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THE LAW OFFICE OF MATTHEW J. TULLER

Family Legacy Protection Planner

IS THERE AN INCOME TAX TIME BOMB LURKING IN YOUR ESTATE PLAN?

As the federal estate tax exemption has ballooned from $1.5 million ten years ago to $5.43 million today, the need for estate tax planning has drastically decreased. 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 deliberately designed to include an income tax time bomb, and the options you have to update your plan so that your heirs will receive the maximum 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 must 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 you purchase 100 shares of Facebook stock for $60 per share for a total of $6,000 but then gift the stock to your son when the price is $100 per share, his basis in the stock is $6,000 (even though the fair market value is $10,000). Thus, if your 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 you purchase 100 shares of Facebook stock for $60 per share for a total of $6,000 but then die and leave the stock to your son and the price is $100 per share on your date of death, then your son's basis in the stock is stepped-up to $10,000. Thus, if your 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: You may unknowingly create an income tax bill for your children by gifting property during your lifetime instead of allowing your children to inherit the property after your death. A common example is when a parent deeds their residence to his or her 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).

AB Trust Planning: An Income Tax Basis Nightmare for Many Couples

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 AB Trust Plan deliberately *excludes* property from the surviving spouse's estate. An AB Trust Plan, also known as a Marital or QTIP Trust/Family or Bypass 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 and any excess will go into the Marital Trust. For example, if Joe dies in 2015 with an estate valued at $6 million, then $5.43 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 to provide for her health and maintenance, receive all of the income from the Marital Trust, and also have access to the Marital Trust principal to provide for her health 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 keeps the basis as of *Joe's* date of death in 2015.

How to Build Basis Planning Into Your Estate Plan

There are several options to choose from if your goal is to maximize basis for heirs:

- Undoing the AB Trust Plan and instead leaving everything outright to the surviving spouse will result in a stepped-up basis for the entire estate.
- Giving the surviving spouse or other beneficiary of a lifetime trust a general power of appointment will cause estate inclusion of the remaining trust assets at death, thereby resulting in a stepped-up basis.
- Giving a trust protector or advisor the ability to add a general power of appointment to cause estate inclusion at the beneficiary's death takes a wait-and-see approach to basis planning.
- Decanting an existing irrevocable trust that does not include basis planning into a new trust that does is an option in some states.

- 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.

Planning Tip: For many married couples whose estates are not taxable, AB Trust Planning will 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 AB Trust plan will have two detrimental effects: (1) the deceased spouse's assets will be unnecessarily tied up 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 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 AB Trust Planning a necessity. This is why basis planning has become so important and must be included in all estate planning discussions.

Do You Need a Basis Planning Review?

Instead of falling back on "one size fits all" AB 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 your estate plan is more than a few years old, chances are it contains an income tax time bomb. Please call us if you have any questions about basis planning and to arrange for a basis planning review.

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