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Income Tax Basis in Estate Planning: Maximizing Advanced Techniques to Avoid Income Tax on Inherited Assets

Implementing Double Basis and Estate Trust Strategies; Overcoming Basis Issues With Gifting and the GST

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Implementing Double Basis and Estate Trust Strategies; Overcoming Basis Issues With Gifting and the GST

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Outline of Topics

- Introduction
- Portability of estate tax exemption and focus on income tax reduction
- Income-shifting strategies
- “Spray” or “Sprinkle” trusts
- “A-B” Trusts, QTIP Trusts, and GPA Trusts
- Other basis preservation trusts
- Potential benefits of Family Limited Partnerships
  - Valuation discounts
  - But with risk of basis reduction
- IRC Section 2038 compliant trusts
- GST issues

Introduction

- **Pre-2012 Planning**
  - Make use of the unified credit during life
    - Remove assets and appreciation from the taxpayer's estate
    - Gift tax is more efficient than estate tax because it is tax exclusive
  - In 2009, taxes on estates were higher than potential income taxes
    - The applicable exclusion amount was $3,500,000 and the estate tax rate was 45%
    - Compare the federal long-term capital gains tax rate of 15%, and highest state income tax rate of 11% (Hawaii and Oregon)
- **Post-2012 Planning**
  - Focus has turned to planning estates to minimize income taxes and maximize basis
    - American Taxpayer Relief Act of 2012 (ATRA) permanently increased the applicable exclusion amount to $5 million, indexed for inflation, and set the maximum estate tax rate at 40%
    - 3.8% Medicare Net Investment Income Tax was enacted under the Health Care and Education Reconciliation Act of 2010, which amended the Patient Protection and Affordable Care Act
  - Federal long-term capital gains tax rates increased to 20%, highest federal income tax rates increased to 39.6% and state income tax rates have reached a maximum of 13.3%

Portability – Basics

- Adopted in 2010 and made permanent by ATRA in 2012
- Portability allows a decedent's unused exclusion amount ("DSUE amount") to be used by a surviving spouse
  - Election made by executor on timely filed Form 706
  - If Form 706 being filed only to elect portability, asset valuation requirements are reduced
  - Surviving spouse may use DSUE amount at time after decedent's death, and will be applied before spouse's exemption is used
  - If not used during the surviving spouse's lifetime, DSUE amount used at subsequent death
  - Consider application with respect to multiple marriages

Portability – Must Be Considered

- Considering that less than 1% of decedents will have taxable estates, the use of portability cannot be ignored by planners
  - Transfer tax legislation is now permanent
  - Exemptions are at highest historic level, and increasing with inflation
  - For the vast majority of taxpayers, estate tax avoidance is going to be less important than income tax basis step up at decedent's death and again at surviving spouse's death
- The alternative to using portability is to use the more traditional "credit shelter" trust

Portability – Factors to Consider

- Whether the use of portability is appropriate in a specific situation will depend on a number of factors. For example:
  - The clients' ages
  - Current asset values
  - Potential for asset growth vs. consumption needs
  - State estate taxes, state income taxes and state portability provisions
  - Nature of client relationship (2nd marriage, blended family, etc.)
- The decision is not necessarily trust planning vs. non-trust planning, because QTIP marital trusts can be used with portability

Portability – Benefits

- For many clients, using portability may offer a number of benefits:
  - Simplicity
  - Double step up in income tax basis
  - Avoid market declines or other "wasting" of credit shelter trust
  - Defer state death tax
  - Avoids necessity of equalizing assets before first (poorer) spouse dies
  - Avoids higher trust income tax rates applicable to credit shelter trust
  - Special assets (IRAs, qualified plans, deferred compensation) may get better income tax treatment if left outright to surviving spouse (e.g., avoid erosion of credit shelter trust by tax on IRD)

Portability – Benefits (cont’d)

- Portability is particularly attractive if the surviving spouse is willing to use the DSUE amount just after the decedent’s death
  - The surviving spouse could create an irrevocable grantor trust using the DSUE amount
  - The appreciation in the trust will escape estate tax at the spouse’s subsequent death, just like a credit shelter trust would have
  - But, the rate of appreciation should be greater in the new grantor trust because the surviving spouse will pay the trust’s income tax liability

Portability – Disadvantages

- There are a number of complexities and disadvantages associated with portability:
  - GST exemption is not portable
  - Although transfer tax exemptions are indexed for inflation, DSUE amount is fixed
  - Generally, state death tax exemptions are not portable
  - Loss of creditor protection if outright transfer to surviving spouse
  - DSUE amount can be lost if surviving spouse remarries
  - Tax apportionment under §2207A in blended family
- QTIP trust planning may resolve some of these problems

