that file a Form 8939, due to the new options presented by the 2010 Tax Act.

The estate of a decedent who died in 2010 now has 2 general options. The estate can choose to either "Opt-In" or "Opt-Out" of estate tax.

1. **Opt-In.** To "opt-in" to estate tax means to choose to use a traditional estate tax regime, which means the estate would be subject to estate tax (but have a \$5

million estate tax exemption and 35% estate tax rate.) As in previous years when the estate tax was in effect, estates subject to estate tax would also receive an automatic full step up in basis for all of the estate assets; or

2. **Opt-Out.** To “opt-out” of estate tax means to choose to have the 2010 estate tax repeal apply to the estate. If you choose to opt-out of the estate tax system, you will not receive an automatic full step up in basis (but \$1.3 million of basis can be allocated to assets received from a decedent and an additional \$3 million of basis can be allocated to assets received by the decedent’s spouse by filing a Form 8939).

Opt-In: Estate Tax and Automatic Full Step up in Basis

Estates that opt-in to the estate tax and automatic full step up in basis will be opting in to the system we were accustomed to in 2009, except the estate tax exemption is increased from \$3,500,000 to \$5,000,000 and the estate tax rate is reduced from 45% to 35% (and the estate tax exemption is reduced by the amount of gift tax exemption the decedent used during his or her lifetime). This means that estates larger than the \$5,000,000 estate tax exemption will be subject to a 35% estate tax on all assets in excess of the exemption amount (unless other deductions, exclusions or credits apply).

A tremendous benefit to estates that opt-in to the estate tax is that the basis of all of the assets in the estate will be stepped up to its fair market value (whereas under the opt-out system, assets would only be stepped up in basis by \$1.3 million plus \$3 million for assets passing to a surviving spouse (or to certain trusts for the benefit of a spouse). When an asset is sold, the difference between the sales price and its basis is gain, which is usually subject to income tax. The greater an asset’s basis, the less potential gain will result when the asset is sold, which means less capital gain income taxes. This is why a step up in basis is desirable and why careful consideration needs to be given when deciding how to trade off between estate tax and income tax considerations.

For estates less than \$5,000,000, you may be able to receive the best of both worlds by deciding to opt-in to the estate tax and automatic step up in basis. This is because the \$5 million estate tax exemption will shelter the estate from estate taxes and you will receive the benefit of a full step-up in basis for the assets without needing to file an IRS Form 8939.

However, even estates greater than \$5,000,000 may want to choose to opt-in if the benefit of the full step up in basis outweighs the estate tax consequences of your particular situation.

Opt-Out: No Estate Tax and Limited Step-up in Basis

Estates that opt-out of estate tax will be subject to the system that we thought was going to apply to all 2010 estates before the passage of the 2010 Tax Act. No estate tax will be due for estates that opt-out, regardless of how large the estate may or may not be. However, in exchange, the assets of the estate will be eligible for the limited \$1.3 million + \$3 million step up in basis. As a result, the basis of some of the estate assets may not be stepped up as high as they might have otherwise been under the opt-in system.

For very large estates, it will make sense to choose the opt-out system, in order to avoid a large estate tax bill. In those situations, the benefit of no estate tax may outweigh the potentially increased capital gains taxes in the future.

For small to medium sized estates, it may be less clear whether to opt-in or opt-out and the decision will require analysis of the specific facts and circumstances of the estate in question.

Conclusion

The decision of whether to “opt-in” or “opt-out” of estate tax is a very important decision that requires analysis of many complicated variables. You will need to gather the date of death fair market value and cost basis information for all the assets in the estate in order to determine which option is most advantageous. We highly recommend that you discuss the

situation in detail with your legal and tax advisors before making the decision, as there will be estate and income tax consequences as a result of whatever decision you make.

If you are responsible for administering the estate of a decedent who died in 2010, we encourage you to contact our office to schedule an appointment to discuss how the 2010 Tax Act affects the administration of the estate. We would be happy to assist you with deciding whether to “opt-in” or “opt-out” of estate tax.

It is also important to note that the IRS has not yet released instructions on the specific mechanics of how to officially and timely “opt-in” or “opt-out” of estate tax. It is anticipated that the election will need to be made by filing an estate tax return that will be due on September 19, 2011 (and there may be an exception for estates smaller than a specified size). For estates that opt-out, the IRS Form 8939 for basis allocation will also be due on September 19, 2011. It is important for you to stay in contact with your legal and tax advisors in order to stay informed of details regarding specific filing requirements as the IRS releases them.

Please feel free to contact us if you have any questions. We would be pleased to assist you with any of the issues mentioned in this article.

END OF MEMO