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in Estate & Trust Planning

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INCOME TAX ISSUES IN ESTATE PLANNING

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As the federal estate tax exemption has ballooned from $1.5 million ten years ago to $5.45 million today, the need for estate **tax** planning has decreased for many people. Instead, higher income tax rates that were ushered in under the American Taxpayer Relief Act of 2012 (ATRA) have shifted the focus of estate planning to a new frontier: income tax **BASIS** planning.

In this issue, you will learn what income tax basis is, how older estate plans have been designed under old tax laws to include an income tax time bomb, and the options clients have to now update their plans so that their heirs will receive the maximum income tax basis.

The Basics of Income Tax Basis. In its simplest form, income tax basis is the cost to buy an asset, which includes the purchase price plus costs and transfer fees. Basis must be tracked because when an asset is sold, income tax liability in the form of capital gains is calculated by subtracting the basis from the sales price. In other words, if the sales price is more than the basis, then the taxpayer must report a capital gain, but if the sales price is less than the basis, then the taxpayer will report a capital loss.

Basis plays an important role in estate planning in two ways. *Basis and lifetime transfers*: When property is gifted during life, the recipient of the gift receives the donor's basis in the property. This is referred to as "carry-over basis." For example, if a client purchases 100 shares of Facebook stock for $60 per share for a total of $6,000 but then gifts the stock to her son when the price is $100 per share, the son's basis in the stock is $6,000 (even though the fair market value is $10,000). Thus, if the

son later sells the stock for $105 per share (or $10,500), he will owe capital gains tax on $4,500 ($10,500 sales price - $6,000 carry-over basis = $4,500 gain).

Basis and transfers after death: When property is transferred after death, in general the inheritor's basis in the property is the fair market value on the date of death. This is referred to as "stepped-up basis." For example, if a client purchases 100 shares of Facebook stock for $60 per share for a total of $6,000 but then dies and leaves the stock to her son and the price is $100 per share on the date of death, then the son's basis in the stock is stepped-up to $10,000. Thus, if the son later sells the stock for $105 per share (or $10,500), he will only owe capital gains tax on $500 ($10,500 sales price - $10,000 stepped-up basis = $500 gain).

Planning Tip: Clients may unknowingly create an income tax bill for their children by gifting property during their lifetimes instead of allowing the children to inherit the property after death. A common example is when a parent deeds his or her residence to their child to avoid probate. If the child did not pay their parent anything for the residence, then the parent has made a gift of the residence to the child. If the parent's basis in the property is $100,000, then the child's basis is $100,000. If the parent lives in the property for 15 more years and then dies when the value is $500,000, the child's basis is still $100,000. If the child decides to sell the property shortly after death, the child will owe capital gains tax on $400,000 ($500,000 sales price - $100,000 carry-over basis = $400,000 gain). If instead the parent had used a revocable trust or a payable on death deed to avoid probate so that the residence passed to the child after death, then the child would not owe any capital gains tax ($500,000 sales price - $500,000 stepped up basis = $0 gain).

A/B Trust Planning: An Income Tax Basis Concern for Many People. Including assets in a deceased person's estate is the key to giving heirs a stepped-up basis. Yet traditional planning for married couples using an A/B Trust Plan deliberately *excludes* property from the surviving spouse's estate. An A/B Trust Plan, also known as a Marital Trust/Family Trust Plan, works as follows:

- When the first spouse dies, their estate plan provides that an amount equal to or less than federal estate tax exemption will go into the Family Trust (B) and any excess will go into the Marital Trust (A). For example, if Joe dies in 2015 with an estate valued at $6 million, then $5.45 million will go into the Family Trust and $570,000 will go into the Marital Trust. The assets in both trusts receive a stepped-up basis as of Joe's date of death.
- Mary, Joe's wife, will have access to the income and principal of the Family Trust (B) to provide for her health, education, support and maintenance. Mary will receive all of the income from the Marital Trust (A), and will also have access to the Marital Trust principal to provide for her health, education, support and maintenance.
- When Mary later dies in 2025, any property remaining in the Marital Trust will be included in her estate and receive a stepped-up basis as of her date of death. However, any of Joe's property remaining in the Family Trust (B) keeps the basis as of *Joe's* date of death in 2015.

