

# ALL ABOUT THAT BASIS: HOW INCOME TAXES HAVE RESHAPED ESTATE PLANNING

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## The New Tax Environment (pp. 1-2)

- ▶ Unified transfer tax system
  - \$10,000,000 exclusion/exemption for estate, gift and GST taxes – for years 2018-2025
  - Indexed for inflation (C-CPI-U) - **\$11.4 million for 2019**
  - For years 2011-2017 (and after 2025), \$5 million adjusted for inflation
    - \$5.49 million for 2017
  - 40% rate on excess
- ▶ Income Tax Rates are Higher
  - Trusts and estates hit top bracket at \$12,500 for 2017 and 2018; **\$12,750 for 2019** (\$12,950 for CGs in 2018)
  - 3.8% additional NII tax
- ▶ Portability is permanent

## The Analysis Has Changed

- ▶ Ordinary income tax rates exceed estate tax rates
- ▶ Higher capital gain rates (23.8%) make basis more important
- ▶ High estate tax exclusion makes estate tax savings illusory for most people
- ▶ The definition of "married couple" has changed
- ▶ For couples in the \$2 to \$22 MM range, is the complexity and federal income tax exposure worth trusts' non-tax benefits?

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## What Is Basis? (pp. 2-4)

- ▶ Basis is benchmark to measure gain or loss on sale
- ▶ Gain or loss = Amount realized – Basis
- ▶ Also sets depreciation base
- ▶ General rule: Basis = cost of asset, less depreciation
- ▶ Special rules for property acquired from a decedent
  - Generally, basis is fair market value at date of death
  - Alternate valuation date value/Special use valuation value
  - In essence, estate tax value
- ▶ Estate tax return filing is irrelevant
- ▶ Basis may step up OR down, i.e. basis adjustment
  - Original cost basis is simply ignored
- ▶ Holding period automatically becomes long-term

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## Basis Consistency and Value Reporting (pp. 3-4)

- ▶ IRC § 1014(f) = Basis consistency
  - Applies to beneficiaries of estates above estate tax filing threshold
  - Estate tax returns filed after 07/31/15
  - Applies only to property that generates estate tax
    - Not marital or charitable deduction property
    - Not certain tangible personal property
  - *Initial* basis cannot exceed final estate tax value
- ▶ Zero basis rule for after-discovered or omitted property

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## Value (not basis) Reporting (pp. 3-4)

- ▶ IRC § 6035 = Value (not basis) reporting
  - Applies to executors (per IRC definition) required to file an estate tax return
  - Applies to all property (including marital or charitable deduction), EXCEPT:
    - Cash, IRD, certain tangible personal property, property disposed of where CG/CL recognized
  - Form 8971 to IRS and Schedules A to beneficiaries
    - Earlier of 30 days after 706 due (w/extension) or filed
  - Supplemental reporting
  - Subsequent transfers

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## Property "Acquired from a Decedent"

(p. 5)

1. Property acquired by will or intestacy
2. Revocable trust property
3. Property decedent transferred with retained right to control
4. Property subject to a general power of appointment
5. Both halves of community property
6. Other property included in gross estate
7. Former QTIP property

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## Exceptions to Basis Adjustment (pp. 5-7)

- ▶ Income in Respect of a Decedent (IRD)
  - Income "earned" by the decedent but not properly reported by him or her – *Peterson v. Comm'r*:
    - Decedent entered into legally significant transaction
    - Decedent performed substantive tasks required
    - No economically significant contingencies exist
    - Decedent would have received property but for death
- ▶ Property re-inherited within one year of gift
- ▶ Property subject to conservation easements

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## Property Acquired by Gift (pp. 7-9)

- ▶ Generally, carryover basis and carryover holding period
- ▶ For losses, basis limited to FMV on date of gift
  - Does not apply for gifts between spouses
- ▶ Basis increased by any gift and GST tax paid
- ▶ Gifting asset gets appreciation out of estate BUT loss of basis adjustment at death

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## Do Trusts Still Make Sense? (pp. 9-18)

- ▶ Bypass Trusts
  - No basis adjustment at second death
  - Administrative cost/complexity
  - High income tax rates on accumulated income
  - Problems with special assets
    - Retirement plans, residences, and S corps and other pass-through entities
  - Disclaimer Bypass Trusts
    - Adds flexibility to the estate plan but requires timely disclaimer
    - At cost of special power of appointment
- ▶ QTIP Trusts
  - Can't sprinkle/spray
  - Estate tax exposure (above DSUE amount)
  - Trust taxed on taxable income not distributed

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## Do Trusts Still Make Sense? (cont.)

