BASIS BUMPING: A "Gift" from the Grave

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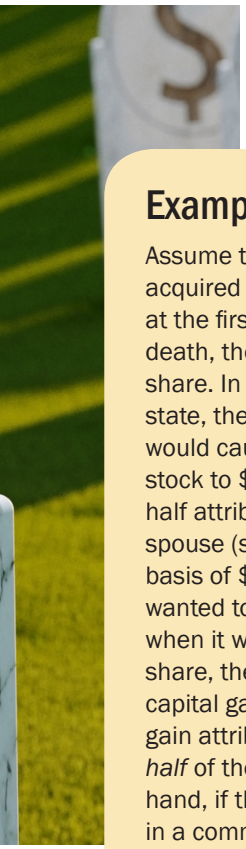
We all know the adage that nothing is certain but death and taxes. But what if death could ease an income tax burden? In the ever-evolving world of estate planning, less clients need our assistance in saving estate taxes. However, properly planning for death (a client's own death or a family member's death) can reduce income taxes paid by the client and/or the client's family. This shift in the focus of a client's estate planning is known as basis-bumping.

What is Basis and How is it Adjusted?

The basis of an asset is its income tax value for purposes of determining capital gains or loss when the asset is liquidated. This value is often the purchase price of the asset, with adjustments for improvements and depreciation. However, when a person dies, Internal Revenue Code (IRC) 1014 resets the basis of the decedent's assets to the fair market value of the assets at the date of death. The beneficiary can then immediately sell the asset with zero capital gain (if the beneficiary is able to sell before any further appreciation). The basis reset often places the beneficiary in a superior position to that of the decedent. If the decedent had sold the asset during lifetime, the decedent would have recognized gain (or loss) equal to the sales price minus the decedent's acquisition basis.

The value of this basis adjustment is double (quite literally) in community property states, such as Nevada. Under IRC 1014(b)(6), if a decedent dies owning community property, not only the decedent's portion of the community property, but also the surviving spouse's portion will receive a new income tax basis. In separate property states, when one spouse dies, only the decedent's separate property and one-half of joint property receives a new basis.



Example:

Assume two spouses jointly acquired stock for $1/share, and at the first spouse's (decedent's) death, the stock is now $100/share. In a separate property state, the decedent's death would cause a reset of half of the stock to $100/share, while the half attributable to the surviving spouse (survivor) would retain a basis of $1/share. If the survivor wanted to sell all of the stock when it was still worth $100/share, the survivor would pay a capital gains tax on the $99/share gain attributable to the survivor's *half* of the stock. On the other hand, if the same spouses lived in a community property state and held the stock as community property, when the decedent dies, the basis of *all* of the stock holdings would reset to $100/share, so that the survivor could sell all of the stock for $100/share with no capital gain.

Basis adjustment is a double-edged sword. While in most cases, long-term holdings generally mean that the assets will be stepped up at death, if the fair market value of an asset is lower than the decedent's basis in the asset at the time of death, the basis will be stepped down. This means that the built-in losses will disappear at death. One planning technique is to transfer assets that have a basis higher than their fair market value by gift. When assets are gifted, they are transferred with carry-over basis (subject to adjustment if subsequently sold at a loss). This means that the recipient will have the same basis in the asset that the transferor had when making the gift. However, an asset cannot be gifted to transfer a loss to another individual. Instead, gifting an asset that has a basis higher than its fair market value gives the recipient the opportunity to hold onto the asset until it rebounds, and then sell the asset at a gain but using the transferor's original cost basis.

Basis adjustment only occurs with assets that are includible in a decedent's estate for estate tax purposes. These are generally assets held by the decedent, individually, or held in a revocable trust of the decedent. Assets in an irrevocable trust may or may not receive a new basis, depending on the terms of the trust (often irrevocable trusts are designed to be excluded from the decedent's estate for estate tax purposes, resulting in no change in basis).