Portability – Particular Problems of Outright Bequests to Spouse

- Using trusts, including credit shelter trusts, QTIP trusts, or a combination of those trusts, can avoid the following problems:
  - Loss of control over disposition of assets at spouse's death
  - Loss of creditor protection and protection from commingling with new spouse
  - May increase state estate taxes at death of surviving spouse
  - No ability to "spray" income to other beneficiaries
  - Loss of GST exemption
  - Loss of DSUE amount in case of simultaneous death

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Issues with Trust Income: Net Investment Income Tax

- 3.8% Medicare Tax on Net Investment Income (IRC Sec. 1411)
  - Net Investment Income:
    - gross income from interest, dividends, annuities, royalties, and rents, unless derived in the ordinary course of an active trade or business
    - net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business (unless it's a passive trade or business)
  - Excludes:
    - interest on state and local bonds
    - gain from the sale of a principal residence
    - wages, unemployment compensation, Alaska Permanent Fund Dividends, alimony, and Social Security benefits

Net Investment Income Tax - Application

- Application to Individuals
  - 3.8% tax is imposed against the lesser of
    - NII; or
    - The excess of:
      - Modified adjusted gross income for such taxable year, over
        - The "threshold amount"
          - $200,000 for individual taxpayers
          - $250,000 for joint taxpayers, and
          - $125,000 for married taxpayers filing separately
- Application to Trusts
  - 3.8% tax is imposed against the lesser of
    - The trust's undistributed NII; or
    - The excess of:
      - The trust's AGI , over
      - The dollar amount at which the highest trust income tax bracket begins ($12,300 for 2015)

Eliminating or Reducing NII Tax

- Strategies for Reducing or Eliminating NII Tax
  - Distribute assets that generate NII from the trust to individual beneficiaries whose income does not meet the threshold and will not incur the tax
  - Convert taxable income to tax-free income where possible in order to reduce NII
  - Convert passive trade or business to active trade or business
    - Profits from a trade or business are passive if the taxpayer does not materially participate
    - Frank Aragona Trust (2014) (Tax Court held that trust materially participated when three of six co-trustees were employees of the company) and Mattie K. Carter Trust (2003) (consider the activities of the fiduciaries, employees and agents in determining material participation)
    - But compare TAM 201317010 – IRS states that only the trustee's activities are important to the determination of material participation

Income Shifting - Generally

- Lower the overall income tax burden on the taxpayer and the taxpayer's family by shifting the income from the taxpayer to other persons or entities
- Common Non-Trust Strategies
  - Transmutation to give lower income spouse income producing assets as separate property
  - Interest-free or below-market loans
  - Sale and lease-back
  - Family limited partnerships
  - Employing family members
  - Annuities
  - Outright gifts to children – beware the "kiddie tax"

Income Shifting With Trusts

- Distribution provisions to decrease the income tax on trust income (discussed below)
  - Distributions to beneficiaries at lower income tax rates
  - Exercise of lifetime or testamentary limited powers of appointment
  - Delaware Tax Trap
  - Beneficiary defective trusts
  - Decanting to a new jurisdiction
  - DINGs, WINGs and NINGs
- Turn on or off grantor trust status

Income-Shifting: Moving Trust Income to Low or No Tax State

- Create trust in low or not tax jurisdiction
- Move the trust to the low/no tax jurisdiction by changing the trustee
- Decant the trust to a new trust in the new jurisdiction
  - No state tax states: Florida, Wyoming, Texas, South Dakota, Alaska, Nevada and Washington
  - Low state tax states: Delaware does not tax income that is accumulated for nonresident beneficiary

DINGs, NINGs, WINGs

- Incomplete Gift Nongrantor Trusts
  - Established in DAPT state with no state income tax
  - Grantor is a permissible beneficiary, and a member of the distribution committee
  - Income and gains are taxed to the trust in the state of administration, not where the grantor resides
    - But see New York treatment of DINGs
    - California tax on resident noncontingent beneficiaries and fiduciaries

Basis Shifting

- Transfer low basis assets to individuals or entities to avoid or minimize capital gains and/or obtain new basis
  - IRC Section 1014
    - Basis of property acquired from a decedent is “stepped up” to the fair market value of the property on the decedent’s date of death
    - Basis of property can move up or down as a result of decedent’s death
    - Caution: Sec. 1014(e): No basis increase if transfer to decedent is made within one year of decedent’s death and the property reverts to the original donor (or the donor’s spouse)
  - IRC Section 1015
    - Basis of property acquired by gifts and transfers in trust
      - Generally, the basis of the property in the hands of the donee is the same as the basis was in the hands of the donor
      - If the donee sells the acquired property for a loss, the basis is the fair market value of the property on the date of the gift
      - If the donee sells the acquired property for a gain, the basis is the donor’s basis at the time of the gift