How to Build Basis Planning Into an Estate Plan. With competent advice, there are several options to choose from if a person's goal is to maximize basis for heirs:

- Undoing the A/B Trust Plan and instead leaving everything outright to the surviving spouse will result in a stepped-up basis for the entire estate.
- Change the A/B trust plan to a "Wait and See" Tax Plan allowing the surviving spouse to choose within nine months of first spouse's death, either the A/B Trust Plan or all to surviving spouse plan.
- Giving the surviving spouse a testamentary general power of appointment in the Will or Trust will cause estate inclusion of the remaining trust assets at death, thereby resulting in a stepped-up basis.
- Giving a trust protector or advisor in the Will or Trust the ability to add a testamentary general power of appointment to cause estate inclusion at the spouse's death takes a "wait-and-see" approach to basis planning.
- Decanting under the Uniform Trust Code an existing irrevocable trust that does not include basis planning into a new trust that does is an option in Virginia.
- Swapping low basis assets held in a defective grantor trust for cash or other high-basis assets will bring the low basis assets back into the grantor's estate resulting in a stepped-up basis.

Planning Tip: For many married people whose estates are not taxable due to the very high Federal Estate Tax Exemption, A/B Trust Planning may cause more harm than good. For example, if a couple has been married for 50 years, they want to leave their estate to their children, and they are not particularly worried about the surviving spouse remarrying, an A/B Trust plan will have two detrimental effects: (1) the deceased spouse's assets may be unnecessarily held inside of a discretionary trust, and (2) the assets remaining in the trust when the surviving spouse dies will not receive a second stepped-up cost basis. On the other hand, a couple in a second or later marriage may prefer the benefits of a discretionary trust – providing for the surviving spouse but insuring that what is left goes to the deceased spouse's heirs – but still want the deceased spouse's heirs to receive a stepped-up basis. Alternatively, either couple could live in a state that collects a state estate tax, which makes A/B Trust Planning a necessity. This is why income tax basis planning has become so important and must be included in all estate planning discussions as a result of ATRA.

Investment management with basis in mind. Because the benefit of the step-up is greatest where the assets had a chance to develop large embedded capital gains, the practical problem this presents for some financial advisors is how to translate it into an investment management approach.

Indeed, for some Financial Advisors, allowing assets to ripen for years or even decades may conflict with cardinal principals of investment risk management, including never letting any single security represent more than a certain limited percentage of the portfolio (e.g. four or five percent). So, in consultation with your Financial Advisor(s), one straightforward solution might be to start with individual securities that each begin representing such a small slice of the portfolio that, even if they grow disproportionately faster than the

rest of the portfolio, it's unlikely they'll ever grow to an uncomfortably large share.

A fine choice for starting small within the portion of the portfolio that is devoted to a long-term strategic allocation would be a number of index funds in exchange-traded fund (ETF) wrappers. These ETFs mitigate the concentration problem by containing dozens or even hundreds of individual securities. And, as a bonus, unlike their open-ended mutual fund counterparts, they typically do not generate capital gains distributions along the way.

Another choice for those that advisors who are comfortable doing so would be to allocate some or all of the equity slice of the portfolio to 50 or 100 individual stocks, harvesting losses along the way to offset capital gains in any stocks that have grown so much they may need to be trimmed back.

Since many folks want income, one refinement of this strategy would be to select dividend paying stocks that are sufficiently large and financially healthy (i.e. lots of sales, free cash flow, etc.) that they could be held for the long term with a high degree of confidence that their dividend payouts would continue or increase.

For those people where the A/B trust structure exists and either cannot or should not be undone, one might adjust this to put the higher-income but lower-growth assets in the bypass (B) trust, distributing the net income to fund the surviving spouse's lifestyle, while keeping the lower-income higher-growth assets in the marital (A) trust, and allowing them to grow to eventually enjoy the step-up in basis.

One word of caution for those advisors who favor non-qualified annuities: any gain within these is excluded from the step-up, and is taxed as ordinary income.

Do You Need an Income Tax Basis Plan Review? YES!! Instead of falling back on "one size fits all" A/B Trust plans, today estate planners must look carefully at each client's unique family situation, financial position and potential estate tax liability to determine the appropriate mix of techniques to minimize both estate taxes and income taxes. If a person has an estate plan more than a few years old, chances are their estate plans may contain an income tax "time bomb" for the beneficiaries.

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About The Editor

Jim Garrett is a Principal of Carrell Blanton Ferris & Associates, PLC. and has practiced law for over twenty years. Before narrowing his practice to estate planning, his practice areas included real estate, business law and consumer protection. Today Jim uses his knowledge and experience in real estate and business in the estate planning context, especially in the areas of business succession planning, charitable giving and asset protection strategies.

Jim believes that estate planning is not just for the benefit of the client, but also for the client's surviving loved ones, valued charities and later generations of the client's family. Jim is a member of Wealth Counsel, a national organization of estate planning attorneys. Membership in Wealth Counsel permits Carrell Blanton Ferris & Associates, PLC to offer legal services nationwide, as part of a virtual law firm of over 1500 attorneys.