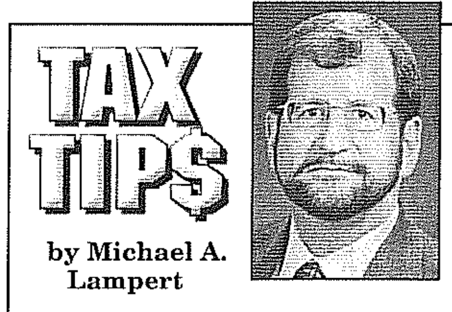
Tax tips for elder lawyers

Basis: The new (and old) elephant in the room



by Michael A. Lampert

What has happened to tax rates over the last 5 to 10 years? The estate and gift tax rates (40% maximum rate) have been reduced, and there is an exemption amount ($5.34 million in 2014) that eliminates the estate tax for the vast majority of our clients. Yet the overall income tax and capital gains rates, after taking into account the Medicare surtax, net investment income tax, phaseouts of itemized deductions and other special rules, inch their way up. With so few clients subject to the estate tax, it is easy to say when doing estate planning, "Phew—don't need to worry much anymore about taxes." Unfortunately, this is not true. Many tax issues still must be considered. This article will address one of the issues, and it is the elephant in the room:

Basis.

In its simplest form, if you pay $10 for an asset (not inventory) and sell it for $18, you have an $8 gain ($18 minus $10). If held for more than one year, it is long-term capital gain. For 2014, there is a top capital gain rate of 15 percent for most taxpayers, 20 percent for high-income taxpayers, 28 percent for collectibles and 25 percent for depreciation recapture. Yet basis rules can be very complex, and there are many traps.

Every reader of this article (should) already know that in most cases when a beneficiary receives an asset from a decedent, the value of the asset steps up (or down) to fair market value (IRC § 1014(a)). As noted in my article in *The Elder Law Advocate*, Vol. XXII, No. 2, Summer 2014, this also works in reverse. When the asset has gone down in value, the asset's basis steps down to the fair market value as of date of death, so:

Tip #1

Be careful if your clients give away appreciated assets during their lifetime. While clients love to "avoid probate," if the asset is given away during their lifetime, there will not be a basis step-up on the gifted asset (IRC § 1015) the way there would be if held at death. (The basis does increase by the amount of gift tax paid by the gifter, if any.) This is often part of the balancing act in Medicaid planing.

Tip #2

Consider selling a loss asset before gifting the asset away so that the gifter can take the income tax loss. If the loss asset is retained until death, the loss will be lost because the basis will step down to fair market value.

So, why not just gift it at a loss, and if the recipient can use the loss, let them take it?

Trap #1

In most cases, if you gift away a depreciated asset (fair market value is less than the basis) and the recipient sells it at a *gain*, the recipient uses the grantor's basis. If the recipient sells the asset at a loss, the recipient uses the fair market value at the time of the gift (IRR 1.1015-1(a)(1)). This is a trap for the unwary.

What about giving the asset to someone expected to die soon, with the hope that it will come back to the gifter after the grantee's death?

Trap #2

If an appreciated asset is gifted to the decedent within one year of the date of death of the decedent and the gifted property is then reacquired from the decedent (or passes from the decedent back to the gifter), the basis does not step up (IRC § 1014(e)).

Tip #3

If the grantee does outlive the one-year period, the recipient gets the basis step-up. If you do not expect the recipient of the gift to live one year, perhaps have the recipient of the gift (the person "about to die") cause the asset to go to another family member at death.

What about existing shelter trusts and other irrevocable instruments?

There are many existing credit shelter trusts, family limited partnerships and other vehicles where the goal was to keep the value of the asset either out of the grantor's estate for estate tax purposes or to reduce the value of the underlying assets in the grantor's estate by using discounted values (such as minority interest, lack of control, etc.). Yet at death there will be little or no basis step-up. If there would be no estate tax regardless, the basis step-up is a good thing. So ...

Tip #4

Consider shutting down the credit shelter trust if permitted under the trust instrument and consistent with otherwise good planning. With the assets in the surviving spouse's name, when the surviving spouse dies, the asset should get a basis step-up.

Tip #5

Look at assets in grantor trusts. Can low-basis/high-value assets be swapped out for cash from the grantor? Assuming it is a grantor trust, there should be no taxable result on the swap. This can allow the asset to receive a basis step-up at death and not have a current income tax effect.

Reverse discount planning: For years, estate tax planners have tried

to argue that the value of an asset is less than it might appear. For example, if a parent owns 50 percent of a $100 asset, it might be argued that because the 50 percent interest is not controlling, it is worth something less than $50 (50% of $100). With estate tax planning, ownership of entities such as family limited partnerships and S Corporations are often owned by a parent in a way where the parent has a minority interest, has no control and the interest is not freely transferable. From an estate tax viewpoint, this can reduce the value of the asset in the parent's taxable estate. But from a basis step-up viewpoint, it is a disaster. The 50 percent interest doesn't step up to $50 at death. It might, instead, only step up at death to the discounted value. But ...

Tip #6

What if we plan in reverse? What if we give (sell) the parent a little higher percentage interest in the entity? Even one percent more (50% plus 1%) usually gives the control for many things, and it is a majority in interest. Sixty percent or more gives them even more control. So, the 51 percent interest might be worth, say $60. This increase in basis to $60 (instead of the $51 based on a simple 51% portion of $100) can provide significant tax savings when the asset is sold or, if depreciable, when it is depreciated.

Reminder: An LLC (taxed as a partnership) and a partnership can elect (a Section 754 election) at the death of an owner to step up the assets inside of the entity based on the percentage owned by the decedent. This can result in significant income tax savings when assets of the entity are sold.

But what if you want a trust to have some control over the assets at the death of the second spouse?

Tip #7

Consider using a QTIP (qualified terminable interest trust) election to include the trust assets in the estate of the second spouse to die. This can cause the basis step-up at the death of the second spouse to die while still utilizing a trust for the surviving spouse.

This article is a bit different from many of my tax tip articles. While still brief, and while only scratching the surface of the rules, it is an attempt to get elder lawyers to focus on basis planning in estate planning for clients. Take basis planning into account during checkups, Medicaid planning and initial planning and when reviewing asset lists, trusts and other entities. Ask: Can I help get a basis increase for the family consistent with their overall estate planning goals?

You will see increasing numbers of articles and seminars on basis issues. Basis truly is becoming the new elephant in the room.

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Jana McConnaughhay is the contact person for publications for the Executive Council of the Elder Law Section. Please email Jana at *jana@mclawgroup.com* for information on submitting elder law articles to The Florida Bar Journal for 2014-2015.

A summary of the requirements follows:

- Articles submitted for possible publication should be MS Word documents formatted for 8½ x 11 inch paper, double-spaced with one-inch margins. Only completed articles will be considered (no outlines or abstracts).
- Citations should be consistent with the Uniform System of Citation. Endnotes must be concise and placed at the end of the article. Excessive endnotes are discouraged.
- Lead articles may not be longer than 12 pages, including endnotes.

Review is usually completed in six weeks.