Basis Shifting – Common Methods

- Transfer low basis assets to senior family members with nontaxable estates in order to cause estate tax inclusion and increase tax basis
  - Outright gifts
  - Gifts in trust (discussed below)
    - Senior family members may possess or may be granted a general power of appointment over some or all of the trust assets in order to cause estate tax inclusion
      - Give a trust protector the ability to grant a general power of appointment or to convert a nongeneral power of appointment to a general power of appointment
      - Section 2041(b)(1), Section 2514(c): a general power of appointment can be exercisable solely in favor or creditors of the power holder's estate
      - Power holder need not know of the existence of a general power of appointment for the property subject to the power to be included in the estate of the deceased power holder (Freeman Estate v. Commissioner, 67 T.C. 202 (1976).
  - Distributions out of trust of low basis assets to senior family members, either outright or in further trust with limited GPAs

Basis Shifting – Common Methods (cont.)

- Transfer low basis assets to people with nontaxable estates in order to increase tax basis
  - Gift low basis assets to family members with substantial capital losses
  - Gift low basis assets to trusts that defer capital gains tax
    - Charitable Remainder Unitrust or Charitable Remainder Annuity Trust
  - Cause inclusion in grantor’s own estate of previously gifted assets
    - Ex. Grantor ceases to pay rent for use of residence previously gifted to QPRT, or for previously gifted artwork, retaining enjoyment and causing inclusion under Section 2036(a)(1)
    - Ex. Grantor is appointed as trustee of self-settled trust in non-DAPT state

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“Spray” Trusts

- If portability is used, the assets will be distributed outright to the surviving spouse or to a marital trust
- QTIP trusts and GPA marital trusts require the surviving spouse to be the sole beneficiary
- As a result, the income will be trapped in the trust or taxed to the spouse, in either case subjecting the income to higher brackets
- A “spray” trust can be used to reduce a family’s aggregate income tax burden
- This is done by allowing the trustee to make distributions not only to the spouse, but also to descendants and possibly charity

“Spray” Trusts – Benefits

- This could allow the trustee to “spray” the income among beneficiaries other than the spouse who are in lower tax brackets
- The beneficiary may be in a lower tax bracket or could reside in a state that has lower state and local tax rates
- Also, if a beneficiary’s income is below the threshold for the net investment income tax under §1411, that tax may be avoided on that distributed income
- The trustee can use the 65 day rule to make these distributions
  - If made within 65 days of the end of the calendar year, the distributions are deemed to be made in that year
  - Allows the trustee to make retroactive distribution decisions to get the most tax efficient result

“Spray” Trusts – Disadvantages

- To the extent distributions are not made, trusts are taxed at the highest tax bracket
- Including children and grandchildren as current beneficiaries can create sense of entitlement
  - Ascertainable standard
  - Fully discretionary standard
- Increased disclosures by trustee to multiple beneficiaries, possibly including accountings

Some Alternative Strategies for Married Couples

- Rely upon Portability
  - Pros
    - Simplicity
    - Maximum Control for Surviving Spouse
    - Maximum Basis Step-Up at Second Death
  - Cons
    - Impractical for Many Second Marriages
    - DSUE Does Not Adjust for Inflation
    - Lack of Control
    - Creditor Protection Lacking
    - No Protection Against a Possible “Step-Down” in Basis

Additional Alternative Strategies for Married Couples

- Traditional Credit Shelter Trust/QTIP Planning
  - Pros
    - Control Over Eventual Disposition
    - Sheltered Assets Appreciate Free of Transfer Tax
    - Creditor Protection
  - Cons
    - Some Degree of Control is Lost by Surviving Spouse
    - Some Additional Administrative Requirements
  - Altering basis in an existing Credit Shelter Trust

Other Basis Preservation Trusts

- Lifetime Grantor Trusts
  - Created by First Spouse
  - Created by Surviving Spouse using DSUE (discussed above)
- Swap low basis assets out of grantor trusts prior to grantor's death to cause inclusion in the grantor's estate
  - IRC Section 675(4)(C): the grantor will possess the power in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value (Rev. Rul. 2008-22)
  - Any transaction between the grantor and the IDGT will be disregarded for income tax purposes (Rev. Rul. 85-13 and PLR 9535026)
  - Grantor can swap a promissory note for the low basis assets in the IDGT
    - Unclear what the basis of the promissory note will be
    - Possible the basis will be the same as the swapped assets

Other Basis Preservation Trusts (cont.)

- Trusts Designed to Cause Inclusion in the Taxable Estates of Others
  - General Power of Appointment Trusts to Trigger Inclusion in:
      - The Estates of Successive Generations
      - Senior Generations with Non-Taxable Estates
  - Trusts with Termination Provisions
  - Issues:
    - Method for Granting a General Power:
      - Affirmative Grant of Power
      - Discretion of Third Party to Grant Power to Beneficiary
      - Grant by Formula
    - Dangers of Granting Power:
      - Need for Discrete Power Grants
      - Creditors

Other Basis Preservation Trusts (cont.)

