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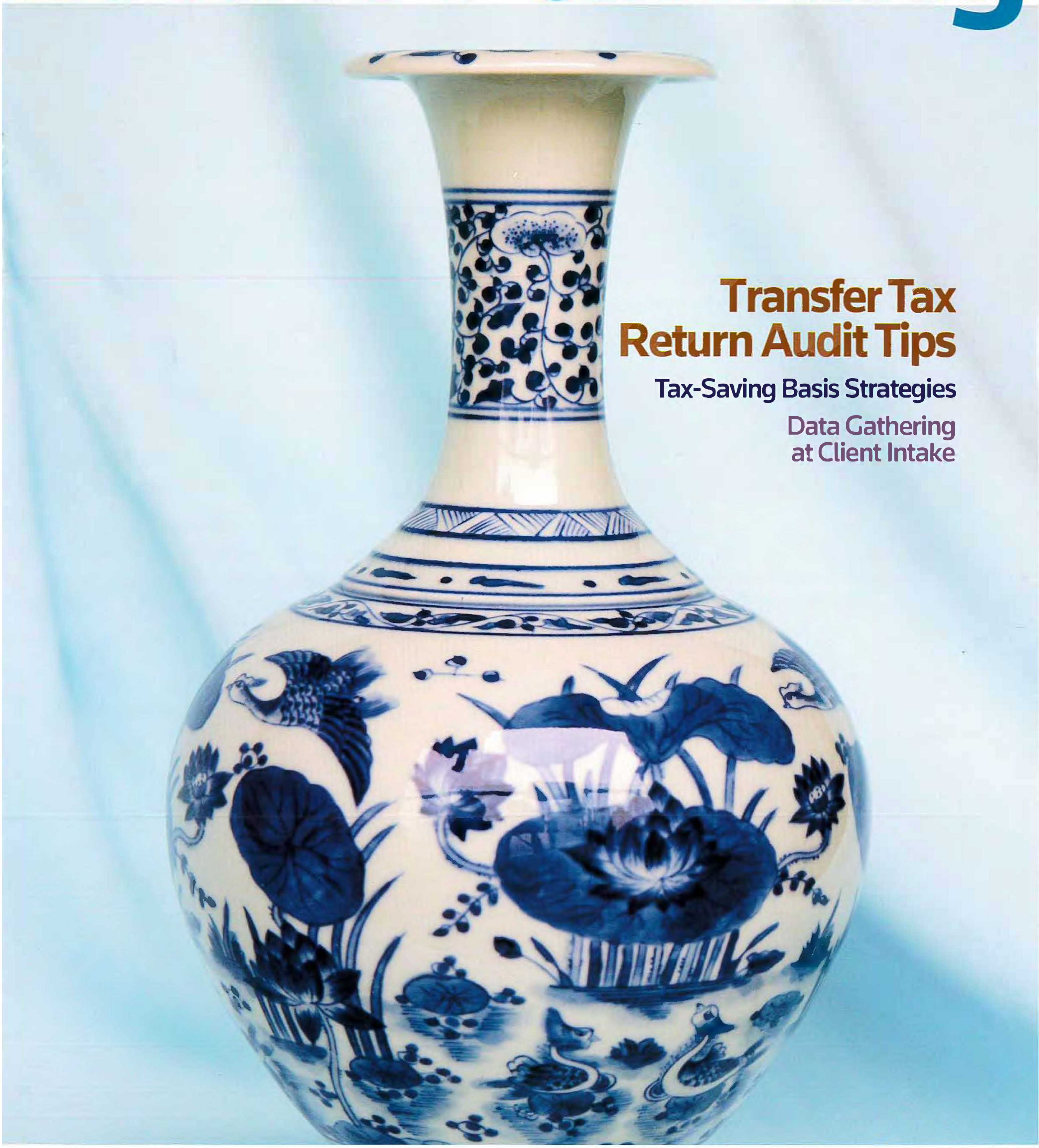

Transfer Tax Return Audit Tips

Tax-Saving Basis Strategies

Data Gathering at Client Intake

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Basis Basics and Beyond: Strategies for Estate Planners

Well-chosen titling of property and gift arrangements can make use of the tax basis rules to produce family income tax savings.