Increased Estate Tax Exemption Affords Basis-Bumping Opportunities

The Tax Cuts and Jobs Act of 2017 (also known as the Trump Tax Act) not only reduced corporate and individual tax rates, but also doubled the exemptions available for the estate tax. In the 2000s, the federal estate tax exemption scaled between $1 million and $3.5 million. In 2011, the federal estate tax exemption was raised to $5 million, adjusted for inflation. Already at these levels, most Americans would not be subject to a federal estate tax. Under the Trump Tax Act, the federal exemption was increased to $10 million, adjusted for inflation. In 2020, this amount is projected to be $11,580,000. With this increased exemption, less than 0.01 percent of estates will be subject to a federal estate tax.

When reviewing an already-existing will or revocable trust, it is customary to see a "bypass" or "credit shelter" trust established when the first spouse dies. This holds the decedent's federal estate tax exemption in a separate irrevocable trust for the benefit of the surviving spouse and/or the decedent's descendants or other beneficiaries. The benefit of this structure is that it keeps the exempt assets of the deceased spouse out of the surviving spouse's estate for both creditor and estate tax purposes. Given the new federal estate tax exemption amount, in most typical situations, the surviving spouse will not have a taxable estate, even if the decedent's assets are included. Instead, it may be more valuable for the assets of the bypass trust to receive another new income tax basis at the surviving spouse's death, so that the remainder beneficiaries can reset the basis and mitigate gains.

Should the bypass trust now be terminated and the assets distributed to the surviving spouse to achieve a new income tax basis at surviving spouse's death? The answer is a resounding ***no***. The bypass trust can be drafted in a way to protect the assets from the surviving spouse's creditors (including new spouses). Further, in situations in which the surviving spouse remarries, a termination of the trust may not be in the interest of the remainder beneficiaries (typically, the decedent's children). Also, the estate tax laws are constantly changing. If the exemption is lowered (the double exemption under the Trump Tax Act is scheduled to sunset on January 1, 2026, and many Democratic presidential candidates have suggested far lower exemptions), terminating the bypass trust and distributing the assets to the surviving spouse could cause estate tax exposure (in violation of the purpose of the bypass trust in the first place).

Instead of distributing the assets or terminating the trust entirely, the bypass trust can be drafted (or decanted under Nevada's superior trust decanting laws (Nevada Revised Statutes (NRS) 163.556)) to grant a formula general power of appointment to the surviving spouse. A general power of appointment is a power, in this case, of the surviving spouse, to appoint property of the trust to himself, his estate, his creditors and/or the creditors of his estate. Under IRC 2041, if a person dies with a general power of appointment, the assets that are subject to the power of appointment are included in the person's estate. A general power of appointment may be based on a formula. The formula can cap the maximum amount that will be added to the surviving spouse's estate without causing an estate tax. Further, it can be drafted to maximize the basis step up, so that it applies to the assets that will have the most significant basis increase, and won't apply to the assets that have a built-in tax loss.

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Basis planning should be a consideration in the review of any estate plan. For clients with low-basis assets who have elderly parents or grandparents with limited wealth, the use of trusts and formula general powers of appointment may allow for an increase in the income tax basis of the assets while the client is alive.

Example: Assume the spouses in the example on page 9 have an elderly relative ("Senior") with an estate below the federal exemption amount. The spouses then gift the stock into a trust for the benefit of their descendants and Senior. The terms of the trust would grant Senior a formula general power of appointment over the assets of the trust, so that when Senior dies, the amount of stock held by the trust with a value up to Senior's remaining estate tax exemption will be included in Senior's estate. This triggers a new income tax basis on that portion of stock that is included in Senior's estate and resets the basis of that stock to the then fair market value, even if Senior does not exercise the power of appointment. Therefore, Senior's death enables the trustee to subsequently sell the stock without a gain, and then diversify the portfolio in the trust for the benefit of the spouses' descendants.

In sum, attorneys and clients should review their existing estate plan documents, including their basic wills and revocable trusts, to determine whether updates should be made to ease a future income tax burden. Trusts may be used as part of an overall estate plan to provide asset protection, estate tax and income tax savings. Nevada is a leading jurisdiction for basis-bumping and trust planning.

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