Basis Planning

The Forgotten Part of Estate Planning

Chattanooga Estate Planning Council

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CAVEATS

- **General Discussion – Exceptions Apply**
- **Particular Facts can Change the Advice**
- **Every Possible Topic is Not Discussed**
- **Always Discuss Your Particular Facts with Competent Tax Advisors and Attorneys**
- **State Laws Vary Widely!**

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More Information

- www.scrogginlaw.com
- www.NAEPC.org
- Jeff@scrogginlaw.com
- Copies of Slides

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The Gift Tax Basis Rules

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The Gift Basis Rules

IRC Section 1015(a)

If the property was acquired by gift …., the basis shall be the same as it would be in the hands of the donor…. except that if such basis ….. is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.

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The Gift Basis Rules

The Basis Rules on Gifting Loss Assets:

- ✓ If the donor's basis in the asset exceeds its fair market value and the donee subsequently sells the asset for a **gain**, the donee uses the **donor's basis** in the property.
- ✓ If the donee sells the asset for a **loss**, the **fair market value** of the donated assets is used as the basis.
- ✓ Thus, if the donee sells for a price **between** the fair market value and the donor's basis, **neither a loss nor a gain is incurred.**

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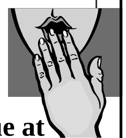
TRAP FOR THE UNWARY
Basis Issues

Always Analyze the Basis Issues on Gifts



- ✓ **Liability in Excess of Basis**
- ✓ **Negative Basis**
- ✓ **Loss of Step Up in Basis**
- ✓ **The Step-Down to Fair Market Value at Death**
- ✓ **Compare Step-Up in Basis at Death to Gift Tax Cost**

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TRAP FOR THE UNWARY
Negative Basis/Liability in Excess

- **Client has been Acquiring Real Estate over 30 Years, Trading up using Like-Kind Exchanges**
- **$5.0M of Equity in his Real Estate**
- **Basis of $1.0M**
- **Secured Debt of $3.0M**
- **He wants to Gift all the Real Estate in 2012**

Result: $2.0M of Realized Gain

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TRAP FOR THE UNWARY
Gift Tax Basis Issues

Gifting of Low Basis Assets May NOT Make Sense

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TRAP FOR THE UNWARY
Transferring Gain Assets

Example

- **Client wants to gift an Assets worth $5.0M to his children; Basis equals $1.0M**
- **Assuming a 25% Capital Gain Cost, when the Asset is sold, the Benefit of the $5.0M Gift is Diminished by $1.0M**

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TRAP FOR THE UNWARY
Transferring Loss Assets

Example

- **Client has an asset worth $10,000 which was purchased for $15,000.**
- **If the donor sells the asset, the $5,000 tax loss is available to the donor.**
- **If the donor gifts the asset to a donee who immediately sells the asset, the $5,000 loss disappears.**

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PLANNING OPPORTUNITY
Planning for a Low Basis

Example:

- **Sale of Business for $1.0 million**
- **Client has Four Grandchildren in College**
  - **Annual Cost = $20,000 each**
- **Client has Enough Assets for Retirement**
- **Client has a Zero Basis in the Stock**
- **Client will be Taxed at 15%**
- **Grandchildren Will be Taxed at 5%**

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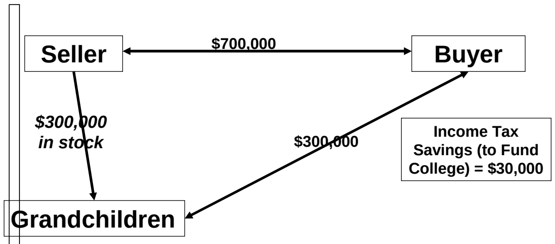
PLANNING OPPORTUNITY
Planning for a Low Basis



Caution: Transfer to Grandchildren Must Precede Any LOI or Sale Agreements

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The Gift Basis Rules

IRC Section 1015(e)

In the case of any property acquired by gift in a transfer described in section 1041(a), the basis of such property in the hands of the transferee shall be determined under section 1041 (b)(2) and not this section.

