How to Avoid Basis Mismanagement and Advisor Malpractice

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Many of us in the legal, financial and accounting worlds discover our new clients' well-intentioned yet disastrous plans after the fact. The widow has already transferred her house into her children's names or an inherited IRA is drained to pay for a Porsche. Observing the lost planning opportunities and the resulting financial fallout is universally gut wrenching.

To help get the message out and to illustrate the information you provide to clients, we encourage you to use the facts and scenarios below in your own educational materials, presentations and conversations. Consider this a "red flag" list of income tax pitfalls and opportunities so you can be your clients' (and their beneficiaries') basis management hero.

Quick Review:

Many of your clients probably don't understand how basis is determined: the step-up in basis at death for both separate and community property assets, and the consequences and opportunities associated with low basis assets. They certainly don't understand how to transmute separate property into community property to get a full step-up of basis at the death of the first spouse.

Fortunately, there are numerous opportunities to avoid the huge and instant tax bill associated with selling low basis assets outright and for making the most of tax basis rules. Charitable Remainder Trusts, Family Limited Partnerships, Family Foundations, Installment Sales, or other structures may be appropriate to dispose of highly appreciated assets, thereby lowering the tax bill via reduced tax rates and charitable deductions.

Ask your clients lots of questions during your counseling interviews so you carefully understand their situation and can help them avoid costly mistakes.

Key Takeaways:

1. *A step-up in basis is a wonderful thing*. Assets get a step-up in basis at the owner's death. Thus mom, who wants to makes things simple for her children and avoid the federal estate tax by giving away the family home to her children while she is living, is likely creating a capital gains tax bill for her children when they later sell the home.

2. *Tax deferred growth is a wonderful thing*. Educating beneficiaries about the benefits of tax deferral before they inherit can keep more money in their pockets in the long run (and their foot off the Porsche's gas pedal).

3. *Tax minimization is also a wonderful thing*. Use a Charitable Remainder Trust (CRT) to dispose of low-basis, highly appreciated assets.

4. *Counter-intuitively, income tax returns are also a wonderful thing*. Always review your clients' income tax returns annually. They provide a wealth of information that your clients may not know is valuable to basis management. We have found that if the return is not reviewed and basis questions are not asked, carry over basis and loss carry forwards are rarely mentioned. Thus, tax planning opportunities are lost.

5. *Team work is a wonderful thing as well*. Make sure that basis step-up opportunities are always examined. Step-up opportunities will generally require our input as estate planning and business attorneys.

What You Need to Know:

First and foremost, stock or property needs to be held for longer than one year to avoid gains being taxed at ordinary rates for high-income payers. This is only an issue for those with marginal rates greater than 15%. In other words, if the ordinary income tax rate is equal to the capital gains rate (15%) there is no practical impact.

Be sure to determine the capital gains tax impact if an asset is sold. Tax planning looks at future years in which income may be reduced (e.g., during retirement) allowing for a more opportune asset disposition of low-basis stock or property.

> *The federal capital gains rate is 20% for income subject to the highest marginal rate of 39.6%; otherwise, it is 15%.*
>
> *And then there's the 3.8% Medicare surtax, effectively jumping capital gains from 20% to 23.8% (at $457,000 AGI (married filing jointly)).*
>
> *And don't forget the Virginia rate of 5.65% applies to capital gains as well.*

Low-basis stock or property that has high appreciation is a wonderful thing from a wealth standpoint, but can produce significant capital gains taxes upon sale.

- If the stock or property is to be sold, then you must have the client set aside the tax payment from the proceeds.
- If the tax payment is not set aside and the full proceeds are spent, your client may be forced to liquidate other assets or borrow to pay the tax bill when due. This is very inefficient and an example of poor planning. Even worse, your client may not be able to pay the tax bill and will incur significant penalties and interest.

Most of your clients own their own homes. Residential real estate has a $250,000 (single) and $500,000 (married) exemption from the capital gains tax with the proviso that the home has been owned and used as a *primary residence* for at least two of the five years prior to sale.

