The New Emphasis on Basis in Estate Planning

By: George L. Schoenbeck, Sosin & Arnold, Ltd.

For decades estate tax minimization and reduction strategies dominated the tax focus of most estate plans for people with moderate to high wealth. Now, after the passage of the American Taxpayer Relief Act of 2012 (the "ATRA") at the beginning of 2013, the vast majority of well-structured estate plans balance estate tax considerations, where relevant, with long-term income tax minimization goals and a variety of other estate planning considerations. Gone are the pre-ATRA days of cookie cutter estate plans designed to blindly utilize the federal estate tax exemptions of married couples to the greatest extent possible. Such plans, while successful at minimizing estate taxes, often resulted in unfavorable income tax consequences for the next generation and, in some cases, may have caused a person to transfer assets earlier than was desirable due to estate tax concerns. Under ATRA very few estates will become subject to estate taxes. And while estate taxes have become less concerning, income taxes have increased both in terms of rates and the breadth of transactions subject to such taxes. By removing the ominous cloud of estate taxes from the horizons of the lives of most Americans, ATRA has permitted individuals and their estate planners excellent opportunities and versatility in crafting their estate plans. In today's environment, planners must carefully balance each client's estate tax and income tax goals by considering such clients' succession goals, life plans and the tax characteristics of their assets.

The Estate Tax Landscape—Then and Now

The Internal Revenue Code gives each person a unified credit against estate and gift taxes which provides individuals with a certain amount of exempt assets they may transfer during life and at death free of such taxes (the "Basic Exclusion Amount").[1] The ATRA made permanent the previously temporary $5,000,000 Basic Exclusion Amount that was introduced in late 2010.[2] That law also indexed the Basic Exclusion Amount for inflation, which has increased it to $5,340,000 in 2014. Illinois has its own estate tax separate from the federal estate tax with a permanent (i.e. not indexed for inflation) exemption of $4,000,000[3]. The maximum federal estate tax rate is 40%. Contrast the estate tax landscape of today with 2001, when the maximum federal estate tax rate was 55% and the Basic Exclusion Amount was only $675,000.[4]

The Step-Up in Basis upon Death & the Rise of the Income Tax

A person who inherits property from a decedent generally will have a basis in that property equal to the property's fair market value as of the date of the decedent's death or, in certain circumstances, the date six months after the decedent's death.[5] This testamentary basis

[1] Pub.L. No. 112–240 (2013); 26 U.S.C. § 2010(c)
[2] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub L No. 111-312 (2010).
[3] 35 ILCS 405/2(b)
[4] *See* http://www.heritage.org/research/reports/2004/01/estate-taxes-an-historical-perspective
[5] 26 U.S.C. § 1014

adjustment is known as the "step-up" in basis. Contrast this favorable provision with the basis rules for lifetime transfers. The recipient of a lifetime gift of appreciated property takes the basis of the donor for purposes of calculating gain while the recipient of a lifetime gift of depreciated property takes the property's fair market value as its basis for purposes of determining a loss.[6] Thus, for income tax purposes, it is almost always better to receive a testamentary, rather than lifetime, gift of property.

The value of the step-up in basis has increased in recent years as income taxes have increased. In the past three years, the highest federal income tax bracket increased to 39.6%, the highest federal long-term capital gain bracket increased to 20% and the highest federal qualified dividend rate increased to 20%. We have also seen the introduction of a new 3.8% Medicare surtax on net investment income.[7] Meanwhile, Illinois' income tax rate increased to 5%.[8] State politicians have discussed either making that rate permanent or instituting a progressive tax structure.[9] Indeed, while estate taxes have drifted out of the sphere of concern for most individuals due to high exemption amounts, income taxes have become more concerning.

