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What to consider when choosing the estate tax or opting out

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For estate and tax planners, 2010 was a year of limbo in which more questions were raised than resolved. In the end, practitioners were left with two estate tax regimes to choose from in settling the estates of 2010 decedents - either apply the $5 million estate tax exemption with a 35% estate tax rate on anything over that amount (default), or, opt out of the estate tax entirely. For the surviving spouses, a unique analysis involving several factors outlined below is required to determine the more favorable outcome.

The first and arguably most important factor in determining whether to opt out of the estate tax is to determine the basis in the assets of the estate. While it may seem attractive and simple to opt out of the estate tax all together, in so doing, Internal Revenue Code ("I.R.C.") Â§ 1022, governing modified carryover basis increases, is triggered. Prior to 2010, property acquired from a decedent received a full step up in basis to the fair market value on the date of death. However, under I.R.C. Â§ 1022, the basis increase is limited to $1.3 million for any property acquired from a decedent with an additional $3 million increase for qualified spousal property (property transferred outright to the surviving spouse without contingencies or property transferred to a QTIP trust). Therefore, a surviving spouse is permitted a total basis increase of $4.3 million on qualified property.

Generally, if the decedent spouse's estate is valued under $5 million, it's more desirable to use the default estate tax regime and receive the full step up in basis since no estate tax will be due. Also, given that the estate tax exclusion is now portable to a surviving spouse (for at least 2011 and 2012), any unused portion of the $5 million exemption can be used to increase that of the surviving spouse's.

To establish which option is better for estates over $5 million, a closer look at the assets and a quantitative analysis to determine the tax liability (both federal and state) under each scenario is required. To demonstrate, consider an example where the decedent opts out of the estate tax and elects to apply the modified carryover basis rules. If the value of the assets is $7 million with a $0 (zero) cost basis, I.R.C. Â§ 1022 will allow the surviving spouse to increase the basis to $4.3 million. The resulting tax due will be the capital gains tax rate (assume 20%) multiplied by the recognized gain on the property, $2.7 million ($7 - $4.3 million), which totals $540,000. However, the capital gains tax may not be due for several years if the surviving spouse does not sell the assets immediately which could result in additional appreciation and an increased tax liability. Assuming the same facts except that the decedent elects estate tax with a full step-up in basis, the amount of tax due is $700,000. This represents the 35% estate tax rate applied to the $2 million in excess of the exemption amount ($7 - $5 million).

In the example above, electing no estate tax and using the carryover basis rules is preferred as it results in the least amount of tax liability. However, for a surviving spouse that acquires highly appreciated assets from the decedent, the outcome can drastically change.

When basis in the property is extremely low compared to the fair market value, the estate may incur more federal, state and local income and capital gains tax than it saved by opting out of the estate tax, making the estate tax the more attractive option.

Another factor to consider is the nature in which the decedent held the assets and whether the modified carryover basis rules will apply to each specific asset. For instance, property is deemed owned by the decedent if it was transferred to a qualified revocable trust. However, that is not the case for property over which the decedent simply had a power of appointment. There are also slightly different applications of the modified carryover basis rules if the property was held by the decedent as a joint tenant or tenant-in-common. Also worth noting is that the basis increase rules will not apply if the property was received by the decedent as a gift or by an inter vivos transfer for less than adequate consideration within three years of the date of death. Therefore, it's important to carefully categorize each asset and determine how the basis will be allocated when calculating the more favorable election.

A surviving spouse that is considering disclaiming property received from the decedent spouse in favor of other beneficiaries must also consider the ramifications to the modified carryover basis increases. If the surviving spouse disclaims property that would have been allocated a portion of the $3 million step up in basis as qualified marital property, additional capital gains tax may be incurred if the $1.3 million basis increase (for non-spouses) is insufficient to minimize the capital gains tax due.

In making the decision, it's best for the surviving spouse to consider how all of these factors interplay with one another, and like with all estate planning, to stay focused on his goals and desires for the ultimate distribution of his and his pre-deceased spouse's assets. It's important for the surviving spouse to conduct this analysis with an eye towards not only the immediate tax liability but to also consider the future liability to his own estate or that may be passed on to other beneficiaries.

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