



# Family Legacy Protection Planner

## **WARNING: WHAT YOU DON'T KNOW ABOUT INCOME TAX BASIS COULD HIT YOUR BOTTOM LINE**

Income tax basis may not be the most exciting topic to read about. However, it is a critically important topic to anyone who owns significant assets. Gaining an understanding of the basics of basis is a way to avoid costly mistakes.

### **The *Real* Meaning of Basis**

According to IRS Tax Topic 703, your basis “is generally the amount of your capital investment in a property for tax purposes. Use your basis to figure depreciation, amortization, depletion, casualty losses, and any gain or loss on the sale, exchange or other disposition of the property.”

In plain English, basis means the cost you paid for an asset, plus any amount you paid to improve the asset, less any deductions you have taken against the asset. This means that your basis is used to determine the amount of capital gain or loss to report on your income tax return when the asset is sold.

### **Lifetime Gifts: A Basis Disaster Waiting to Happen**

Thoughtful estate planning requires an understanding of when and how basis can change. You should always consider that the benefit of giving away assets during your lifetime may be offset by the carryover basis that your donee will receive. For example, if you decide to gift to your daughter that low basis AT&T stock or a lake house that has been in the family for years, then that gifted property will retain its low basis in your daughter’s hands. In other words, your basis is transferred to your daughter and becomes her basis. Unfortunately, this also means that there will likely be significant capital gains when your daughter sells the property you gave her.

Bottom line: Gifting low basis property during your lifetime may not be the most tax efficient way to place the property into your daughter’s hands. In the alternative, passing the property to your daughter after you die will give her a “step up” in basis to its fair market value as of the date of your death. This makes sense if your estate isn’t taxable for state or federal purposes and your heirs are likely to sell the inherited property shortly after your death instead of holding on to it for years into the future. Of course, you will have to consider whether your estate is likely to grow in

value to become subject to estate tax at your death, or if there is any possibility that the estate tax exemption (presently \$5,340,000) will become less significant in the future due to inflation or legislative action.

To avoid a basis disaster, if you're considering gifting that low basis stock or house to your children or other beneficiaries, please contact us before you do.

### **AB Trusts – Do You Need to Get Rid of Yours?**

For married couples, basis has become more important now that portability of the federal estate tax exemption has been made permanent. In simple terms, "portability" means that when the first spouse dies, the surviving spouse can claim the deceased spouse's unused federal estate tax exemption and add it to his or her own exemption.

For example, if Fred dies in 2014 and none of his \$5.34 million exemption is used, then his wife, June, can add Fred's \$5.34 million exemption to her \$5.34 million exemption so that June now has an exemption equal to \$10.68 million. All property passing to June from Fred's estate, revocable trust, or by right of survivorship will receive a full step up in basis to the fair market values as of Fred's date of death. Subsequently, when June dies her beneficiaries receive a full, *second* step up in basis to the full fair market value as of June's date of death.

Let's consider another possibility. What if Fred and June have a typical 1990s estate plan, which uses "AB Trusts" (also called "Marital and Family Trusts" or "QTIP" and "Bypass Trusts") to ensure full use of both spouses' federal estate tax exemptions?

Back in 1999, the federal estate tax exemption was only \$650,000. Using our scenario with Fred and June, if Fred and June were lax and neglected to update their estate plan and Fred dies in 2014, then not only will June be stuck with AB Trusts that were drafted using decades old planning priorities, but their heirs won't receive a step up in basis for the assets remaining in the B Trust when June dies. Instead, they will inherit the B Trust assets with the basis calculated as of Fred's 2014 date of death. In some cases, the lack of a step up for the B Trust assets may not make a big difference due to stagnant asset values or the enhanced asset protection opportunities that may be available for B Trust assets.

If you are married and your estate plan is *more than a few years old*, please give us a call so that together we can determine if an AB Trust plan still makes sense for you and your family. We may be able to revise your existing estate plan to take advantage of the good features of AB Trust planning while gaining the benefits of an additional step up in basis.

### **Beyond the Basics – Advanced Basis Planning Opportunities**

Moving beyond the basics to some advanced planning opportunities, if you have low basis stock or other property that you are eager to sell, but would prefer not to take the immediate tax hit, here are some options to consider:

- You can enter into an installment sale for the low basis property which spreads the gain over a number of years and avoids running your income up the AGI ladder
- You can fund a Charitable Remainder Trust (CRT) with low basis property which achieves the following:
  - The CRT can sell the property and monetize the sale proceeds back to you in the form of income
  - This income stream will be four-tiered (return of principal, capital gains, tax-free income, and ordinary income) so the effective tax rate will be lower than the ordinary income tax rate
  - The net is higher inside the CRT than outside of it, because the charitable exemption allows for the full proceeds to be available for CRT's assets
  - You can take a charitable deduction for the donation to the CRT, which may be especially valuable while you're still earning employment compensation
  - You can use the CRT income stream to fund a substantial life insurance policy and make your children the beneficiary of the policy
- Perhaps you have some low basis property with sentimental value (example, that AT&T

stock or lake house you inherited from Aunt Betty). If you're concerned about gifting such property directly to your children or other beneficiaries because you fear they may not share your personal interest in the property and will sell it rather than keep it, then a number of different trust structures can be used (preferably with a non-family member as the trustee) to ensure that your wishes will be carried out.

### **The Bottom Line on Basis**

While it's not a particularly glamorous concept and it can be confusing at times, basis remains a critical factor in any estate plan. Failing to update one's estate plan or ignoring a low cost basis when property is gifted or sold can lead to disastrous tax consequences. So before you gift or sell that AT&T stock you inherited from Aunt Betty, give us a call first. We are here to answer all your questions.

## **ENSURE YOUR FAMILY IS PROTECTED**

If you want to ensure that your family is protected, please schedule your complimentary Estate Planning Strategy Call with San Francisco's premier estate planning attorney, Matthew J. Tuller.

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