Estate Planning For Income Taxes: Maximizing Basis Planning Opportunities

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Estate Planning 'game' Has Changed

- Primary tax "problem" for the mass affluent has shifted from the estate tax to income tax
- Only 2,584 *Taxable* Estate Tax Returns were files in 2021[1].
- Federal estate tax exemption has increased more than 1,700% over the past two decades

[1] Source: SOI Tax Stats - Estate Tax Filing Year Tables, Table 1. Selected Income, Deduction and Tax Computation Items, by Tax Status and Size of Gross Estate, 2021 https://www.irs.gov/statistics/soi-tax-stats-estate-tax-filing-year-tables

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Estate Tax Exemptions 2000 - 2023

Year	Estate Tax Exemption	Year	Estate Tax Exemption	Year	Estate Tax Exemption
2000	$675,000	*2008*	$2,000,000	*2016*	$5,450,000
2001	$675,000	*2009*	$3,500,000	*2017*	$5,490,000
2002	$1,000,000	*2010*	$5,000,000	*2018*	$11,180,000
2003	$1,000,000	*2011*	$5,000,000	*2019*	$11,400,000
2004	$1,500,000	*2012*	$5,120,000	*2020*	$11,580,000
2005	$1,500,000	*2013*	$5,250,000	*2021*	$11,700,000
2006	$2,000,000	*2014*	$5,340,000	*2022*	$12,060,000
2007	$2,000,000	*2015*	$5,430,000	*2023*	$12,920,000

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Income Tax Planning Issues at Death

- Filing of final income tax return
- “Unwinding” of tax-favored accounts
- Step-up in basis

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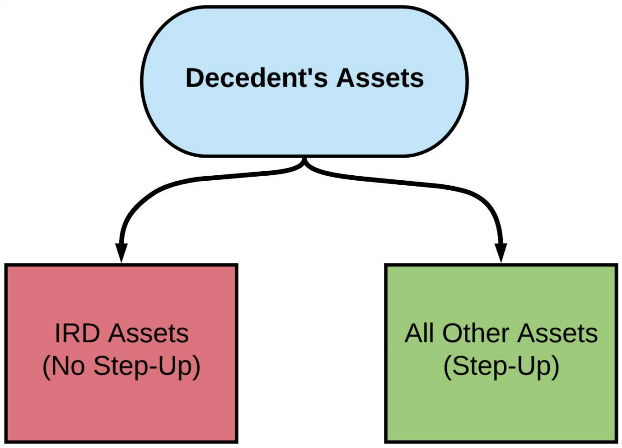
Two Classes Of Assets At Death



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Income In Respect Of A Decedent (IRD)

- Income earned during life, but not yet taxed
- Subject to income tax (no step-up) and estate tax
- Common IRD assets include:
  - Account Receivables
  - NUA
  - Pre-tax retirement accounts
  - Final bonus (not paid before death)
  - Installment sale gains
  - Embedded gain on U.S. savings
  - Final paycheck (not paid before death)
  - Gain on NQ Annuities

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Understanding The IRD Deduction

- Mitigates "double taxation"
- Income tax deduction for Federal estate tax paid
  - No similar deduction for state estate taxes paid
- Recipient of IRD is entitled to the deduction
- Two question test:
  - Did you inherit an item of IRD?
  - Did the estate owe Federal estate tax?

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Step-Up-In-Basis Assets

- Everything other than IRD
- Beneficiary's basis is "stepped up" to the fair market value on the date of death
  - FMV on alternate valuation date (when AVD is elected)
  - Future gain/loss receives long-term capital gains treatment
- Allows beneficiary to sell asset income-tax-free
  - Also eliminates the need to know the decedent's basis
- No cap!

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The Door Swings Both Ways! Step-Down in Basis

- Everything other than IRD
- Beneficiary’s basis is stepped down to the fair market value on the date of death
  - FMV on alternate valuation date (when AVD is elected)
  - Future gain/loss receives long-term capital gains treatment
- Unrealized gain is lost

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Key Concept!

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Step-up in Basis Rules For Joint Accounts (Separate Property States)

- "Qualified Joint Interest"
  - Joint tenants with rights of survivorship
  - Joint tenants by the entirety
- Each spouse presumed to own 50% of the assets in the account
- Surviving spouse receives a step-up in basis on deceased spouse's 50% "share" of the joint account

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Step-up in Basis Rules For Joint Accounts (Community Property States)

- General rule: Property acquired during marriage is community property
  - Other property can be voluntarily "converted" to community property
- Treated as though each spouse owns 100% of the assets in the joint account
  - "Full step-up" (-down) upon both deaths!
- Community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin

