

Step Up To The Plate: Income Tax Basis Planning on a (relatively) New Playing Field

presented by
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General Basis Rules

- Acquisition
 - "Cost Basis" (IRC Sec. 1012)
- Lifetime Gift
 - "Carryover Basis" (IRC Sec. 1015)
- Testamentary Transfer
 - "Stepped Up (or Down) Basis" (IRC Sec. 1014)



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Brief History of Tax Basis

- Income Tax Act of 1913 (right after the 16th Amendment) did not define basis
- Revenue Tax Act of 1916 – basis of pre 1913 assets = FMV of assets on sale date
- Reg's under 1916 act (and later codified in 1918 act) specified that assets acquired after 1913 obtained a cost basis
- Gift basis rules first addressed in 1921 and finalized in 1934
- Step up rules first introduced in 1921, but later clarified and modified
- Basis adjustments for improvements and depreciation first appeared in 1924




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Lingering Tax Basis Rules

- Gifts in Trust before 1921 – basis = FMV at the time of contribution
- Carter's Carryover Basis – 1976 statute... generally repealed retroactively (rule could still apply if death in 1977 or 1978)
- Annuities – deferred annuity contracts purchased before 1979 may get a step up
- Basis and Gift Taxes – increase in basis for gift taxes paid on a gifted asset more generous for pre-1977 gifts
- Residential Rollovers – Pre 8/5/77 rollover gain must be reflected in basis
- 2010 Carryover Basis – 2010 decedents – could choose estate tax or carryover basis (estates with substantial estate tax may have elected carryover basis)




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Historical Approach to Basis in Estate Planning (older estate and income tax laws)

- Estate and Gift tax exemptions
 - From \$600,000 to \$3.5 million (gift tax exemption capped at \$1 million)
- Estate tax rates
 - Up to 55%
- Lower top capital gains tax rate
- Itemized tax deductions more freely available
- No 3.8% Affordable Care act surtax
- State and local income taxes not as much of a focus
- No spousal portability




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Changing Approach to Basis in Estate Planning (newer estate and income tax laws)

- Estate and Gift tax exemptions
 - Increased to \$11.4 million
- Estate tax rates
 - Flat 40%
- Higher top capital gains tax rate of 20%
- Itemized tax deductions phased out for higher income taxpayers
- 3.8% Affordable Care act surtax
- State and local income taxes more of a focus
- Spousal portability available




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Primary Motivations in Earlier Planning

- Maximize Use of Estate and Gift Tax Exemptions
- Maximize Marital Deduction Planning
- Aggressive Lower Valuations
- Use of Lifetime Planning/Charitable Giving/Second to Die Life Insurance




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Changing Motivation in Estate Planning

- Tax Law Changes Change Motivation
 - Estate Taxes Are No Longer Relevant in Decision Making for Most People
 - Income Taxes Can Be Substantially More Costly (particularly for estates and trusts)




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Required Change in Mindset

- Valuation – desire for high instead of low
- Undoing Prior Work
- Terminally Ill Clients
- Emphasis on Flexibility/Uncertainty
- Basis Planning is Relevant/Important to Modest Estates
- Granular/Asset-by-asset Approach
- Fiduciary Income Tax – push income to beneficiaries when available and appropriate
- Reduced IRS Estate and Gift Staff
- Complexity/Number of Variables in Determining Basis



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Tax Benefit v. Tax Detriment of Lifetime Giving (To Gift or Not to Gift)

- Tax Benefit Formula:
 - $[FMV(d) \text{ less } FMV(t)] \times T(e)$ = tax benefit of gifting
 - FMV(d) = projected fair market value at death
 - FMV(t) = fair market value at time of gift
 - T(e) = expected federal and state estate tax rate of the asset's owner



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Tax Detriment Formula

- $[FMV(d) \text{ less } (B)] \times T(i)$ = tax detriment of gifting
 - FMV(d) = projected fair market value at death
 - (B) = asset's current tax basis
 - T(i) = expected federal and state income tax rate of the beneficiaries
 - Factor in sale timing and time value of money?



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Tax Benefit v. Tax Detriment of Funding Credit Shelter Trust

- Tax Benefit Formula:
 - $[FMV(d2) \text{ less } FMV(d1)] \times T(e)$ = tax benefit of credit shelter
 - FMV(d2) = projected fair market value at surviving spouse's death
 - FMV(d1) = projected fair market value at first spouse's death
 - T(e) = expected federal and state estate tax rate of the surviving spouse




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Tax Detriment Formula

- $[FMV(d2) \text{ less } FMV(d1)] \times T(i) = \text{tax detriment of credit shelter}$
 - FMV(d2) = projected fair market value at surviving spouse's death
 - FMV(d1) = projected fair market value at first spouse's death
 - T(i) = expected federal and state estate tax rate of the heirs
 - Factor in sale timing and time value of money?




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Variations with Lifetime Transfers (carryover basis exceptions/modifications)

- Basis of gifted property is lower of carryover basis or FMV of asset
- Gifted "Loss Property"
 - If basis is greater than FMV, then basis for determining loss is the lower FMV (if later sold between basis and FMV, then neither gain nor loss is realized)
- Spousal and Divorce Transfers
 - "Lower of" rule doesn't apply




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Variations with Lifetime Transfers (cont.)

