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Two Income Tax Options for Estate Planning

(e.g.,Capital Gains and Depreciation Recapture at Death)

9-12-13 by James M. Kane, Attorney

Many families will pay no estate tax due to the inflation-adjusted $5.0 million estate exemption ($10 million for a married couple). [1] But, the tradeoff we face for this Congressional estate tax generosity is more exposure to costlier income tax for an estate.

The primary focus for this alert is to suggest two important, flexible, income tax options for married couples as part of their estate planning.

Flexibility in that each of the two options can be tweaked or even disclaimed when the first spouse dies. This provides extremely pliable, wait-and-see options for fine-tuning the income tax savings as necessary.

Individuals who may find themselves with potentially more income tax exposure hold low basis assets, such as family business interests, depreciable rental property, long-term investment holdings, etc.

Boiling down these two income tax planning options to their essence, they:

- Give a married couple two opportunities to get a stepped-up basis to the fullest extent possible when (i) the first spouse dies; and (ii) thereafter when the surviving spouse dies.

- Allow the surviving spouse to trigger defective grantor trust status for the surviving spouse's trust, if desired after the first spouse dies. This can provide the surviving spouse with the benefits of a trust, but with income tax savings by avoiding both the more-compressed income tax rates applicable to trusts and the 3.8% investment tax computed at the trust level.

The following example illustrates how income tax exposure can surface in a married couple's situation:

Example. Assume Bill and Jane own an interest in their family business, an LLC

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[1] As to estate tax for many married couples, the inflation-adjusted $5.0 million exemption from estate tax essentially enables a married couple to avoid estate tax if their combined estate is valued at $10 million or less at death. This eliminates a threat of 40% federal estate tax for the bulk of married households. [Georgia has no death tax; some other states have death taxes in the 15% range.]

(taxed as a partnership). The business is successful, was started from virtually scratch, and has a low cost basis of $300,000. The value of the company is now $8.0 million.

If Bill and Jane were to sell the LLC they will have a $7.7 million capital gain and possibly ordinary income recapture for certain depreciated assets. [2]

Assume a combined federal and state income tax, plus the 3.8% Medicare investment tax, of 40%. The income tax on this sale will be $3.0 million [40% income tax rate times the $7.7 million gain].

This example of income tax exposure for Bill and Jane is potentially severe as to the surviving spouse for his or her lifetime to the extent the surviving spouse needs to sell assets that do not get a stepped-up basis at the first-to-die spouse's death.

By contrast, Bill and Jane getting a stepped-up basis so as to eliminate the above low cost basis in the LLC and the threat of deprecation recapture fits with the following first option.

The Two Options

One, make sure as many assets as possible for a married couple get the stepped-up cost basis. The key notion here is that every dollar of unused estate tax exemption (particularly if unused by the surviving spouse) translates to a loss of potential income tax basis step-up.

This option gives the surviving spouse a **formula general power of appointment,** preferably with the consent of a non-adverse party. This ensures that the surviving spouse's otherwise unused estate exemption or DSUE exemption is applied to assets to obtain a stepped-up basis. In short, the surviving spouse is forcing estate inclusion in his own estate for estate tax purposes so that these inclusion assets get a stepped-up income tax cost basis.

This power is the subject of my previous email alert, dated July 26, 2013, available on my **chamberlainlaw.com** attorney web bio.

Two, the trust that will exist for the benefit of the surviving spouse (originating from the first-to-die spouse's estate planning) can be defective for income tax purposes. This helps reduce ongoing income tax. This requires, for example, a **15-day trust withdrawal right** for the surviving spouse that triggers the defective status at the time of the first spouse's death.

The above planning requires additional paperwork. I do not provide a detailed discussion of these options in this alert.

Understanding Stepped-Up Cost Basis

Cost basis deals with how gain is measured for income tax purposes when property is sold. If you buy stock shares for $300,000 and sell them for $500,000, you will have a $200,000 gain for income tax purposes [$500,000 selling price less the $300,000 cost basis].

[2] Most buyers will insist on purchasing the assets rather than the LLC member interest so as to allocate the purchase price to the assets rather than the LLC interest.

This same concept of measuring gain applies to a person who later sells property that she received as a beneficiary from an estate or as a recipient of a gift.

Assume a person has ABC Stock with a current FMV of $500,000 and is about to sell that stock. Assume the person earlier received this ABC Stock from her father's estate when he died. At the father's death the stock had a FMV of $300,000. The father paid $50,000 for this stock 20 years prior to his death.

Because the current owner (the daughter) received this ABC Stock as a result of her father's death (from her father's estate in this example), when she sells the stock the tax law allows her to use the same $300,000 FMV of the stock as existed on the date of her father's death for her cost basis. This is called the **stepped-up basis** to FMV at death.

The daughter will have a $200,000 gain for income tax purposes when she sells the stock she received from her father's estate. This is the $500,000 selling price less the $300,000 stepped-up cost basis.

By contrast, if the father just before his death gifted this $300,000 FMV stock to his daughter, the gift would be treated as a $300,000 FMV gift for gift tax purposes. But, for income tax purposes the daughter having received this stock as a gift from her father (prior to his death) will thereafter be limited to using the father's $50,000 carryover cost basis.

This means if the daughter sells the gifted stock for $500,000 (regardless of whether her father lives or dies before her sale of the stock), the daughter will have a $450,000 gain for income tax purposes [$500,000 less $50,000 carryover cost basis].

This carryover basis for gifted property compared to the more generous stepped-up basis for property at death often creates a strong disincentive for making lifetime gifts in certain situations.

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