DAVID R. YORK AND ERIC B. WHITING

Although much time and attention is devoted to transfer taxes by estate planning practitioners, the reality is that these taxes affect only a sliver of the population. The Joint Committee on Taxation estimated that in 2016 only about two in 1,000 estates were subject to the federal estate tax, or about 0.2% of all decedents.[1] By contrast, the Congressional Budget Office estimates that 70% of families own property designated as capital assets (i.e., residences, other real estate, privately owned businesses, stocks, bonds, and mutual funds) with a combined value of $50 trillion.[2] With the increased applicable exclusion amount resulting in fewer and fewer taxable estates, basis planning has become increasingly important for estate planners, especially in light of state income taxes, the current Medicare surtax, and the potential for eliminating both the estate tax and step-up in basis for larger estates. This article first summarizes the basic elements and rules regarding basis in capital assets and the second half reviews ten ideas that estate planning practitioners can use as they advise their clients.

Basis basics

Basis is generally the owner's capital investment in property for tax purposes. In most situations, the basis of an asset is its cost to acquire. The cost is the amount paid for it in cash, debt obligations, and other property or services. Cost includes sales tax and other expenses connected with the purchase. With respect to stocks or bonds, basis is the purchase price plus any additional costs such as commissions and recording or transfer fees.

Certain events that occur during the period of ownership may increase or decrease basis, which results in "adjusted basis."[3] Basis is increased in property by items such as the cost of improvements that add to the value of the property, and decreased by items such as allowable depreciation and insurance reimbursements for casualty and theft losses.

Basis and gifting

To figure the basis of property received as a gift, a practitioner must know the adjusted basis to the donor just before it was gifted, the fair market value of the property at the time it was gifted, and any gift tax paid as a result of the gift.[4] If the fair market value of the property at the time of the gift is less than the donor's adjusted basis, then basis depends on whether the donee ultimately has a gain or a

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loss when he or she disposes of the property:

- Basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustment to basis while the donee held the property.
- Basis for figuring loss is the property's fair market value when the donee received the gift plus or minus any required adjustment to basis while the donee held the property.
- If the donee uses the donor's adjusted basis for figuring a gain and ends up getting a loss, and then uses the fair market value for figuring a loss and has a gain, the donee has neither gain nor loss on the sale or disposition of the property. In other words, no gain or loss is recognized if a donee disposes of property at a price between the donor's adjusted basis and the fair market value of the property at the time of the gift.

If the fair market value of the property is equal to or greater than the donor's adjusted basis, then the donee's basis is the donor's adjusted basis at the time of the gift. Basis is increased by all or part of any gift tax paid, depending on the date of the gift.

The basis of property inherited from a decedent is generally one of the following:

1. The fair market value of the property at the date of the individual's death or the alternate valuation date if the personal representative for the estate chooses to use alternate valuation.
2. The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.
3. If a federal estate tax return does not have to be filed, the donee's basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

The following assets do not receive an adjustment to basis at death:

- Property representing income in respect of a decedent (such as retirement plan assets or a promissory note).
- Gifts made more than three years before death.
- Assets in an irrevocable trust that are excluded from the decedent's estate for estate tax purposes.

Consistency in reporting basis

On 7/31/2015, President Obama signed H.R. 3236, Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41), into law. H.R. 3236, section 2004 enacted new IRC Sections 1014(f) and 6035. Section 1014(f) provides rules requiring that the basis of certain property acquired from a decedent, as determined under Section 1014, may not exceed the value of that property as finally determined for federal estate tax purposes, or if not finally determined, the value of that property as reported on a statement made under Section 6035. Section 6035 requires that the executor of the estate report to both the IRS and the beneficiary the value of property included on a required federal estate tax return. Section 6035(a)(1) provides that the executor of any estate required to file a return under Section 6018(a) must furnish, both to the IRS and to the person acquiring any interest in property included in the estate, a statement identifying the value of each interest in the property as reported on the return and any other information as the IRS may prescribe.

Community property

In community property states (i.e., Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), married individuals are each usually considered to own an undivided one-half interest in the community property. When either spouse dies, the total value of the community property, even the part belonging to the surviving spouse, generally becomes the basis of the entire property.[5] For this rule to apply, at least half the value of the community property interest must be includable in the decedent's gross estate, whether or not the estate must file a return.