And then there's rental property to consider. Rental property may be entitled to a step-up in basis at the death of one of the spouses. Further, by using a Community Property Trust, property may be entitled to a double step-up allowing the survivor to sell with no capital gains and to diversify investments. Clients often overlook this benefit.

Community Property Trusts for married couples in separate property states are an effective way to get a double step-up in all assets owed by the couple no matter how titled. For larger estates, million of dollars in capital gains taxes can be avoided with this relatively simple trust structure.

Installment sales can be used to spread the gains on sales of businesses and rental properties over a number of years.

In addition, low-basis stock or real estate are ideal assets for Charitable Remainder Trust (CRT) funding because the property passes to the trust at full value and without immediate capital gains tax implications.

- The CRT then can sell the property (after it's owned by the trust) and monetize the proceeds back to the grantor in the form of income.
- The income stream is five-tiered (return of principal, capital gains, capital gains plus the Medicare tax, tax-free income, and ordinary income) so the effective tax rate is lower than the ordinary income tax rate.
- The charitable exemption allows for the full sales proceeds to be available for the trust to generate income with no up-front loss to capital gains taxes.
- The donor can take a charitable deduction for the donation to the trust, which can be especially valuable in high-income years.
- The CRT income stream can be used to fund a significant life insurance policy (inside an Irrevocable Life Insurance Trust) if your client's estate is likely to be subject to estate taxes and thus they need the liquidity of the insurance proceeds.

In addition, low-basis stock can also be gifted to Family Limited Partnerships (FLPs) and Family Foundations.

Using the FLP discount, the gift tax impact for the distribution is reduced. Of course, this mostly applies to those families with wealth greater than the federal exemption equivalent amount (i.e., $10.68 million for a married couple).

Moreover, so long as the surviving spouse is an American citizen, the marital exemption allows unlimited low basis stock and property to be passed tax free upon the owner's death to that spouse. Lifetime transfers to an American citizen spouse are also unlimited.

If these assets do pass via a marital transfer, it is vital that the advisor/estate planning attorney team execute a plan to address the surviving spouse's estate tax exposure.

And, keep in mind that low-basis property or stock may have emotional value (e.g., a family business, a home or vacation home or a treasured art collection).

- Beyond the tax implications, it is important for parents to have not only the asset-disposition plan in place, but to have a family meeting to discuss the broader significance of the property.
- Parents may not want their children to sell inherited property but the children may be tempted to sell anyway. If this is a concern, then a trust (with a non-family member as trustee) can be used to carry out the parents' intent.
- The tax implications for the beneficiaries can be handled by a number of trust structures to ease these worries.
- Property to be shared by siblings (e.g., a vacation home) needs to be discussed and the usage plan and rights be well documented to avoid conflicts before the parents become incapacitated or die.

Lastly, an IRA normally has no basis. However, IRAs funded by nondeductible IRA contributions (after-tax amounts) will.

Actions to Consider:

1. Include adult children and other beneficiaries in your counseling sessions, so they know the benefits of basis management and the disasters of mismanagement.

2. Offer beneficiary preparation workshops jointly with our office.

3. Invite your clients to come in for an update and 1040 analysis to identify additional planning opportunities.

4. Encourage your clients to attend one of our Wills vs. Trusts Workshops offered several times a month at all of our office locations.

5. Call our office to create a customized action plan to better protect your clients and their beneficiaries from themselves, keep more assets under management, be the hero, and reduce the number of basis management disasters you're forced to witness.

6. Explore whether a Charitable Remainder Trust, Family Limited Partnership, Family Foundation, trust structure, or installment sale is appropriate to dispose of highly appreciated assets. We'd be happy to assist you with this analysis.

7. And finally, if any of your clients are beneficiaries of trusts where a bank or trust company is the trustee and the client is unhappy with their service, please let the client know that our firm offers trustee services and that we can help remove the current trustee.

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