Section 1041(b)

…. the property shall be treated as acquired by the transferee by gift, and (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

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PLANNING OPPORTUNITY
Planning for a Losses

A terminally ill Married Client has a Capital Asset with a $1.0 million loss

If the Client Dies owning the Asset, the Loss is Wiped Out for Tax Purposes

If the Client Sells the Asset before Death, the Loss can Offset Lifetime Capital Gains

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PLANNING OPPORTUNITY
Planning for a Losses

If the asset is gifted to a Spouse, the High Basis is Carried Over (T.R.1.1041-1T(d)Q&A11)

However, Compare the Retained Basis Benefit to the Impact of <u>not</u> Funding the Terminally Ill Client's Full Estate Tax Exemption

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TRAP FOR THE UNWARY
Basis Issues

1041(a): No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of (1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce.

1041(e): **Subsection (a) shall not apply to the transfer of property <u>in trust</u> to the extent that (1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds (2) the total of the adjusted basis of the property transferred.**

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PLANNING OPPORTUNITY
Planning in Marriage & Divorce

<u>Alternatives</u>

- **Transferring Negative Basis Assets <u>Directly</u> to a Spouse or Ex-Spouse in Divorce**
  - **Transfer to a Terminally Ill Spouse?**
- **Use of a IDGT to Avoid the Immediate Recognition**
  - **Renunciation of the IDGT Term could Trigger the Tax Recognition – EVEN if caused by Death**

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Planning Resource

Post Divorce Practical Checklist

at www.scrogginlaw.com

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The Estate Tax Basis Rules

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The Estate Basis Rules

IRC Section 1014(a)

…. the basis of property in the hands of a person acquiring the property from a decedent ….. shall…. be … the fair market value of the property at the date of the decedent's death.

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The Estate Basis Rules

In *Crane v. Comm'r*, inherited property was encumbered by a $250,000 mortgage and had a date-of-death value of the same amount.

The Supreme Court held that the basis of the property was <u>not</u> the Equity (zero) but the <u>full value of the property</u>, including the mortgage.

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The Estate Basis Rules

<u>Exceptions to the Step Up Rule</u>

(1) **IRD Property** *(IRC sections 1014(c) and 691)*

(2) **S corporation stock** to the extent assets of the S corporation would have constituted IRD if held directly by the deceased shareholder *(IRC section 1367(b)(4).*

(3) **Partnerships** have a similar rule. *(Treasury Regulation 1.742-1)*

(4) **The "Net Unrealized Appreciation" on Employer Stock** derived from an ERISA Plan *(Revenue Ruling 75-125, 1975-1 CB 254)*

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<u>PLANNING OPPORTUNITY</u>

Portability of the Estate Exemption

In order to Obtain Portability, you <u>must</u> File a Federal Estate Tax Return

A Waste of Money if it Expires January 1, 2013?

A Wise Contingency while we Wait for a Permanent Rule?

Make Sure you Cover the Issue with Clients and have their Decision in Writing

Portability can also allow a <u>second step up</u> in the basis of assets

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Pre-Mortem Basis Planning

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PLANNING OPPORTUNITY

Gifts vs Bequests

- Unmarried Client **($3.5 million exemption in 2013)**
- Business Value = **$1,500,000**
  - Basis = **$50,000**
- Remainder of Estate = **$300,000**

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PLANNING OPPORTUNITY

Gifts vs Bequests

	Estate	Gift
Business Sale Price	$1,500,000	$1,500,000
Basis	$1,500,000	50,000
Taxable Gain	**None**	**$1,450,000**
Possible Gain (15%)	None	**$217,500**
Possible Gain (20%)	None	**$290,000**

Depreciable Value of Assets can Also Change

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PLANNING OPPORTUNITY

Gifting High Basis Assets

Gifting of High Basis Assets May Make Sense

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PLANNING OPPORTUNITY

Gifting High Basis Assets

- **A Chronically Ill Client owns a Family Farm with a Basis of $3.0M and a Fair Market Value of $1.5M.**
- **If the Client Dies, the Basis Steps Down to $1.5M**

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PLANNING OPPORTUNITY

Gifting High Basis Assets

If the Client <u>Gifts</u> the Property in 2012 to Children, the Children can use the $3.0M FMV as the Basis for any Gain on a later Sale (but not for Loss purposes)

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PLANNING OPPORTUNITY
Gifting High Basis Assets

	Gain on the Sale
$3,000,000	
	No Gain or Loss
$1,500,000	
	Loss on Sale

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PLANNING OPPORTUNITY
Gifting to the Terminally Ill