- ▶ Bypass Trust benefits (pp. 9-13)
  - Control over ultimate disposition
  - Creditor protection/divorce protection
  - Management assistance
  - Protection of governmental benefits
  - Protection from state inheritance taxes
  - Income shifting
  - Wealth migration
- ▶ Compared to outright gift + portability?
  - Appreciation not estate-taxed
  - No risk of losing DSUE amount on remarriage
  - Preserve GSTT exemption of first spouse
  - No estate tax return needed

## Do Trusts Still Make Sense? (cont.)

- ▶ Compare/contrast QTIP Trusts (pp. 11-15)
  - Creditor/divorce protection
  - Less retained income for compressed tax brackets
  - New cost basis at second death (if QTIP elected)
  - Preserve GSTT exemption (by "reverse" QTIP election)
  - No estate tax savings (but DSUE amount available)
- ▶ QTIP drawbacks (pp. 15-17)
  - No "sprinkle" power
  - Estate tax exposure (above DSUE amount)
  - High income tax rates for taxable (not accounting) income
  - Rev. Proc. 2001-38 and Rev. Proc. 2016-49

## Do Trusts Still Make Sense? (cont.)

- ▶ *Clayton* QTIP Trusts (p. 17)
  - Executor chooses between QTIP and Bypass
  - Elected property goes to QTIP
  - Nonelected property goes elsewhere (typically, Bypass)
  - Up to 15 months to decide
  - Sample Language (See Exhibit B)
  - Can the surviving spouse be the executor? Cf. "One -Lung" Trusts
- ▶ QTIP Tax Apportionment Trap (pp. 17-18)
  - By default, the tax ultimately caused by the QTIP is paid by the QTIP assets
  - The *benefit* of the QTIP+Portability inures to the surviving spouse's family
  - Can this be contracted around?

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## Example 12: Tax Apportionment (pp. 17-18)

- ▶ H dies leaving \$20 million estate to QTIP Trust, remainder to H's children
- ▶ H's executor makes QTIP and portability elections
- ▶ W's Applicable Exclusion Amount = \$22.4 million
- ▶ W makes gift of \$20,000,000 to her children
  - Applicable Exclusion Amount then \$2.4 million
- ▶ W dies with \$20 million in QTIP Trust
  - QTIP Trust owes estate tax of nearly \$8,000,000
  - H's children receive only \$12,000,000
- ▶ Note: Same result if W merely keeps her \$20 million estate until her death

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## The "LEPA" Trust (p. 18)

- ▶ Life Estate Power of Appointment Trust
- ▶ All income to spouse—like QTIP Trust
- ▶ No need to file an estate tax return
- ▶ Automatic basis adjustment at death
- ▶ Spouse must have unrestricted GPOA to appoint to self or estate
  - Inter vivos vs. testamentary
- ▶ BUT:
  - Spouse may appoint assets elsewhere
  - Possible creditor exposure – inter vivos vs. testamentary GPOA?
  - No "reverse LEPA" election for GSTT purposes

## Clients' Estate Planning Goals

	Outright to Spouse	All to Bypass Trust	All to QTIP Trust	All to LEPA Trust
Keep it Simple	Y	N	N	N
Creditor/Divorce Protection	N	Y	Y	Y/N
Control Ultimate Disposition	N	Y	Y	N
Management Assistance	N	Y	Y	Y
Sprinkle/Spray to Kids, etc.	N*	Y	N	N
Preserve GST Exemption	N	Y	Y	N
Avoid High Trust Income Taxes	Y	N	Y**	Y**
Avoid Estate Tax on Appreciation	N	Y	N	N
New Cost Basis at 2 <sup>nd</sup> Death	Y	N	Y	Y

\*But enhanced gifting possible using DSUE amount

\*\*Due to less income accumulation, but no ability to shift income



## Twenty Ideas to Obtain Basis

1. K.I.S.S. and rely on portability
  - Is it really simple?
  - Will clients file the return?
  - Risks and downsides to portability
2. Have parties enter into "contract to make a will"
  - Certainty vs. flexibility
  - Enforceability of contract varies by state (*see, e.g., Tex. Ests. Code § 254.004*)
  - Consider impact on marital deduction

## Language To Draft Into Trusts

3. Use QTIPable or *Clayton* QTIP Trust (pp. 11-17)
4. Use LEPA Trust (p. 18)
5. Have Trustee distribute low-basis assets to surviving spouse (pp. 17-18)
6. Grant independent trustee distribution authority beyond H.E.M.S. ("for any reason") (pp. 19-20)
7. Give third party power to grant a general power of appointment (p. 20)

## More Basis Techniques for Trusts

8. Grant non-fiduciary power to appoint to spouse (p. 20)
9. Decant appreciated assets to estate-tax includable trust (p. 21)
10. Make (even very) late QTIP election (p. 21)

