

Searching for Basis in Estate Planning

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Focus Has Been Estate Tax: 2004: 48% with \$1.5 Million Exemption vs. 15% Capital Gains Tax Rate (and Can Usually Be Postponed)

Hence, Avoiding Wealth Transfer Taxes Was the Primary Focus

Now Only .03% Will Face Wealth Transfer Taxes

- **Huge Exemptions (\$5 million plus)**
- **Lowest Estate Tax Rate in Decades (40% Federal) vs. Higher Income Tax Rates (23.8% to 55%)**
- **Refined and Tried and True Estate Tax Reduction Strategies (LPs, ISGT, QPRTs)**
- **Perception that “We’ve Already Done Enough for the Kids.”**

So Attention Needs to be Focused More on Basis (and Income Tax Avoidance Matters)

Transfer Tax Issues:

- **Current Value vs. Future Value and Future Income (Tax Exclusive and Rev. Rul. 93-12)**
- **Certainty of No Estate Tax Inclusion**
- **Availability of Exclusion or Exemption**
- **State Gift Tax or Estate Tax (Possible Change of Law or Domicile or “Location” of the Property)**
- **Change in Tax Status of Property (e.g., Loss of S Status) or “Business” Status**
- **Basis (and Negative Basis and Other Income Triggering Assets Such as Installment Sale Note)**
- **Need for Durable Gift Giving Power of Attorney**

Gift of Depreciated Property (Basis Greater than Current Value)

- **Carryover Basis (Section 1015) Plus Addition of Gift Tax on Gain (Grantor Trust?)**
- **Gain Measured from Carryover Basis; Loss Measure from FMV; Sale “In Between” Means No Gain/Loss**
- **Consider If Donor Should Take Loss (Grantor Trust Alternative)**
- **Consider Immediate Pre-Death Gifts to Preserve Inherent Losses (But Consider Impact on Estate Tax and Credits)**

- **Generally, No Gain Is Experienced (But Negative Basis Property and *Dietrich*)**
- **Basis Is Carried Over with an Adjustment (Increase) for the Federal Gift Tax Imposed on the Appreciation Inherent in the Gifted Asset**
- **Nature of the Gain and Income Generated May Change in the Hands of the Donee (as May State and Local Taxation)**
- **In Some Cases, the Gain Will Be Taxed Back to the Donor (e.g., CRT—Ferguson)**
- **No Discount is Permitted for the Inherent Gain (and, Therefore, Income Tax Liability) in the Gifted Property—Hence, It May Be Better for the Donor to Experience the Gain Before the Gift**
- **Forfeiture of the Step-Up in Basis at Death (Unless Estate Tax Inclusion Occurs)**

- **Outright vs. In Trust vs. UGTA**
- **“Always” in Trust: Asset Protection; Income Tax Flexibility; Avoid Foolish Dissipation of Wealth; Reduce Sense of Entitlement; Generation Jumping**
- **Better Yet: Grantor Trust**
 - **Income Tax Free Compounding (Rev. Rul. 2004-64)**
 - **Sales and Exchanges Between Trust and Grantor Are Income Tax Free (Rev. Rul. 85-13)—Market Timing. Arranging Pre-Death Purchase (Line of Credit). *Wandry?***
 - **Substitute Grantor’s (or Spouse’s) Highest Basis Assets for Trust’s Lower Basis Ones**
 - **Turning Grantor Trust Status Off or On: Why and How**
 - **Step Up at Death (Section 1014) When Grantor Trust Status Ends**

Make No Pre-Death Transfers

**Section 2038 Formula (CSM): How It Works; Additional Upside?;
Downsides**

Grant Trust Beneficiary a GPA: How It Works; Downsides

Authorize Trustee to Grant Beneficiary a GPA: How It Works: Downsides

**Trigger the Delaware Tax Trap (Making a Special Power a General One):
Section 2041(a)(3); How It Works; Where It Won't Work; Disclaimer?;
Downsides (Loss of GST Exemption)**

**Commonality Among the Section 2038 Formula, the GPA, and Delaware Tax
Trap: Start in Trust**

Gifts of Low Basis Assets from Others to Low Estate Tax “Nearly Deceased”

“Normal” Considerations—e.g., Negative Basis Property (Avoid with Grantor Trust?)

Section 1014(e):

“If appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.”

What About It Passes to a Trust for the Donee? Discretionary?

Cross “re-inheritances”?