- Liability in Excess of Basis
 - General rule is current taxable income to transferor to the extent of the difference between the basis and applicable debt
- Basis Adjustment for Taxable Gifts
 - Increase in basis for gift tax paid
- Sale to A Related Party
 - Recognized loss on sales to a related party are denied (IRC Sec. 267)
- Installment Sales to Family Members
- Unknown Gift Bases




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Variations with Testamentary Transfers (step-up exceptions/modifications)

- **IRD**
 - No step up for IRD items
- **Partnerships/LLCs**
 - Tax basis of 751 "hot asset" held in a partnership is not changed
- **S Corp IRD**
 - If S stock is inherited, then the IRD rules apply; S corp stock basis must be reduced by the IRD items attributable to the decedent
- **Employer Stock**
 - Employer stock distributed from a qualified plan doesn't get a step up
- **Alternative Valuation**
 - Basis is FMV at the earlier of the date of distribution or 6-month alternative valuation date




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Variations with Testamentary Transfers (cont.)

- **Special Use Valuation**
 - Basis is the special use value
- **Conservation Easements**
 - Tax basis is the decedent's basis
- **Jointly Owned Assets**
 - Rules depend on when death occurred and identity of beneficiary
- **Gifted Appreciated Property (One Year Rule)**
 - No step up if receive gifted property back from decedent within 1 year of gift
- **DISC Stock**
 - Basis adjusted for unrealized dividends in the entity
- **Uniform Basis Rules**
 - Basis of inherited asset is the same whether in the hands of the executor, trustee, beneficiary, heir, etc.




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State Basis Issues

- **State Estate and Gift Issues**
 - Dozen or so states impose an estate tax (complicates the decision making)
- **Differing Tax Bases**
 - Income tax basis rules can differ between federal and state laws



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Assets/Situations to Consider Basis Planning

- Attractive for Basis Adjustments at Death
 - Highly Appreciating Property
 - Very Low Basis Property
- Less attractive for Basis Adjustments at Death
 - High Basis Property
 - Loss Property
 - Assets not entitled to a basis step-up, like IRA's and qualified plans



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Highest to Least Benefit from Step Up

- Creator Owned IP
- Negative Basis Commercial Real Property
- Community Property
- Investor/Collector Owned Art, Gold and Other Collectibles
- Low Basis Stock or Other Low-Basis Capital Assets/Highly appreciating
- Roth IRA Assets
- High Basis Stock
- Fixed Income Assets
- Cash
- Stock and Other Capital Assets with Unrealized Loss
- Variable Annuities
- Traditional IRA and Qualified Plan Assets



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Strategies for Obtaining Basis Step Up

- Hold Asset Until Death
- "Re-gifting"
- Argue that IRS Arguments for Inclusion Apply
- Distribute Assets to Beneficiary




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Strategies for Obtaining Basis Step Up (cont.)

- Use of General Powers of Appointment
 - Types of Powers of Appointment
 - Original Drafting
 - Revising Old Plans
 - Full GPOA v. Formula GPOA
 - Giving Someone the Power to Grant a GPOA
 - Delaware Tax Trap




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Strategies for Obtaining Basis Step Up (cont.)

- Irrevocable Trusts
 - Decanting (to include GPOA)
 - Use of Distribution Power in Further Trust (to include GPOA)
 - Use of Distribution Power Outright
- Sale to IDGT
- Swapping Assets with an IDGT for Increased Basis




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Strategies for Obtaining Basis Step Up (cont.)

- Portability
- Discount Planning
- Partnership and LLC Basis Issues




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Estate Planning Documents and Advice

- Powers of Attorney
 - Broad estate planning related powers, including gifting, disclaimers, participation in modification of irrevocable trusts, etc.
- Disposition Documents
 - Flexibility and revisit periodically
- Client and Fiduciary Considerations
 - Document basis/value information and determination




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Compliance, Record Keeping and Audits

- Keeping basis records forever
- Gift tax basis disclosure
- Transfers to spouses or ex-spouses – basis disclosure
- Estate Tax Basis Reporting
- Brokerage statements
- Statute of limitations
- Taxpayer penalties
- Appraisals




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Caveats

- 1014(e) – One Year Rule
- Future Changes in Estate Tax Law
- Defeating Intended Plan of Disposition
 - Waste or Squandering
 - Changing the Will or Beneficiary Designations
 - Use of Broad Powers in Power of Attorney
 - Second Marriage
 - Creditors
 - Other unintended consequences



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CPA's Role in Basis Planning and Updating (Issue and Opportunity Spotting)

- Old estate planning documents (particularly containing tax planning language)
- Credit shelter trust funded years ago (particularly where a spouse died before normal life expectancy)
- GST or Irrevocable Trusts (particularly where funded years ago)
- Terminally ill spouse
- Old FLPs/LLCs where some or all ownership interests were gifted to younger generations
- Encourage clients to review and update planning regularly



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