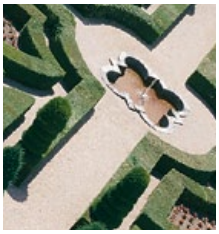
DECISION TIME: 2010 ESTATES

Finding Your Way Through the New Estate Wonderland



Stacy Singer
Manager, Estate Settlement Services Chicago

For much of last year, the administration of 2010 decedents' estates was akin to a journey with Alice to Wonderland. Little was known, uncertainty reigned and everyone involved was left uncomfortable by the unfamiliar landscape and the risk of incurring avoidable taxes. While the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "2010 Tax Relief Act"), signed into law by President Obama on December 17, 2010, provided a certainty that had been lacking, it created its own version of Wonderland for fiduciaries and advisors administering 2010 decedents' estates.

BACKGROUND

Prior to 2010, every decedent at death was entitled to an applicable exclusion amount (which varied by year) that could be passed estate tax free to any beneficiary. In addition, all assets included in the decedent's taxable estate generally received a step up in cost basis for income tax purposes to the value as of the date of death (or as of the alternate valuation date, if timely elected on a federal estate tax return).

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), however, suspended the estate tax for 2010. All assets, instead, were to pass to the beneficiaries with a carryover cost basis. The severity of this regime was tempered by two basis allocations available to the executor to increase the cost basis up to the fair market value at the date of death. The first was a $1.3 million general basis adjustment to any assets; the second, a $3 million spousal basis adjustment to assets passing in authorized ways to or for the benefit of the surviving spouse.

The 2010 Tax Relief Act made significant changes to this law as it pertains to 2010 decedents. The new Act provides estates of 2010 decedents with a $5 million applicable exclusion amount, an estate tax of 35% and a deduction for state estate taxes. These provisions, along with a $5 million GST exemption, a 0% GST tax rate and a step up in cost basis, all were made applicable as of January 1, 2010.

In order to avoid a potential constitutional challenge to the retroactivity of these estate tax provisions, the 2010 Tax Relief Act did provide an executor of a 2010 decedent with a choice. By default, the terms of the 2010 Tax Relief Act will apply – meaning, an estate tax with a $5 million applicable exclusion amount, a 35% rate, a state estate tax deduction and a step up in cost basis (the "New Law"). However, the executor may make an affirmative election instead to apply the EGTRRA provisions of no estate tax and a carryover cost basis, including the $1.3 million general and $3 million spousal adjustments (the "EGTRRA Election"). *Note: A 2010 decedent has a $5 million GST exemption regardless of whether the EGTRRA Election or the New Law applies.*[1]

For fiduciaries and advisors, the challenges of this election lie in considering all of the issues and documenting the choice, both in trust records and in communications with beneficiaries. Many estates of 2010 decedents have assets less than $5 million and generally can minimize taxes by allowing the New Law to apply, avoiding estate tax and obtaining a full step up in cost basis. However, there are exceptions, and those exceptions are at the center of this new estate Wonderland.

1 There is some debate among commentators as to whether the $5 million GST exemption applies under both the EGTRRA Election and the New Law. Most commentators, as well as the Joint Committee Report on the New Law, indicate that the $5 million GST exemption applies in either case.

CONSIDERATIONS IN CHOOSING BETWEEN THE NEW LAW AND EGTRRA ELECTION – ADJUSTED GROSS ESTATES UNDER $5 MILLION

For most estates with an AGETG[2] under $5 million, the choice is seemingly simple – allow the New Law to apply so that the estate assets are excluded from federal estate tax and receive a step up in cost basis. However, even in those situations that appear simple, there are still issues to consider:

