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CERTIFIED SPECIALIST | ESTATE PLANNING TRUST AND PROBATE LAW | TAXATION LAW | CALIFORNIA STATE BAR | BOARD OF LEGAL SPECIALIZATION |

September 8, 2011

Dear Clients and Friends:

Executors and trustees representing estates of decedents who died in 2010 have an important election to make within the next month. Legislation enacted in December 2010 reinstated the default estate tax regime with a $5.0 million exemption and a 35% estate tax rate on assets above that exemption. Nevertheless, the executor or trustee of an estate may elect out of the default estate tax regime and avoid any estate tax that would otherwise have been due for the estate of a decedent who died in 2010. The default estate tax regime is generally advantageous for estates with a value less than that exemption, and estates with a zero tax liability because of available deductions. Executors of estates with a zero tax liability because of the marital deduction nonetheless may elect out of the estate tax regime to minimize estate tax on the surviving spouse's death. Each estate situation is unique and should be analyzed to determine whether reducing or eliminating a potential estate tax may outweigh an increase in income tax liabilities. Estate tax returns for 2010 decedents are generally due September 19, 2011 unless an extension of time to file is obtained.

The election has the consequence of subjecting the estate property to a modified carry over income tax basis under Internal Revenue Code section 1022. Section 1022 provides that a decedent's income tax basis carries over to the recipients of assets acquired from the decedent, subject to certain adjustments. Assets that have depreciated as of the date of death receive a new income tax basis equal value as of that date. Date of death values control under section 1022 because there is no alternate valuation date election available, unlike the estate tax regime.

On August 5, 2011, the Internal Revenue Service issued guidance regarding Form 8939, which the executor or trustee of the decedent's revocable trust must file to make the election. The filing of Form 8939 is sufficient to elect out of the estate tax regime. Once made, the election is irrevocable.

The recent guidance provides that Form 8939 is due **November 15, 2011**. If the executor fails to file Form 8939 timely, the estate may be deemed to have waived the election and the default estate tax will apply. The government is unlikely to grant any extension of the time to file the Form 8939, except in extraordinary circumstances.

Section 1022 allows a limited increase in the basis of appreciated assets. Appreciated assets include real property, stock in a closely held business, securities and other assets that result in the realization of capital gain when sold. The executor may not increase the basis in any asset that constitutes a right to receive

ordinary income, such as retirement plan accounts and installment notes. The executor cannot increase the basis in property received as a gift within three years of the decedent's death, unless received from the decedent's spouse. An interest in a DISC and certain foreign investments are ineligible for the basis increase. The executor cannot increase the basis of an asset more than its fair market value at the decedent's date of death.

The basis increase is available only for assets both owned by and acquired from the decedent. A decedent owned an asset if the decedent held title individually or through a revocable trust, in joint tenancy or as community property. For purposes of section 1022, property is acquired from a decedent if the property (1) was bequeathed, devised, or inherited from the decedent, (2) passed from a trust that the decedent had a power to revoke or amend; or (3) passed without consideration from the decedent as of the date of death.

The section 1022 basis adjustment for assets acquired from and owned by a decedent is $1,300,000, increased by the following:

1. The decedent's unused capital loss carry-forward;
2. The decedent's unused net operating loss carry-forward;
3. Any unused passive activity losses; and
4. Any loss that would have been allowable if the decedent's assets had been sold at fair market value immediately prior to death.

The unused capital loss carry-forward and net operating loss carry-forward, if any, would be reflected on the decedent's final 2010 income tax returns. Notwithstanding the $3,000 limitation on the deduction of capital losses against ordinary income, the increase for built-in capital loss to the $1,300,000 basis adjustment would be unlimited.

Unused passive activity losses would not be deductible for income tax purposes, but would increase the income tax basis of the activity in which they were incurred. The increase for allowable losses applies to assets held in a trade or business, assets held for profit and capital investment, but not to losses on personal assets. For community property assets, only the decedent's share of the unused capital loss carry-forward and unused net operating loss carry-forward would increase the $1,300,000 basis adjustment.

Section 1022 also provides a special spousal basis adjustment of $3,000,000 for assets passing outright to a surviving spouse, or in specific trusts for the surviving spouse. To be eligible for the special spousal basis adjustment, the trust must provide that the surviving spouse receive all the net income at least annually, and that no trust property may be distributed to any person other than the surviving spouse during his or her lifetime.

Section 1022 provides that both decedent's share and the survivor's share of community property qualify for the basis adjustment. The recent guidance confirms that the $3,000,000 special spousal basis adjustment may be used to increase the income tax basis of both the deceased and surviving spouse in community property assets. Similarly, the basis in both the decedent's and the survivor's shares in any depreciated community property assets would be reduced to their date of death value.

The recent guidance on the section 1022 basis adjustment is a safe harbor, and the government is unlikely to issue any further regulations or guidance. An executor may take a contrary position to the safe harbor, but that approach would require a statement to the estate tax return explaining the contrary position and risk a possible audit.

The November 15, 2011 deadline is rapidly approaching. Please feel free to call on us if you have any further questions regarding the election out of the estate tax regime or the recent Internal Revenue Service guidance.

Very truly yours,

HARTOG & ASSOCIATES, INC.