- Joint Exempt Step-Up Trusts (“JEST”)
  - Can Allow Couples to Benefit from §1014(b)(6)
  - Dearth of Definitive Authority
- Section 2038 Compliant Marital Trusts (Discussed below)

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Potential Benefits of Family Limited Partnerships

- Family limited partnerships have been used in estate planning for a variety of purposes
  - Pros
    - Family can retain control over the assets
    - Investing assets as a block instead of individually gives families greater investment opportunities
    - FLPs can protect family assets from creditors (and spouses) obtaining an interest in them
    - Valuation discounts for lack of control and lack of marketability allow for transfer of more family assets at reduced transfer tax costs
  - Cons
    - For estate tax purposes, discounted value of partnership interest establishes the fair market value of the interest, and the basis
- Partnerships allow for transferring of basis from one partner to another, including a “mixing bowl” approach to basis switching

Family Limited Partnerships – Tools for Basis Transfers

- Section 754 Election:
  - Allows for adjustments to the inside basis of partnership assets and the shifting of basis from one partnership asset to another
  - Allows for the increase of the inside basis of the partnership following the sale or exchange of partnership interests or the death of a partner (Section 743) or when there is a distribution to a partner (Section 734)
- Caution: Mixing Bowl Rules - Generally contributions to and distributions from a partnership are non-recognition events, so partners can contribute assets to the partnership, retaining their same basis in the partnership as they held in the asset, and receive a distribution of a different asset that then acquires the same basis
  - But if contributed property is distributed to a different partner within 7 years of the date of contribution , the contributing partner recognizes a taxable gain or loss in the year of distribution (Section 704(c)(1)(B))
  - And if within 7 years of the contribution the contributing partner receives a distribution of property other than the property he/she contributed, the contributing partner must realize gain at the time of receipt of the property (Section 737)
- Caution: Disguised Sales (Section 707) – if the contributing partner receives a distribution of any other property or cash within 2 years of the contribution, then the distribution may be characterized as a “disguised sale” and cause gain recognition

Section 2038 Compliant Trusts

- Section 2038 Causes Inclusion in Grantor's Estate if the Grantor Retains a Power to Revoke (alter beneficial enjoyment)

- **Section 2038 Marital Trust**:
  - Grantor creates trust for benefit of Spouse
  - Gift complete for gift tax purposes (Spouse and Spouse's estate are only possible beneficiaries)
  - Transfer qualifies for the marital deduction under section 2523(b); 25.2523(a)-1; (b)-1.
  - Trust is a grantor trust during Grantor's lifetime
  - Section 2038 causes inclusion in Grantor's estate if Grantor predeceases Spouse

- **Section 2038 Generally (and in the Non-Marital Context)**:
  - Section 2038 is inapplicable if:
    - Consent of all interested parties is required
    - Power only held by a third party
    - The power is contingent upon an occurrence beyond decedent's control
    - The power is limited by an Ascertainable Standard
  - Possible Uses Include Addressing:
    - Trust holding assets that will have uncertain basis
    - Contingent events
    - Grantors who may become disabled

GST Tax Issues – Relevant Code Sections

- Practitioners do not often consider income tax basis adjustments in the context of the GST tax
- The basis of property included in a generation-skipping transfer (“GST”) is adjusted (but not above fair market value) for GST tax paid under §2654(a)
- If property is transferred in a taxable termination that occurs as a result of the death of an individual, the basis of the property is adjusted similarly to the adjustment under §1014(a)
  - If the inclusion ratio is less than one, any increase or decrease in basis is limited to a pro rata increase or decrease, as the case may be, according to the inclusion ratio.
- The basis of transferred property in all other cases is increased by an amount equal to the GST tax attributable to the value of the property in excess of the adjusted basis of the property

GST Tax Issues – Planning Points

- A non-exempt trust's assets will get a stepped-up basis at the death of the last non-skip beneficiary, but GST tax is payable even if the beneficiary has remaining exemption
- The better result, and may be applicable to exempt trusts as well, is to trigger estate tax inclusion if transfer tax will be avoided and step up in basis will be preserved (for a non-exempt trust) or obtained (for an exempt trust)
- This will depend on a number of factors:
  - Beneficiary's net worth
  - Beneficiary's remaining estate exemption
  - Beneficiary's state of residence

GST Tax Issues – Planning Points (cont'd)

- Consider the following to cause inclusion in a beneficiary's estate for estate tax purposes
  - Trustee's discretionary authority to make distributions
  - Power to grant or modify general power of appointment
  - Contingent general power of appointment
  - Triggering the "Delaware Tax Trap"