- **Is the AGETG under $5 million due to a discounted valuation of closely held or otherwise difficult to value assets?** Fiduciaries and advisors should consider whether the value of an asset is based on an aggressive valuation that could invite scrutiny by the IRS, and consequently, whether it would be preferable to elect carryover cost basis to avoid a potential IRS audit. *Note: A federal estate tax return will have to be filed for the decedent if the decedent's gross estate exceeds $5 million.*
- **Is the AGETG under $5 million due to an aggressive approach towards deductions?** Here, fiduciaries and advisors should review whether it may be preferable to make the EGTRRA Election in order to avoid filing a federal estate tax return that reflects aggressive deductions, which again may invite an unwanted IRS audit. Depending on the amount of unrealized capital gain, it may be more appropriate simply to elect carryover cost basis to avoid the requirement of filing a federal estate tax return.
- **Does the governing instrument provide for different dispositions depending upon whether the New Law applies or the EGTRRA Election is made?** Some estate planning documents provide for a different asset distribution if the estate tax was not in effect as of the date of death. Because of the availability of the EGTRRA Election, a question exists whether an estate tax was in effect in 2010, and beneficiaries may have different opinions regarding the proper disposition. Some states have enacted legislation that provides default rules of construction that may or may not prove helpful when considering the terms of the 2010 Tax Relief Act. In any case, fiduciaries and advisors should complete and share with the various (potential) beneficiaries careful analyses of the consequences of the formula language and available state interpretation statutes before making a determination regarding whether to remain within the default provisions of the New Law.
- **Would the applicable state estate tax law impose additional tax under one of the two regimes?** Such a situation may occur due to the particular wording of the law or the governing instrument. In these cases, fiduciaries and advisors should carefully calculate the potential taxes under both regimes to determine if there is a tax advantage to one over the other.
- **Do the assets consist largely of retirement assets or other significant amounts of income in respect of a decedent (IRD) for which cost basis is not relevant, but which might later be subject to estate tax at the second death?** Fiduciaries and advisors will need to scrutinize the specific asset mix, beneficiary designations and the document's terms to determine if this situation applies. Because IRD assets cannot receive a basis allocation and are not subject to capital gains taxes, the avoidance of estate tax at a subsequent death takes on additional importance.

CONSIDERATIONS IN CHOOSING BETWEEN THE NEW LAW AND THE EGTRRA ELECTION – ADJUSTED GROSS ESTATE OVER $5 MILLION

Just as the approach for estates with an AGETG[2] under $5 million appears simple at first glance, it would seem that those estates with an AGETG in excess of $5 million should make the EGTRRA Election to avoid estate tax and have carryover cost basis apply. After all, the estate tax is assessed at 35%, while the capital gains tax rate (at least through 2012) is 15%. However, the ultimate decision regarding which law should apply is significantly more complicated. Whereas estate tax applies to estate values in excess of $5 million, carryover basis causes the state and federal capital gains taxes to apply to the unrealized appreciation on all assets. Here, too, however, the decision may be more complex than it appears, and several issues should be carefully considered:

- **What is the potential amount of estate tax owed if the estate tax regime of the New Law were applied?** After deductions, the amount may be small, and the certainty provided to fiduciaries and advisors by the New Law's step up in cost basis in some cases could make projected savings in future capital gains taxes more attractive than the estate tax savings estimated from an EGTRRA Election. In addition, the amount owed may be reduced by the deduction for state estate taxes, which generally will be owed under either approach but deductible only under the New Law.

2 Defined here to mean Adjusted Gross Estate plus Taxable Gifts (referred to here as the AGETG) value (i.e. the value after all deductions, discounts, etc.)

- **What is the total unrealized gain? Are the available basis allocation amounts sufficient to negate the effect of the unrealized capital gains?** Fiduciaries and their advisors need to consider who will bear the taxes, what rates will apply and when sales are likely to occur, especially in light of the historically low rates presently in effect. If the default rules of the New Law apply, the residuary beneficiaries typically will bear the burden of estate taxes whereas the income tax savings from a step up in cost basis will accrue to the recipients of those particular assets with unrealized appreciation. As a result, the impact of the regime choice may be felt by different beneficiaries depending on the election.
- **Do any of the assets reflect a significant discount that may be challenged by the IRS?** If so, fiduciaries and their advisors should review whether it would be more cost effective simply to make the EGTRRA Election and incur the future income tax liability from carryover cost basis than risk potential estate tax costs resulting from an adverse IRS audit.
- **Is there a surviving spouse?** If there is, and the beneficiaries of the surviving spouse's plan are the same as those of the decedent's plan, it will be important to calculate the net tax savings of an EGTRRA Election. By doing such pro-active calculations, fiduciaries can determine if future income tax liabilities from carryover cost basis will be less than the estate tax savings if the marital trust is never taxable (or never funded). For example, while no estate tax will be due at the first death if the marital deduction is utilized, fiduciaries need to be mindful that a significant estate tax may be due at the second death under the New Law. By contrast, if the EGTRRA Election causes assets to pass to a credit shelter trust and not to a marital trust, then the income tax cost of carryover cost basis may be small compared to the estate tax savings of assets not being taxable at the second death. Therefore, even if the unrealized gains are quite large, the savings resulting from the avoidance of the estate tax at the second death may offset the increased state and federal capital gains tax resulting from the EGTRRA Election.
- **What is the impact of the EGTRRA Election on the formulas used in the governing instrument, considering any state law impacting the interpretation?** Beneficiaries may have different interests, and the choice between the EGTRRA Election and the New Law can complicate many of a trustee's fundamental duties – the duty of loyalty, the duty of fairness and the duty of impartiality, among others. In some cases, the surviving spouse may prefer to stay in the estate tax system under the New Law (even if more estate tax will be owed at her death) because the surviving spouse may benefit more from the funding of a Marital Trust. However, the decedent's children may prefer the EGTRRA Election in order to opt out of the estate tax system so that only a Family Trust for their benefit will be funded. Additionally, if the remainder beneficiaries of the Marital Trust are different from the remainder beneficiaries of the Family Trust, the Marital Trust remainder beneficiaries may prefer the estate tax system under the New Law if that would result in the funding of the Marital Trust. Thus, fiduciaries and advisors will need to carefully analyze the instrument's formula language and communicate to beneficiaries its potential impact under each regime. In certain cases, a court proceeding may be required to reconcile conflicting interests.
- **What are the costs of preparing the two different types of tax returns?** If information on the decedent's cost basis is not available or will be difficult to obtain, it might be more cost-effective for fiduciaries to utilize the estate tax system under the New Law and have the assets receive a step up in basis. While this would require filing a Federal Estate Tax Return, which appears as of this writing to be more detailed and to require more information than the Form 8939 Carryover Basis Return, the final result may make the additional effort a worthwhile investment.
- **Does the governing instrument or applicable state law have a provision relating to compensating or equitable adjustments?** It is not uncommon for a trust document, for example, to provide "The Trustee may make tax elections as the Trustee deems advisable, without regard to the relative interests of the beneficiaries, and the Trustee shall not make any compensating adjustment for such elections." In contrast, section 506 of the Uniform Principal and Income Act grants a fiduciary discretion to adjust between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries arising from elections and decisions the fiduciary makes regarding tax matters. The ability to make such adjustments can provide significant flexibility in compensating a beneficiary who is worse off under one system, even though the total tax burden under that system is lower. If such an adjustment is permitted, fiduciaries will need to weigh whether it