Example. Adam and Amanda, a married couple, owned community property that had a basis of $80,000. When Adam died, half the fair market value of the community interest was includable in his estate. The fair market value of the community interest was $100,000. The basis of Amanda's half of the property after the death of her spouse is $50,000 (half of the $100,000 fair market value). The basis of the other half to Adam's heirs is also $50,000.

Portability

The concept informally known as "portability" is now permanent as a result of the enactment of the American Taxpayer Relief Act of 2012. Portability allows a surviv-

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[1] Joint Committee on Taxation, "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System," 3/16/2015, available at www.jct.gov/publications.html?func=startdown&id=4744.

[2] Congressional Budget Office Report, "The Distribution of Asset Holdings and Capital Gains," 8/4/2016.

[3] Section 1011.

[4] Section 1015.

[5] Section 1014(b)(6).

ing spouse to use a deceased spouse's unused (estate tax) exclusion (DSUE). This effectively allows a married couple to fairly easily double the amount that can be passed without paying estate tax by allowing a surviving spouse to fully use both his or her own applicable exclusion amount and that of the deceased spouse. In order for the surviving spouse to be able to use the DSUE amount, the executor of the first-to-die's estate must make an election on a timely-filed Form 706 estate tax return. Portability applies to only unused estate and gift tax exemption and not to GST exemption.

EXHIBIT 1
Advantage of a Marital Step-Up Trust

	No Planning	Traditional Estate Plan	Marital Step-Up Trust
Asset Protection	None	Yes	Yes
Avoids Probate	No	Yes	Yes
Federal Estate Tax Return Required for Portability	Yes, but no formal valuations required	Yes, but formal valuations required	Yes, but no formal valuations required
Full Step Up in Basis at Second Death	Yes	No	Yes
Income Tax Reporting Requirements	No additional requirements	Yes, taxed as a complex trust	Taxed as a simple trust

Basis planning considerations

With that as a summary overview of basis and related matters that affect basis planning, below are ten basis planning considerations for estate planning attorneys to review with clients in today's tax environment.

Idea #1: Do not step-down. Although we typically refer to basis adjustment as a "step-up in basis," the reality is that basis adjusts at death to the fair market value as of date of death. If a client has assets with built-in losses, consider recommending that the client sell the assets and take advantage of the losses during his or her lifetime. If the client wants to keep an asset with a built-in loss because the client thinks that the asset might rebound and appreciate in the future, consider recommending that the client make a gift of the asset during lifetime. In that situation, the lifetime gift would preserve the potential of taking advantage of the original tax basis if the asset later appreciates in the future.

For example, assume Barbara has stock with a basis of $100,000 and a fair market value of $10,000. She wants to leave the stock to her child. If Barbara were to die while the stock is worth $10,000, the stock's basis would step down to $10,000, and the child would be subject to taxable gain if the stock were subsequently sold for any amount over $10,000. If, on the other hand, Barbara gifts the stock to the child during life, the value of the gift would only be $10,000, but the child could still sell the stock in the future for anywhere between $10,000 and $100,000 at no gain and would be subject to gain only if the stock were sold for more than $100,000.

Idea #2: Reverse gifting. This strategy involves transferring assets to someone whose current assets would not subject him or her to federal estate tax. This could be done in one of two ways. First, a person could use his or her annual exclusion gifts (or even partially use his or her unified tax credit) to make gifts to individuals, such as parents who are below the estate tax exemption, who could then return those assets on death.

Care needs to be taken when determining who to make the recipient of these gifts, as any gifts would be subject to potential creditor claims of the donee. Also, the donee would need to have the unlimited right to leave assets on death as the donee chooses. Furthermore, if someone transfers property to a third party and then reacquires that property as an inheritance from the third party within a year, the Code disallows any basis adjustment, and instead the basis is carried over as if the transfer occurred prior to death.[6]

The second option is to consider creating a power of appointment support trust (POAST), in which a client creates an irrevocable trust and either sells or gifts assets to it. The trust provides that a third party (such as a modest-wealth parent) is a beneficiary and has a general power of appointment on death. The general power of appointment will cause the portion of the trust assets subject to the power of appointment to be included in the third-party's estate, and the assets receive a step-up in basis.[7] Again, care should be taken on who is given the power, as the third party

[6] Section 1014(e).
[7] Sections 2041(a)(2) and 1014(b)(9).
[8] Section 2010(c)(5)(A).

would have ability to exercise the power in any manner he or she chooses and a general power would be subject to potential creditor claims.