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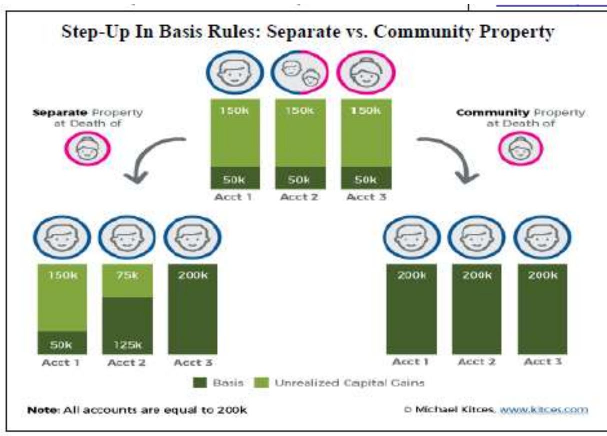
Step-up in Basis Rules For Joint Accounts (Comparative example)



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Maximizing Step-Up In Basis Using Pre-Death Asset Transfers

- Goal: Allow couple in separate property state to get a "full" step-up at both deaths
- Shift assets out of joint accounts and into first-to-die spouse's individual account
- Leave assets back to surviving spouse

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Challenges When Using Pre-Death Asset Transfers

- One-year "Boomerang Rule" (IRC 1014(e))
  - Step-up is "voided"
  - Applies when gifted assets pass back to original donor (or original donor's spouse) on account of donee's death, within one year of gift.
- Loss of control over gifted assets
- Medicaid eligibility may be impacted

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The Importance Of Identifying The Owner of Capital Losses

- Joint tax returns report the combination of each spouse's separate income, deduction, credits, etc.
  - Joint tax return ≠ all tax items belong to both spouses
- Realized capital loss carryforwards of a decedent "die" with them
  - Last joint return in year of death
- Whose loss is it????
  - Schedule D does not distinguish!!

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The Importance Of Identifying The Owner of Capital Losses

- Revenue Ruling 1974-175
- "In the absence of any express statutory language, only the taxpayer who sustains a loss is entitled to take the deduction. See Calvin v. United States, 354 F. 2d 202 (10th Cir. 1965). Therefore, the business loss and the capital loss sustained by the decedent for the period ending with the date of his death are deductible only on his final income tax return. Thus, no part of such net operating loss or capital loss is deductible by the decedent's estate or carried over to subsequent years." (emphasis added)

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Making The Most Of Already-Realized Capital Losses

- Already-realized capital losses include:
  - Carryover capital loss
  - Year-of-death capital realized losses
- Sell gain-laden assets of the surviving spouse
  - Generally OK to repurchase after sale (must have economic substance)
- Give preference to:
  - Assets likely to be sold w/ short-term gain
  - Assets surviving spouse was likely to sell soon anyway

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Maximizing Unrealized Losses Earmarked For A Non-Spouse Beneficiary

- Gift to non-spouse beneficiary prior to death
- Subject's non-spouse beneficiary to "double basis" rules
- Shields future growth, up to the decedent's basis at the time of the gift, from taxation

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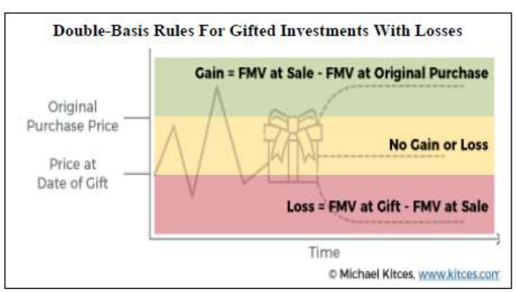
Understanding The "Double Basis Rules"

- Recipient of gift has two separate basis amounts
  - Fair market value on date of gift to determine a loss
  - Donor's basis at time of gift to determine a gain



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Maximizing Unrealized Losses Earmarked For A Spouse Beneficiary

- Same strategy. Even better result!
  - Gift to non-spouse beneficiary prior to death
  - "Full" unrealized capital loss is preserved
- Recipient spouse retains donor spouse's basis
- IRC Section 1015(e), entitled "Gifts between spouses", states: "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".
- 1041(b)(2) states "the basis of the transferee in the property shall be the adjusted basis of the transferor."

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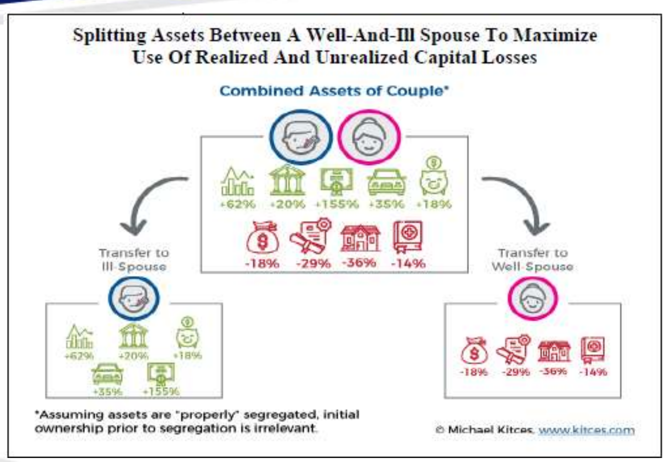
Maximizing Unrealized Losses Earmarked For A Spouse Beneficiary



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Recapping Near-Death Basis Planning For Spouses!