should be made, as well as who would be required to agree to such an adjustment.

- **Should an outside counsel or tax advisor be brought in to quantify, evaluate or give an opinion on whether to make the EGTRRA Election and/or the impact on beneficial interests?** For fiduciaries lacking technical knowledge in the intricacies of the 2010 Tax Relief Act, it will be essential to obtain advice on how to proceed. Having written advice from outside counsel will be another important element in a responding to any future criticism (or litigation) regarding the election decision.
- **Is a court order or written settlement agreement needed? If so, should any written agreement be approved by the Court?** Such a court order may be helpful if the IRS questions the resolution agreed to by the beneficiaries.

DISCLAIMER PLANNING

The 2010 Tax Relief Act extended the time period under IRC Section 2518 to execute a qualified disclaimer until September 17, 2011 (for deaths occurring prior to December 17, 2010). This additional time, together with the provisions of the law, provides potential opportunities for post mortem planning, particularly in the GST context. Because the GST tax rate in 2010 was zero, it may be beneficial to create additional direct skips or to fund additional amounts into a trust with a zero GST tax rate. Bear in mind, however, that a disclaimer is not permitted once the beneficiary has accepted the benefits of the property, so fiduciaries will need to exercise caution prior to distributing income or principal to a beneficiary. In addition, any disclaimer should comply with state law; if a state disclaimer statute has a shorter time period for a beneficiary to disclaim, the beneficiary should comply with the shorter time period of the state disclaimer statute.

COMMUNICATION WITH BENEFICIARIES

Fiduciaries and their advisors should strive to be as transparent as possible in communications with beneficiaries. All individuals entitled to receive an accounting (as determined under local law) should receive notice of the election decision. Detailed letters also should be sent to beneficiaries both advising of the election decision and providing an overview of the consequences. In those situations where the election choice is less clear, or where the different elections result in different beneficial interests, fiduciaries should consider sending a letter including both present and future illustrations of the consequences of the election to all current income beneficiaries and presumptive remainder beneficiaries (even if such individuals would not be entitled to receive an accounting under local law). In addition, any illustrations provided should contain a caveat, indicating that the information provided is for illustrative purposes only, and does not represent a precise calculation of the consequences of any given election.

CONCLUSION

Making the election regarding which tax system should apply to the estate of a 2010 decedent implicates many of a fiduciary's fundamental duties. In some cases, the choices to be made are untenable – there is no one "right" answer, as either choice has both benefits and detriments, in some cases impacting only specific individuals. In the end, fiduciaries and advisors need to make the most reasoned decision possible after carefully evaluating all of the issues and providing the impacted parties with sufficient information regarding the choice. Where such a choice is simply impossible (and even when it is not), the fiduciary may be better off requesting court guidance or approval to provide additional protection against possible complaints from beneficiaries. After all, sometimes even the most experienced visitor needs a guide through Wonderland.

For more information regarding 2010 estates, contact your Northern Trust representative today.

Northern Trust