- ✓ **Preserve the Higher Exemption of a Dying Spouse**
- ✓ **Provide for a Flexible By-Pass Trust**
- ✓ **1014(e) reads: "….. *if (A) <u>appreciated property</u> was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and (B) 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 <u>adjusted basis of such property in the hands of the decedent</u> immediately before the death of the decedent.***

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PLANNING OPPORTUNITY
Gifting to the Terminally Ill

- **A client's wife is terminally ill, but owns no assets.**
- **In 2012, the donor transfers $1,500,000 in zero-basis assets to the spouse, who revises her will to provide that those specific assets pass into a bypass trust.**
- **At the wife's death the assets step up to $1.5 million. Upon a subsequent sale (at 20%) the tax savings would be $300,000.**

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PLANNING OPPORTUNITY
Gifting to the Terminally Ill

- **If the wife dies within one year, the donor/spouse can disclaim an interest in the trust and the assets will step-up to their fair market value, saving taxes for the children.**
- **If the wife survives the transfer by one year, the step-up occurs and the disclaimer is unnecessary.**

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PLANNING OPPORTUNITY
Gifting to the Terminally Ill

- **In the alternative, the husband could create a trust over which the wife has a general power of appointment.**
- **Arguably, the general power of appointment is not a gift and, therefore, section 1014(e) may not apply – but the IRS may treat this as an "Indirect" Violation of 1014(e)**

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Planning Resource

"Planning in 2012 for Clients with Shorter Life Expectancies"

at www.scrogginlaw.com

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Common Basis Mistakes

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Discounting Values

Beware of Basis Reductions in Gifting of Minority Interests

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TRAP FOR THE UNWARY

Appraisals

Failure to Obtain Appraisals of **Non-Readily Marketable** Assets in **Non-Taxable Estates**

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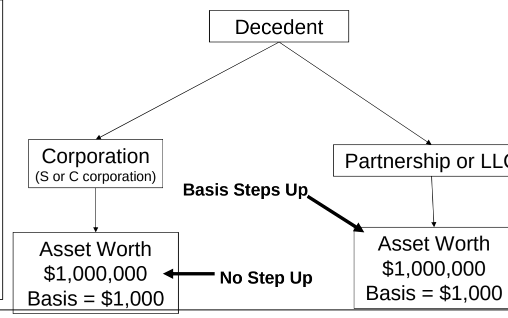
TRAP FOR THE UNWARY

Gaining Basis on a Death



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TRAP FOR THE UNWARY

Shareholder Buy-Outs

Redemption

Versus

Cross-Purchase

(Only Applies to Corporations)

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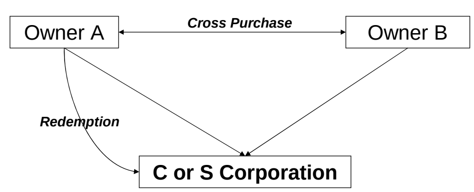
TRAP FOR THE UNWARY

Shareholder Buy-Outs



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TRAP FOR THE UNWARY
Shareholder Buy-Outs

	Redemption	Cross-Purchase
Sales Price	2,000,000	2,000,000
Beginning Basis	1,000	1,000
Basis on Purchase	-0-	1,000,000
Total Basis	1,000	1,001,000
Taxable Gain	**1,999,000**	**999,000**

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Basis Planning with High Estate Exemptions

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If High Estate Exemptions Remain, Planning Will Shift to Increasing an Asset's Fair Market Value!

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PLANNING OPPORTUNITY
Obtaining a Higher Basis

Example

- Married Couple in 2012 **(UTC = $5.12M each)**
- Business Value is $4.0M
  - Wife Owns 40%
  - Husband Owns 40%
- Wife's Life Insurance = $1.0M
- Husband is in Poor Health
- 40% Discount for Minority Interest

Total Husband's Estate: $960,000

Total Combined Estate: $2,920,000

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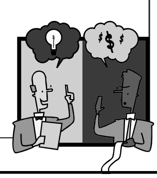
PLANNING OPPORTUNITY
Obtaining a Higher Basis

Move the Life Insurance Outside the Taxable Estate



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PLANNING OPPORTUNITY
Obtaining a Higher Basis

- At Husband's Death Business Value:
  - Business Value $4,000,000
  - Times Ownership 40%
  - 40% Discounted Value 60%
  - Estate Tax Value **$960,000**
- Value without Discount: **$1,600,000**

Basis of $640,000 is LOST

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PLANNING OPPORTUNITY

Obtaining a Higher Basis

Solution:

Transfer more than 10% of the Company to the Husband

At H's Death Transfer more than 10% of the Company BACK to the Wife

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Planners will Start Considering How to Bust Discounting Techniques!

