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Changes in Revenue Recognition Guidance

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Estate Taxes and Carryover Basis

A World Turned Upside Down

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The long scheduled, but little expected, one-year repeal of the federal estate tax took effect on January 1, sparing the beneficiaries of those who died in 2010 the burden of paying federal estate taxes. However, the repeal leaves many carefully constructed estate plans with some unexpected and potentially painful consequences.

To help clients avoid messy post-death tax tangles, CPAs need to understand both the opportunities and the pitfalls created by the repeal. Many may advise clients to amend their planning. Recognizing that some clients may die without making the necessary changes, CPAs should also be thinking about ways to salvage their clients' planning, if necessary, within the context of the changing tax landscape. That means paying attention to some complex and potentially difficult new laws.

New Federal Capital Gains Rules

In doing away with the estate tax, Uncle Sam also eliminated the so-called "step-up" in basis, which established date-of-death (or six-month alternate) valuations for all inherited property. As such, heirs may now be responsible for capital gains taxes on inherited appreciated property when they sell. Coming up with that basis could mean sifting through decades of paperwork to figure out how much a stock or piece of property appreciated since originally purchased.

Even when basis is known, these capital gains tax bills can be significant. Consider, for example, the impact of inheriting a Back Bay brownstone valued at $12 million today but purchased for a fraction of that amount 40 years ago. Under 2009 rules, the heirs would have inherited the house at the date-of-death (or alternate) value. Today, the sale of that same house would trigger millions in capital gains.

To reduce the burden on less affluent taxpayers, Congress has provided stopgap rules that limit post-death tax on gains by allowing the executor to allocate an increase in basis (up to fair market value) of $1.3 million to the properties being acquired from the decedent. An additional $3 million allocation is provided for assets left to a spouse.

These allocation rules, however, could create significant inequities. If the executor of an estate is a second wife, for example, she could choose to allocate all those exemptions to property that she inherits, shifting the capital gains tax burden onto the children. With some families, it might be wise to provide explicit direction as to how a basis increase is to be allocated.

State Taxes

The capital gains problem is thornier in Massachusetts, where the law now effectively provides for a purely carryover basis. That means all gains, whether accrued while the decedent held the property or after his death, are subject to the state's 5.3 percent capital gains tax. Moreover, the enlarged state capital gains tax will not be affected by any return of the federal basis step-up rules when the federal estate tax repeal "sunsets" in 2011.

The reasons for Massachusetts's harsh tax treatment of inherited property lie in a technical but inescapable reading of the tax statutes. Massachusetts has its own tax basis rules set forth in General Laws chapter 62, §6F, which generally applies the basis step-up rules of Code §1014(b) to property acquired from a decedent. The reference to §1014(b), however, must be read in conjunction with the

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definition for "Code" for purposes of chapter 62, as set forth in §1(c). That definition refers to the Internal Revenue Code, as amended on January 1, 2005 and in effect for the taxable year. "Code" therefore would include IRC §1014(f), enacted in 2001 under EGTRRA, which provides that §1014 shall not apply to decedents dying after December 31, 2009. Since the sunset provisions of EGTRRA are not part of the Code and not incorporated into the Massachusetts statute, §1014 will not automatically be reinstated into the Massachusetts statute when EGTRRA sunsets.

In the absence of any general basis step-up, an heir's initial Massachusetts basis would be determined under §6F(b)(2)(B), essentially providing for a carryover basis. That basis thereafter would be adjusted under §6F(c), generally by applying the same adjustments that are made to the federal basis. However, §6F(c) expressly disregards any federal adjustment that was not applicable in determining Massachusetts gross income. Since the allocation of additional basis under IRC §1022 is not an item in determining Massachusetts gross income, it does not seem to be a basis adjustment for Massachusetts tax purposes. The same analysis would apply to a basis step-up under IRC §1014, if and when it again applies for federal purposes.

Funding Formulas

For years, planning lawyers have written pourover trusts that split upon the death of a first-to-die spouse into two shares — a marital trust and a credit-shelter trust. The split is designed to pass to the credit-shelter trust the maximum amount that can be transferred free of estate tax. However, if the formula used refers to federal estate tax terms and concepts that no longer apply, the formula may trigger significant interpretational issues.

The new carryover basis rules also require rethinking of the relative benefits of "pecuniary" versus "fractional" funding formulas. A so-called pecuniary formula effectively fixes either the marital or credit-shelter share as a specific dollar amount. Though a pecuniary formula can offer advantages, it also forces recognition of gains upon funding. Since a pecuniary-formula division could wreak havoc when coupled with a carryover basis regime, new IRC §1040, caps the resulting gains, for estates, at the amount of post-death appreciation, mimicking the result under the old basis step-up regime. Trusts might obtain this same benefit through an election to treat the trust as part of the estate, pending regulations extending the §1040 rules to trusts. There seems to be no reason that §1040 should not apply to the same extent to cap Massachusetts gains. Section 1040 thus should obviate what otherwise would be a need for wholesale conversion of pecuniary funding formulas into fractional formulas. But the pre-death gains remain attached to the property, waiting to be sprung in a subsequent taxable event.

Planning Opportunities

The gift tax is now 35 percent, down from 45 percent in 2009, for gifts in excess of $1 million. The generation-skipping tax has disappeared entirely. That means 2010 may be a particularly advantageous year for wealthy people to make substantial gifts, particularly if grandchildren are the recipients.

However, there are risks. Congress might decide to reinstate the estate and GST tax retroactive to January 1. When EGTRRA sunsets at the end of this year, assets still held in a multigenerational trust may again become subject to the GST tax, possibly without having benefitted from any effective allocation of GST exemption or generational step-up.

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