*Idea #3: **Surviving spouse tax planning.*** This strategy involves using portability to maximize step-up in basis on the death of both spouses. A host of different ways are available to accomplish this type of planning. The simplest option is to do an outright transfer to the surviving spouse on the death of the first spouse followed by a portability election. This option requires timely filing a Form 706 estate tax return.[8] As with outright gifts, this option does not provide any asset protection, and the assets potentially could be redirected by the surviving spouse.

An alternative to an outright distribution is to reverse the traditional credit shelter trust structure and instead direct all of the assets to a marital trust. The surviving spouse should be given the ability to disclaim any assets at the death of the first spouse in case that made more sense under the laws at that time or if there was an asset that had potential for significant appreciation and there were future estate tax planning concerns. By directing the assets to the marital trust and not to the credit shelter trust, all of the assets will receive a step-up in basis on the surviving spouse's death. Portability would be elected on the first spouse's death to preserve the estate tax exemption of the first spouse. In addition to the second step-up in basis, the assets inside the martial trust, if properly drafted, would be protected from potential creditor claims of the surviving spouse and could create greater assurance as to where the assets end up at the death of the surviving spouse. (See Exhibit 1.)

*Idea #4: **Community property trust.*** As described above, when one spouse dies in a community property state and the decedent owned property jointly with a surviving spouse, both the decedent's interest in the property and the surviving spouse's interest in the property each receive a step-up in basis. Jointly owned property that is not subject to community property laws receives only a step-up in basis on the deceased spouse's one-half interest. Because the step-up in basis rules apply to "property held by the decedent and the surviving spouse under the community property laws *of any State*,"[9] taxpayers in non-community property states should consider establishing a community property trust to hold jointly owned property.

Alaska, Tennessee, and South Dakota allow couples to elect into their community property laws and establish a trust and treat the assets in the trust as community property. Upon the death of first spouse, all assets in the trust receive a step-up in basis. A full step-up in basis on the death of the first spouse could allow a surviving spouse to diversify low-basis assets tax-free or could also be used to increase basis and allow a surviving spouse to increase depreciation on income-producing real property. It is important to note that couples who set up these types of trusts are potentially changing the marital rights of the property contributed to a community property trust.

*Idea #5: **Section 754 election.*** When a partner of an entity taxed as a partnership dies, Section 754 allows a partnership to make an election to have the decedent's inside basis adjusted to equal the decedent's new stepped-up outside basis. The successor partner acquires a basis in the decedent's share of the underlying assets as if he or she had purchased an undivided interest in them at market values on the date of death. The inside basis step-up is limited to the decedent's "outside basis" step-up at death.

Only the estate and its successors-in-interest benefit from a postmortem Section 754 election—not the other partners. This inside basis increase allows the successor partner to recognize a smaller share of gain or a larger share of loss than the other partners when the partnership sells assets. The successor partner can also claim higher depreciation deductions than the other partners based on higher inside depreciable basis.

A 754 election can also cause a step-down in basis if the partnership assets are worth less than their tax basis on the date of the transfer. A partnership's electing to make a 754 election will cause inside basis adjustments at each subsequent partner's death, even if the other partners do not want that to occur in the future.

Idea #6: Gift IRD assets to charity at death. Many taxpayers elect to leave some portion of their assets to charity at death. Instead of waiting until death, first consider making gifts during lifetime to get both an income tax deduction and a reduction of the assets in the estate for estate tax purposes. To the extent a donation is made at death, the estate documents or beneficiary designations should direct that any charitable contributions come from assets that are treated as income in respect of a decedent. That way, low-basis assets can be given to the charity, which generally will not be subject to tax on the disposition of those assets, and high-basis assets can be used for noncharitable beneficiaries.

Idea #7: Use Section 2036. Under Section 2036, the value of the gross estate of a decedent includes the value of property transferred during the decedent's life to someone else if the decedent retained "for his life the possession or enjoyment of, or the right to the income from, the property, or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income."[10] In a whole host of cases, the IRS has argued that Section 2036 should be used to treat interests in family partnerships as being owned by parents and setting aside lifetime transfers to children and other decendents.[11] The IRS has used the following factors as indicia that possession or enjoyment was retained:[12]

Section 6035 requires that the executor of the estate report to both the IRS and the beneficiary the value of property included on a required federal estate tax return.