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PLANNING OPPORTUNITY ???

Retained Control

A client created an FLP over which she Retained all Authority.

At her death, do you argue that under IRC 2036, the gifted interests are included in her Taxable Estate?

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Grantor Trust Rules

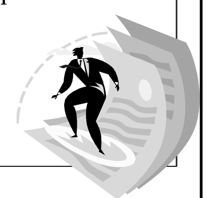
- The **Income Tax** Rules

Differ from

- The **Gift Tax** Rules

Which Differ from

- The **Estate Tax** Rules



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Income Defective Trust

- Income Taxable to **Grantor**
- Trust Assets **Excluded** from the Grantor's Estate

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The <u>ESTATE</u> Defective Trust

- **Income Taxable to Trust or Beneficiary**
- **Trust Assets Included in the Grantor's Taxable Estate**

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Purposes of the Estate Defective Trust

Reduction of Taxes & Income

- ✓ **Passage of Taxable Income to Lower Bracket Beneficiaries**
- ✓ **Reduction of After-Tax Income in the Grantor's Estate**

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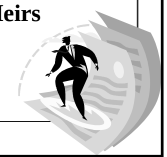
PLANNING OPPORTUNITY

Estate Defective Trusts

Step-up in Basis

- ✓ **Current Value**
- ✓ **Future Appreciation**
- ✓ **Elimination of Basis Calculation on Gifts**
  - ✓ **Depreciation Recapture**
  - ✓ **Unknown Basis**
- ✓ **Fair Market Value Step-Up for Heirs**
  - ✓ **Reduced Taxes on Post-Death Sale**
  - ✓ **New Depreciable Basis**



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PLANNING OPPORTUNITY

Estate Defective Trusts

- ➢ **Client with Deferred Compensation and Pension Benefits which Terminate at Death – Being Taxed at 35%**
- ➢ **Client Holds Depreciated Real Estate**
  - ➢ **Basis = $100,000**
  - ➢ **Fair Market Value = $1,100,000**
  - ➢ **Annual Income = $50,000**
  - ➢ **Annual Appreciation = 5%**
- ➢ **Overall Heir's Tax Rate = 15%**

Caution: Beware of Liability in Excess of Basis and Negative Basis

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PLANNING OPPORTUNITY

Estate Defective Trusts

Client Dies in Five Years

- ✓ **$250,000** in Income Moved Out to Heirs
  - ✓ Income Tax Savings of **$50,000**
  - ✓ No State or Federal Estate Tax on the After-Tax Income
- ✓ Basis Steps up to **$1,404,000**
- ✓ **Depreciation Recapture** Disappears

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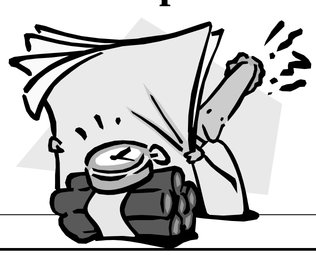
TRAP FOR THE UNWARY

Estate Defective Trusts

Beware of Transfers Which are a Completed Gift



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TRAP FOR THE UNWARY

Estate Defective Trusts

Beware of Increased Estates or Reduced Exemptions

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TRAP FOR THE UNWARY

Estate Defective Trusts

Beware of State Transfer Taxes & Low Exemptions

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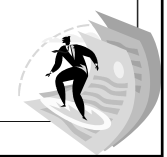
PLANNING OPPORTUNITY ???

FLPs

Can a PURPOSELY Defective Family Limited Partnership Create some of the Same Benefits?



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Planning Resource

"Estate Defective Trusts," Taxes Magazine, January 2005, republished in Practical Estate Planning, April 2005

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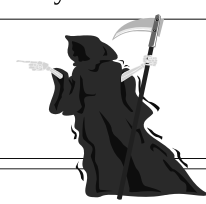
A THOUGHT TO REMEMBER

According to Benjamin Franklin, only **death** and **taxes** are inevitable.
So live your life **accordingly**.



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