Pre-ATRA Planning

Prior to the ATRA, estate plans commonly sought to maximize the use of each spouse's Basic Exclusion Amount by diverting all of the assets of the first spouse to die, up to the decedent's remaining Basic Exclusion Amount, to a credit shelter trust and the remainder to a marital trust for the survivor. The credit shelter trust was structured in such a manner that excluded it from the estate of the survivor. The marital trust was structured in such a manner so as to include it in the estate of the survivor. All such funds in excess of the Basic Exclusion Amount would pass to the marital trust (or outright to the spouse) free of estate tax pursuant to the estate tax marital deduction, which is unlimited.[10] The intent of this strategy was to maximize the use of the Basic Exclusion Amounts of both spouses to the greatest extent possible and defer any estate taxes to the death of the second spouse. The strategy works well from an estate tax perspective.

However, from an income tax perspective, it has the propensity to reduce the number of step-ups in basis the couple's assets receive. By excluding the credit shelter trust from the estate of the survivor, the assets in that trust receive only one step-up in basis—upon the death of the first to die—before they are transferred to the next generation. They do not receive a second step-up in basis upon the death of the survivor. This drawback was largely irrelevant for many years because the estate tax savings heavily outweighed the benefits of obtaining a second step-up in basis in most cases. In fact, estate planners often encouraged clients with assets that could appreciate significantly to transfer such assets to their beneficiaries during life regardless of the basis consequences. This practice gave rise to the phrase "when in doubt, transfer out." Despite the catchiness of that saying, with the high estate tax thresholds of the post-ATRA world, income taxes have become the more important tax consideration in structuring most estate plans.

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[6] 26 U.S.C. § 1015
[7] Lee, Paul. Meet me at the Intersection of Estate & Income Tax (Planning for the ATRA-Math), March, 2014.
[8] 35 ILCS 5/201
[9] *See* www.sj-r.com/article/20140325/News/140329582
[10] 26 U.S.C. § 2056 (a)

A Hypothetical Illustration

Assume John Smith dies on May 1, 2014 with an estate plan designed to fund a credit shelter trust up the Basic Exclusion Amount. His gross estate is valued at $1,500,000. Part of his gross estate consists of a parcel of real estate known as Blackacre. John's basis in Blackacre is $500,000 and the parcel's value at John's date of death is $1,000,000. His credit shelter trust will have a basis of $1,000,000 in Blackacre. The credit shelter trust supports John's wife, Jane, until her death in 2024, when she dies with a gross estate of $500,000. At that point, the credit shelter trust distributes its assets to the children of John and Jane. In 2024 Blackacre has a fair market value of $2,000,000. However, the children will inherit the credit shelter trust's basis in the property of $1,000,000 and will not get a second step-up in basis upon the death of Jane.

The family of John and Jane will unnecessarily have $1,000,000 of built-in capital gains waiting for them when they sell Blackacre because John and Jane relied on an estate plan focused exclusively on estate tax minimization. Note that the strategy yielded no estate tax benefits for the couple whatsoever because their combined estates were under the Illinois and federal taxable thresholds. Contrast this result with an alternative where John's trust uses a formula that funds the marital trust first and then utilizes the credit shelter trust only if his estate is taxable. All of John's $1,500,000 estate will fund his marital trust. The marital trust will be included in Jane's estate. The couple will pay no estate taxes and the children of John and Jane will have a basis in Blackacre of $2,000,000 after they inherit it from their parents.

Today's Tax Considerations in Estate Planning

Estate planning now involves a careful balance of income tax and estate tax considerations. Instead of employing one size fits all plans that sweepingly transfer all of a decedent's assets into a credit shelter trust up to the Basic Exclusion Amount, prudent planners now look to more carefully craft their clients' plans in manners that appropriately balance each client's unique estate tax, income tax and other estate planning goals. For individuals with gross estates currently under state and federal taxable thresholds, careful planners implement strategies that contemplate a double step-up in basis, but which give the survivor or fiduciaries alternatives in amending the plan after the death of the first spouse in order to address possible changes in the estate tax laws or unanticipated increases in the wealth of the survivor. For individuals with estates in excess of the Basic Exclusion Amount, the considerations involve a careful analysis of the person's assets and the family's goals for those assets to minimize the combined estate and income taxes to which the assets may be exposed. Plans for such individuals should also take into account lifetime gifting strategies, sales of assets to irrevocable trusts, family limited partnerships and other strategies, the appropriateness of which will vary from person to person.