THE NATIONAL LAW REVIEW

# What You Need to Know – How to Avoid a Basis Management Disaster

Article By
Wayne M. Zell
Odin, Feldman & Pittleman, P.C.
Blueprint for Wealth

Estates & Trusts
Tax
Corporate & Business Organizations
All Federal

Wednesday, October 15, 2014

When it comes to estate planning, many people who set out with the best of intentions make a mess of the estate plan after the fact. Take the example of the widow who has already transferred her house into her children's names, or an inherited IRA is drained that is to pay for a Porsche. The lost planning opportunity and the financial fallout is universally gut wrenching.

Please feel welcome to use the below facts and scenarios in your estate planning, conversations, and personal education. Consider these facts and information as a "red flag" list of tax pitfalls and opportunities so you can avoid heartache and be your own basis management hero.

### Quick Review:

The most important step is to understand how tax basis is determined, the step-up in basis at death for both separate and community property assets, and the consequences and opportunities associated with low basis assets. Many people don't understand the rules governing when basis applies to IRAs and when it doesn't, or how to transform separate property into community property to get a full step-up of basis at the death of the first spouse.

Fortunately, there are numerous opportunities to avoid the huge and instant tax bill associated with selling low basis assets outright and for making the most of tax basis rules. Charitable Remainder Trusts, Family Limited Partnerships, Family Foundations, Installment Sales, or trust structures may be appropriate to dispose of highly appreciated assets, lowering the tax bill with reduced tax rates and charitable deductions.

You should have a firm understanding and grasp of your situation to avoid costly mistakes. When engaging an advisor, it is important to avoid communicating via email or a five minute phone call, as this may result in missed planning opportunities and cost you significant tax dollars.

### Key Takeaways:

1. A step-up in basis is a wonderful thing. Assets get a step-up in basis at death; so, if you want to makes things simple for your children and avoid state inheritance or estate tax by giving away the family home, you are likely creating a huge income tax bill. When the property is gifted, the recipient gets a tax basis equal to the lesser of the fair market value or the giver's tax basis. If the property is appreciated, it will generate significant gain and tax when it is later sold.

2. Tax deferred growth is a wonderful thing. Educating beneficiaries before they inherit can keep more money in their pockets in the long run (and their foot off a Porsche's gas pedal).

3. Tax minimization is also a wonderful thing. Use tools such as the Charitable Remainder Trust (CRT) to dispose of low-basis, highly appreciated assets without setting off the IRS's alarms and collection agents.

4. Counter-intuitively, income tax returns are also a wonderful thing. Always review income tax returns annually.

They provide a wealth of information that you may not know is valuable to basis management. Review tax returns annually to be aware of carry over basis and loss carry forwards and avoid lost tax planning opportunities. Don't miss Wall Street corporate takeovers, rental property, and mutual fund red flags.

5. Teamwork is a beautiful thing as well. Make sure that basis step-up opportunities are always examined. Step-up opportunities will generally require an estate planning attorney's and CPA's input.

### What You Need to Know:

First and foremost, stock or property needs to be held for longer than one year to avoid gains being taxed at higher ordinary rates for high-income payers. This is only an issue if your marginal rate is greater than 15%. In other words, if the marginal rate is equal to the capital gains rate — 15% — there is no practical impact.

Be sure to determine the capital gains tax impact if an asset is sold. Tax planning looks at future years in which income may be reduced (e.g., at the onset of retirement) allowing for a more opportune asset disposition of low-basis stock or property.

The capital gains rate is 20% for income subject to the highest marginal rate of 39.6%; otherwise, it is 15%.

And then there's the 3.8% Medicare surtax, effectively jumping capital gains from 15% to 18.8% (at $250k AGI married filing jointly) or 23.8% ($450k AGI married filing jointly).

– Low-basis stock or property that has high appreciation is a wonderful thing from a wealth standpoint, but can produce very high capital gains taxes if sold.

– If the stock or property is to be sold, then you must set aside the tax payment from the proceeds.

– If it is not set aside and the full proceeds are spent, when taxes are due, this could require pulling cash from future uses to the present (this is very inefficient and an example of poor execution).