- **What is Community Property?**
- **It is a Form of Property Ownership Between Spouses**
- **Usually, Each Spouse Owns an Undivided Half of Each Community Property Asset**
- **Typically, Only Assets Acquired During Marriage (Excluding Gifts and Inheritances)**
- **The Traditional Community Property States are Louisiana, Texas, New Mexico, Arizona, California, Nevada, Washington (State) and Idaho**
- **Wisconsin Adopted it By Statute**
- **Each Is An Opt Out State**
- **Some Jurisdictions Are Opt In Regimes**
- **Alaska is an Opt In System. Now, So Is Tennessee**
- **Each Spouse Owns One Half of Each Community Property Asset**
- **Community Property Nature is Lost If Spouse Moves To A Non-Community Property Jurisdiction. Cf. UDCPAD Act, Which Does Not Preserve It As CP**

1. Each Spouse Reports One Half of the Income From CP

2. Each Spouse's Estate Includes One Half of the CP

3. Each Spouse is "Deemed" to Make a Gift of Gratuitous Transfers of CP

4. Basis of Both Halves of CP at Death of First Spouse is "Stepped" Up Under Section 1014(b)(6)

Non-Tax Effects: Real Ownership; Creditor Claims; Limit How Much

- **Trust is typically drafted as a joint trust with Husband and Wife as Grantors and Trustees**
- **One or both of Husband and Wife contribute property to the Trust**
- **One or both of Husband and Wife can serve as Co-Trustees**
- **Both Husband and Wife must sign the Trust**
- **Mandatory Warning!**
- **Trust is irrevocable unless agreement provides for revocation or by executing a later community property agreement. Later community property trust can be used to transmute community property to separate property**
- **Essentially, disposition at death can be just like any joint revocable trust —e.g., provide for a credit shelter trust and marital deduction trust disposition with the other half remaining in a survivor's revocable trust**

- **Couple Forms Joint Trust Over Which the First Spouse to Die, Upon Death, Has a General Power of Appointment**
- **Goal No. 1: Cause All Assets in the Trust to be Included in Gross Estate of the First Spouse to Die, So There Is the Most Property Available to Fund a Credit Shelter Trust and Apply GST Exemption of that Spouse**
- **Goal No. 2: Have the Basis of All the Trust Assets Be Stepped Up When the First Spouse Dies**
- **PLR's Indicate that Goal No. 1 Might be Achievable (But Maybe Not)**
- **PLRs Indicate that Section 1014(e) Limits the Step Up to One Half of the Assets**
- **Is There a Downside in Trying?**

- **Each Spouse Creates a Lifetime QTIP Trust for the Other Spouse If Such Other Is a US Citizen**
- **Each Trust Is a Grantor Trust With Respect to the Grantor Spouse, Not the Beneficiary Spouse**
- **When First Spouse Dies, the QTIP Trust for that Spouse Is Included in the Gross Estate of that Spouse and Is Used to Fund a Credit Shelter Trust for the Surviving Spouse Who Was the Trust's Grantor**
- **This Credit Shelter Trust Remains a Grantor Trust With Respect To the Surviving Spouse Who Was the Trust's Grantor**
- **Hence, the Trust Can Grow Income Tax Free Because the Burden of the Income Tax on the Earnings in the Credit Shelter Trust Are Taxed Directly to the Surviving Spouse (Rev. Rul. 2004-64)**
- **Because the Credit Shelter Trust is a Grantor Trust, the Survivor Can Substitute His or Her Higher Basis Assets for Lower Basis Assets Held by the Credit Shelter Trust**
- **Reciprocal Trust; Section 2036/2038/2041 Issues**

- **To Elect Alternate Valuation Date Values (Section 2032) Both the Gross Estate and the Estate (and GST Taxes Due on Direct Skips) Must Decline by Reason of the election**
- **Compare Immediate Reduction of Estate Tax to Reduction in Basis**
- **Best Case: Estate Consists in Significant Part of Right to IRD (e.g., IRAs) Which Declines Sufficiently to Allow the Section 2032 Election But the Assets Entitled to a Step-Up in Basis Do Not Decline or Increase in Value by the Alternate Valuation Date**
- **“The Estate Collar”, Gordon & Hoopingarner, Trusts & Estate (Dec. 2008): Alternate Valuation Option with Hedges**

- **Married Person's Unused Losses, Excess Deductions, Etc.—Final Joint Return**
- **Consider Section 754 Election (Reg. 1.742-1)**
- **Sale of S Corp's Assets Plus Liquidation in Same Year**
- **Consistent Planning Will Produce the Best Result**
- **Focus More on Basis Than Ever Before**
- **“Estate Planning So Good, You'll Wish You Could Die”sm**