STEP #1
Move investments with gains into the ill spouse's name only to try and secure a step-up in basis (keeping in mind the one-year "boomerang" rule).

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Recapping Near-Death Basis Planning For Spouses!

STEP #2
Move investments with an unrealized loss into the healthy spouse's name only

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Recapping Near-Death Basis Planning For Spouses!

STEP #3
If at all possible, use up any existing carryforward capital losses or current-year realized gains (and other favorable tax attributes) by/in the year of death.

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Revisiting Credit Shelter Trusts To Maximize The Step-up

- In the recent past, many families were more concerned with Federal estate taxes than they were with Federal income taxes.
- Many sacrificed income tax benefits for estate tax protection
- “Bread-and-butter” approach called for a credit shelter trust
  - Also known as “bypass trust”, or a “B trust”

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Credit Shelter Trusts Benefits and Drawbacks

- Allowed deceased spouse to use their exemption amount to support surviving spouse
  - "Portability" can accomplish this today without the use of a trust
- Credit shelter assets were not included in surviving spouse's estate
- No 2nd step-up upon surviving spouse's death
  - Potentially result in additional capital gains
  - Reduce basis for future depreciation, 199A testing, etc.
- Income retained within credit shelter trust subject to trust tax rates

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Strategies To Fix A Not-Yet-Funded Credit Shelter Trust "Problem"

- Update the estate plan to remove the credit shelter trust altogether
- Utilize disclaimer planning
  - Make the spouse the primary beneficiary of the Will, and the credit shelter trust the contingent beneficiary
  - Make the credit shelter trust the primary beneficiary of the Will, and the spouse the contingent beneficiary

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Strategies To Fix A Funded Credit Shelter Trust "Problem"

- Use the funds in the credit shelter trust first
  - Opposite of past planning practices
  - Unless the protection of the trust is critical
- Make the most of asset location strategies
  - Factors to consider include:
    - Federal income tax rates
    - Federal estate tax rates
    - State income tax rates
    - State estate tax rates
    - Expected return
    - Expected turnover
    - Expected yield

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Unwinding Other Estate Planning "Problems"

- Valuation discounts
  - Step-up in basis is lower if valuation discount is used
  - Amend documents to allow pro-rata distributions?
  - Distribute assets?
- Utilize powers of substitution?
- Stop gifting?

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Unwinding Other Estate Planning "Problems"

- Testamentary powers of appointment to older/unhealthy persons?
  - Watch out for creditors!
- Can we decant to another trust with more favorable distribution provisions?

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The Next Generation of Estate Planning Trusts

- Community property trusts:
- – Florida
- – Kentucky
- – South Dakota
- – Tennessee
- – Alaska* (full community property opt-in available)

- Effectively a trust that treats property inside as community property

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The Next Generation of Estate Planning Trusts

- IRC Section 2038 Marital Trust
- Goal: Allow for a "full step-up" on all assets at either spouses' death
- Typical mechanics
  - Established by one spouse
  - Opposite spouse is a discretionary beneficiary
  - Benefits payable to beneficiary spouse's estate upon beneficiary's death
    - Controlled by beneficiary spouse's Will
  - Drafted to include language "forcing" assets into establishing spouse's estate
    - Power to terminate

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The Next Generation Of Estate Planning Trusts

- Joint Exempt Step-Up Trust (JEST)
- Goal: Allow for a "full step-up" on all assets at either spouses' death, PLUS:
  - Control the future disposition of those assets
- Typical mechanics
  - Single joint trust
  - Separate shares for each spouse
  - Each spouse retains a right to revoke their share of the trust
  - Each spouse provides other with a general power of appointment
  - Separate shares converted to separate credit shelter trusts (and potentially additional separate QTIP trusts) upon first spouse's passing
- Not yet 100% clear if this will work!

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Recap, Takeaways, and Key Planning Points

- For those subject to Federal estate tax, estate tax generally remains a primary concern
- For all others, death is more about income tax minimization strategies (for beneficiaries)
- Basis planning strategies for community property are limited

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Recap, Takeaways, and Key Planning Points

- Married couples with separate property can often engage in substantial near-death basis planning
- Strategies include:
  - Shifting positions with gains into first-to-die's estate
  - Shifting positions with losses into second-to-die's estate
  - Revisiting the need for new credit shelter trusts
  - Revisiting the way existing credit shelter trust assets are used and/or invested
  - The use of more advanced trusts to secure a "full" step-up upon either spouse's death
- Be aware of where we are in the current market cycle!
  - Gains more likely than ever before!

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