– If you are a home owner, residential real estate has a $250,000 (single) and $500,000 (married filing jointly) exemption from the capital gains tax with the main proviso that the home has been owned and used as a primary residence for at least 24 months.

– If you own rental property, the property may be entitled to a step-up in basis at the death of one of the spouses. This benefit is often overlooked.

Installment sales can be used to spread the gains on sales of businesses and rental properties such that gains are spread over a number of years to avoid running up the AGI and tax rate ladder.

Community Property Trusts for married couples in separate property states are an effective way to get a double step-up in all assets owed by the couple no matter how titled. For larger estates, millions of dollars in capital gains taxes can be avoided with this relatively simple trust structure.

In addition, low-basis stock or real property are ideal assets for Charitable Remainder Trust (CRT) funding because the property passes to the trust at full value and without immediate capital gains tax implications.

- The CRT then can sell the property (after it's owned by trust) and monetize the proceeds back to the grantor in the form of income.
- The income stream is four-tiered (return of principle, capital gains, tax-free income, and ordinary income) so the effective tax rate is lower than the ordinary income tax rate.
- The net is higher inside the trust than outside because the charitable exemption allows for the full proceeds to be available for the trust's assets.
- The donor can take a charitable deduction for the donation to the trust, which can be especially valuable in high-income years (such as the last few years of earning employment compensation).
- The CRT income stream can be used to fund a significant life insurance policy (inside an Irrevocable Life Insurance Trust if your estate is federally taxable).

In addition, low-basis stock can also be gifted to Family Limited Partnerships (FLPs), Family Limited Liability Companies (FLLC) and Family Foundations.

Using the FLP/FLLC discount, the gift tax hit for the distribution is substantially reduced. Of course, this mostly applies if your family has wealth greater than the unified gift and estate tax credit (i.e., $10.68 million for a married couple).

Moreover, if you are a surviving spouse and you are an American citizen, the marital exemption allows unlimited low basis stock and property to be passed tax free upon the owner’s death to that spouse. (Lifetime transfers to an American citizen spouse are also unlimited.)

If these assets do pass through a marital transfer, it is vital that your advisor/estate planning attorney team execute a plan to address your estate/gift tax exposure.

And, keep in mind that often times, low-basis property or stock may have emotional connections (e.g., a family business, a home or vacation home with sentimental value, or a treasured collection).

Beyond the tax implications, it is important if you are a parent to have not only the asset-disposition plan in place, but to have a family meeting to discuss the broader meanings of the stock and/or property.

As a parent, you may not want property that is gifted to be sold, but your kids may be tempted to do so. If this is a concern, then a trust (with a non-family member as trustee) or an FLLC (with a non-family member as a manager) can be used to carry out your parental intent.

The tax implications for the beneficiaries can be handled by a number of trust structures to ease these worries.

Property to be shared by siblings (e.g., a vacation home) needs to be discussed and the usage plan and rights be well documented to avoid conflicts before parents become incapacitated or die.

Assets get a step-up in basis at death; if you give away the family home or other assets, you are likely creating a huge tax bill as well as subjecting your home to creditors and bad acts of your children. In addition, you will be disinheriting any children who are not the recipients of the transfer as to that asset.

Lastly, remember that Porsche? An IRA’s basis is the after-tax balance formed by nondeductible IRA contributions as well as rollovers (after-tax amounts). Earnings on IRA contributions are tax-deferred.

## Actions to Consider:

1. Include adult children and other beneficiaries in your estate planning, so they know the benefits of basis management and the disasters of mismanagement.

2. Visit your financial advisor to receive a 1040 analysis to identify additional planning opportunities.

3. Call our office to create a customized action plan to better protect you and your family, and keep more assets under management. Be the hero, and avoid any gut-wrenching basis management disasters.

4. Explore whether a Charitable Remainder Trust, Family Limited Partnership, Family Limited Liability Company, Family Foundation, trust structure, or installment sale is appropriate to dispose of your highly appreciated assets. We’d be happy to assist you with this analysis.

5. If you are a beneficiary or trustee of a non-grantor trust, ask us to analyze the trust to determine whether that trust can be recanted to grant your beneficiary a general power of appointment, bringing trust assets into his or her estate and using up any available federal estate tax exemption.