

Can you inherit a



Editor's note: Kent

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this year?

Federal estate tax laws have been changing in recent years, and 2010 is no exception. In fact, 2010 is unique in that the estate tax exclusion — the highest amount you can transfer without taxation — is unlimited. That's right, this year, there's no tax for those who inherit an estate.

Passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created this opportunity. Actually, estate tax exemptions have been in transition since 1998 (see accompanying table). On the first day of this year, however, we arrived at the point where the estate tax (and the generation-skipping transfer tax or GSTT) does not exist for deaths in 2010.

Note the federal gift tax remains in place at a 35 percent

rate with a maximum exclusion of \$1 million. The gift tax is not slated to change. The exemption level increased to \$1 million in 2002 and will remain at that level indefinitely. This exclusion is not indexed for inflation.

Recent History of the Estate Tax Exclusion

1987-1997	\$600,000	2004-2005	\$1,500,000
1998	\$625,000	2006-2008	\$2,000,000
1999	\$650,000	2009	\$3,500,000
2000-2001	\$675,000	2010	No Tax
2002-2003	\$1,000,000		

Since the federal estate tax has been repealed and no new legislation replaces it, the stepped-up basis for inherited

property will be replaced by a new carry-over basis rule. Estate executors will be able to increase the carry-over basis of a decedent's assets by \$1.3 million with an additional \$3 million increase for qualifying property passing to a surviving spouse (or to a qualifying trust for a surviving spouse), for a possible total of 4.3 million.

However, estates that have previously elected special-use valuation, the qualified family-owned business deduction or elected to pay estate tax installments for pre-2010 deaths still possibly will be subject to recapture rules. As a result, there's still estate tax for these situations.

Basis overview

Stepped-up basis: The stepped-up basis rules apply to the basis of property a taxpayer receives from the person who bequeaths property under IRS Code Section 1014(a). Under this code section, the beneficiary's basis equals the fair market value of the property at the time the decedent dies. If the property cost \$50,000 originally, but was worth \$200,000 at the time of death, the value would be \$200,000.

Carry-over basis: The new carry-over basis rule says the property's basis will be the lesser of the decedent adjusted basis or the property's fair market value. This means the inherited property basis may be substantially lower.

value basis if the inherited assets are sold after 2010."³

The complete article is posted at www.calt.iastate.edu.

A comparative example

Let's look at a hypothetical example: If Joe owns real estate purchased for \$50,000, the basis in his real estate is \$50,000. On the day Joe dies, the fair market value of the real estate is \$200,000. If Joe bequeathed the real estate to a Sam using stepped basis rules, Sam's basis in the real estate is the fair market value of \$200,000.

In contrast, if Joe had given the real estate to Sam before his death or if the real estate is not eligible for the exemptions, Sam receives a carry-over basis. In this case, it's the \$50,000.

Using the stepped-up basis rules, suppose after Joe's death Sam sells the real estate for \$200,000. There's no gain to claim. But using the carry-over basis rules, if Sam sells the real estate in 2010 for the same \$200,000, he would see a gain of \$150,000 on the sale. (There's uncertainty about this if Sam sells the property in 2011 or later.)

State law. States are changing estate tax laws in response to the changes in federal law. For now, many states are not following the increases in the level of federal estate tax exemptions and are taxing estates that have a value well under the federal exemption levels.

Rules in 2010 mean there's temporarily no exclusion limit on estate taxes.

The two exemptions are:


1. The executor can allocate up to \$3 million to increase the basis of assets that pass to the surviving spouse (or to a qualifying trust for the surviving spouse)
2. The executor can allocate an additional \$1.3 million (increased by unused losses and loss carry-overs) of aggregate basis to other assets (on an asset-by-asset basis).¹

Some uncertainty exists: As of this writing, parties have been discussing uncertainties regarding the new carry-over basis rules. One interpretation is that any estate assets basis not included in the exemption is the carry-over basis for assets sold in 2010 and later.

However, the article "The Death (for the moment) of the Federal Estate Tax" by Roger McEowen, director of the Center for Agricultural Law and Taxation, states: "The (2001 EGTRRA provision) specifies that its provisions 'shall not apply to taxable ... years beginning after Dec. 31, 2010.'² Thus, based on a strict reading of the statute, the modified carry-over basis rule is only applicable to assets inherited in 2010 that are also sold in 2010. For assets inherited in 2010 that are sold after 2010, the income tax basis is the fair market value of the assets at the time of the decedents' death. So, for deaths in 2010, there is no estate tax, and the heirs will retain a fair market

Recordkeeping. Executors of estates utilizing the carry-over basis value will need to know the decedent's basis in all assets so they can allocate that basis to the assets. Thus, it's vital to keep good records. There's no fresh start in basis under the new rules to wipe away poor recordkeeping.

Sunset. The sunset might not be a pretty one under these estate tax laws. Uncertainty about the repeal of estate taxes makes planning challenging. While we know about the changes that have occurred to date, assuming Congress makes no additional changes to federal estate tax law, it "sunset" (ends) in 2011 and brings back the gift and estate tax rates and exemptions that were effective in 2001.

Because of this uncertainty, it's important to review your estate plans with a knowledgeable adviser frequently. 

¹ The Death (for the moment) of the Federal Estate Tax, written by Roger McEowen, director of the Center for Agricultural Law and Taxation

² H.R. 1836, Pub.L. No. 107-16, Sec. 901 (a).

³ Ibid.