1. Transfer of the majority of the decedent's assets.
2. Continued occupation of transferred property.
3. Commingling of personal and entity assets.
4. Seeking assurances from a financial advisor that the decedent could withdraw assets.
5. Disproportionate distributions.
6. Use of entity funds for personal expenses.

A taxpayer whose estate's value falls below the estate tax exclusion amount and who has one or more of these factors should consider arguing that Section 2036 applies. In that case, all of the assets of the partnership would receive a full step-up in basis because the full value of the partnership would be included in the taxpayer's estate.

Idea #8: Give the trust protector the authority to grant a testamentary limited power of appointment to the settler. One factor that makes effective tax planning difficult is the need to make decisions in the present that are subsequently affected by future events. Changes in tax laws, asset values, and client objectives all affect the efficacy of tax planning. Accordingly, flexibility is always an important tool.

One way to give flexibility for clients who want to balance estate tax planning and income tax planning when using an irrevocable defective grantor trust is to grant a trust protector or some other trusted individual with the authority to give the grantor a power of appointment that could be exercised on the grantor's death. The power could be given by the trust protector if it is determined that estate inclusion is desired in order to allow for basis step-up. This strategy essentially allows the client to hedge his or her bets when establishing an irrevocable trust in case tax laws change or the values change and different tax objectives are desired.

9 Section 1014(c)(6) (emphasis added).

10 Section 2036(a).

11 See, e.g., Estate of Thompson, 382 F.3d 367, 94 AFTR2d 2004-5764 (CA-3, 2004); Estate of Reichardt, 114 TC 144 (2000); Estate of Thompson, TCM 2002-246; Estate of Harper, TCM 2002-121; and Estate of Schauerhamer, TCM 1997-242.

12 See *Id.*

13 Section 675(4)(c).

Idea #9: Swap high-basis assets for low-basis assets in an irrevocable trust. Even if a client does not want to cause an entire intentionally defective grantor trust (IDGT) situation, the client may still want to ensure that high-basis assets are in the trust on death because those assets will not receive a step-up in basis on death. This may be accomplished in three primary ways.

1. In most IDGTs, the grantor retains the ability to substitute assets of equivalent value. This power causes the trust to be taxed to the grantor for income tax purposes.[13] High-basis assets or assets with a built-in loss held by the grantor could be swapped with an equivalent value of low-basis assets held by the IDGT prior to the grantor's death to cause inclusion of the low-basis assets in the grantor's estate.
2. If no substitution power exists, the grantor could purchase low-basis assets from the IDGT in exchange for cash. If done at fair market value and while the trust is still a grantor trust, this should not trigger any gift or income tax.
3. Another option would be to distribute low-basis assets to a beneficiary to cause estate tax inclusion and basis step-up on the death of the beneficiary. This is likely the simplest solution but asset protection from the IDGT is lost, and it also includes the assets in the estate for estate tax purposes. The grantor (or other beneficiary with a limited life expectancy) would need to be a beneficiary in order to make an outright distribution.

Idea #10: Sale of business interest to an ESOP. Section 1042 provides that, if the ESOP sponsor is a C corporation, shareholders selling to the ESOP may elect to defer the recognition of gain on the sale if:

1. The ESOP owns at least 30% of the shares or value of the corporation following the sale.
2. The selling shareholder held the shares for at least three years prior to the sale.
3. The selling shareholder uses the sales proceeds to purchase qualified replacement property (QRP), which is defined generally as any security of a domestic operating corporation.

The gain would be deferred into the QRP and could continue to avoid recognition on the sale as long as the selling shareholder holds the QRP. Further, if the shareholder dies while holding the QRP, the QRP receives a stepped-up tax basis, meaning the gains realized on the sale to the ESOP may never be recognized.

Conclusion

By making use of strategies to increase the basis of assets owned by a decedent at death—and avoiding situations where basis would be decreased at death—clients can use income tax rules to better conserve family wealth. This income tax saving opportunity is likely to resonate well with even clients who are outside the reach of the federal estate tax due to the $5.49 million applicable exclusion amount. ■