## 11. The Optimal Basis Increase Trust ("OBIT") (pp. 22-24)

- ▶ Grant spouse a testamentary GPOA over only non-IRD, appreciated assets
  - Result: A "step up" in basis, but not a step down
- ▶ Subject the power to a formula to avoid estate tax when the spouse dies
- ▶ Designing the formula is not trivial
  - "Cascading" power over most appreciated assets
  - See Exhibit C (in context of Delaware Tax Trap)
  - Complexity of administration
- ▶ Restrict the exercise of the power by spouse
- ▶ Potential testamentary GPOA creditor exposure

## Bonus Idea: (pp. 21-22)

# ▶ BUY LIFE INSURANCE!

## 12. Spring the "Delaware Tax Trap" (pp. 25-29)

- ▶ Need only grant surviving spouse a *special* power of appointment (SPA)
- ▶ Spouse *exercises* SPA over *appreciated* assets to "spring" the trap. To spring the trap, one must:
  1. Exercise a power of appointment
  2. To create a second power of appointment
  3. Which can be validly exercised
  4. To postpone vesting of estate or interest in (or suspend absolute ownership or power of alienation over) property
  5. for a period ascertainable without regard to the date of the creation of the first power—*Must have a RAP in 1<sup>st</sup> trust!*
- ▶ Common law: Granting someone a "presently exercisable general power" (PEG power) does this (See Exhibit C)
- ▶ Exercise = Estate tax inclusion = Basis step-up!

## More on "Delaware Tax Trap" (pp. 25-29)

- ▶ First trust's language only requires granting special power of appointment
- ▶ Check your Rule Against Perpetuities language
- ▶ Costs of springing the trap:
  - Assets subject to PEG power holder's creditors
  - Trust income likely taxed to PEG power holder
  - Distributions to others may be gift by PEG power holder
  - Estate tax inclusion for PEG power holder
    - Loss of GST tax exemption
    - Assets may get step-up or step-down at second power holder's death
- ▶ Moral: Choose your new power holder carefully

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## Basis Strategies for Existing Assets

13. Transmute separate property into community property or partition CP (p. 29)
14. Give low basis assets to taxpayer (p. 29)
  - Gifted property "re-inherited" within one year of death receives no basis adjustment
15. Grant GPOA to terminal person (p. 30)
16. Swap high-basis assets into grantor trust (p. 30)
17. Capture capital losses (p. 30)
  - Selling depreciated assets avoids step-down
  - Can offset other gains, but lose net capital losses at death

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## 18. Spousal Trusts for Two Adjustments

(pp. 30-31)

- ▶ SUGRIT: Step-Up Grantor Retained Income Trust
- ▶ Grantor-spouse creates inter vivos trust and retains income for life
- ▶ If grantor-spouse dies first, retained income interest causes asset inclusion in estate, resulting in basis adjustment
- ▶ If grantor's spouse dies first, trust assets pass to spouse's estate, resulting in basis adjustment
  - Spouse's estate can pass to grantor-spouse in way that will cause inclusion at grantor-spouse's death
- ▶ Creation of trust is taxable gift that does not qualify for marital deduction
  - Adjusted taxable gift rules prevent double transfer tax
- ▶ Best if neither spouse will use full exclusion

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## 19. Accidentally Perfect Grantor Trust

(pp. 31-35)

- ▶ Shifting wealth to older-generation family members is no longer taboo
- ▶ Transfer property into trust to avoid senior's lifetime creditors and maintain control
- ▶ Junior creates grantor trust and gives or sells low-basis assets to trust
- ▶ Trust grants low-net-worth senior beneficiary general power of appointment over appreciated assets

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## Accidentally Perfect Grantor Trust (pp. 31-35)

- ▶ GPOA results in basis adjustment at death of senior beneficiary
  - If power is not exercised, trust remains grantor trust as to junior
  - If power is exercised, trust becomes complex trust
  - Limited by depreciation or depletion?
- ▶ May allocate senior beneficiary's GSTT exemption
- ▶ **RESULT:** Assets pass at senior's death into creditor-proof, estate-tax-exempt, GST-tax-exempt trust f/b/o junior or other descendants, with new cost basis, without estate tax or gift tax

## 20. Pass-Through Entities (pp. 36-41)

- ▶ Outside basis is adjusted, so issue is how to adjust inside basis
- ▶ Consider amending existing partnerships to minimize discounts at death
  - Allow executors of deceased partners to require Section 754 election (not available to S corps)
  - Grant less wealthy individuals "put" at death at liquidation value
- ▶ Distribute non-cash assets to partners during life
  - Beware of distributing assets if inside basis exceeds outside basis, assets subject to debt, or "hot" assets

## Planning for New Basis at Death

- ▶ Basis is the new tax game in town
- ▶ High estate tax exclusions can make basis available with no estate tax costs
- ▶ Trust benefits are still important to clients, but may come at a cost of basis adjustment
- ▶ Creative additions to existing estate planning tools can give best results
- ▶ Talk with clients about basis-adjusting opportunities and risks