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Assessing the Importance of Basis Step-Up Under the American Taxpayer Relief Act of 2012

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I. Narrowing the Gap

	2001	2012	2014
Exemption	675,000	$5,120,000	$5,340,000
Federal Estate Tax Rate	55%	35%	40%
Capital Gain Rate	15%	15%	20%
Health Care Surtax	0%	0%	3.8%
MA Income Tax Rate	5.6%	5.25%	5.2%

Combined Massachusetts and federal top marginal rate on capital gains: 28% (20% + 3.8% + 4.2%) (the effective MA rate when taking into account federal capital gains).

The big benefit to dying owning appreciated assets at death: basis step-up to date of death values under IRS Section 1014(a).

Why the big concern over basis step-up?

- Significant increase in the federal estate exemption
- Decline in the top marginal federal estate tax rate

- Increase in the capital gains rate and the introduction of the health care tax
- Portability

II. Planning to achieve basis step-up:

1. Give the trust beneficiary a general power of appointment.

Example: well-to-do client has impoverished parents. Clients could make a gift low basis assets into an intentionally defective grantor trust (IDIT) naming a parent along with the client's children as discretionary beneficiaries. The trust agreement gives the parent a very limited general power of appointment (e.g., limited to the creditors of the parent's estate). When parent dies not having exercised the power, the trust property will get a basis step-up then because it will be fully includible in the parent's taxable estate.

How can the power of appointment be structured?

- By formula: e.g., give the power holder the right to appoint such amount of property so as not to cause a federal estate tax in the power holder's estate
- Can power be given over specific low basis assets?
- Empower the trustee to grant a general power of appointment (similar to what is done for generation-skipping purposes)

2. Suppose the trust has low basis assets but no provision for a general power of appointment?

- Decant into a new trust [Kraft v. Morse, 466 Mass 92 (2013)]
- Enter into a non-judicial settlement (now permitted under the MUTC)

3. Portability - It was thought to make estate planning simpler, but with the convergence of the income tax planning objectives with estate tax planning objectives, it actually complicates estate planning.

Disadvantages of Portability

- No portability of GST exemption
- Portable amount is not adjusted for inflation
- Income and appreciation not sheltered by the deceased spouse's unused exclusion amount (DSUEA)
- Must file a timely estate tax return even if otherwise not needed
- If left outright to the spouse, the property will be subject to the creditors of the spouse
- The ability of the surviving spouse to divert funds away from the family.

Advantages

- Second basis step up can be achieved
- If the total of the two estates is under the exclusion amounts, then no estate tax results and yet significantly reduced capital gains tax can be obtained.

Portability with a QTIP Trust format vs. outright disposition to the surviving spouse

- Not subject to the reach of creditors
- Assures property goes where the first spouse wants it to go
- Reverse QTIP election assures use of GST exemption of the first spouse to die
- Property will still be includible in the surviving spouse's estate if no QTIP election is made so that second basis step-up can be obtained.

4. Even with portability, one may still want to split ownership of assets:

- E.g., if "poor" spouse dies first and even though there is portability, if most of the assets are appreciated, then putting some in the name of the poor spouse to get step up in basis so they can later be sold to support surviving spouse without significant capital gains tax consequences.

5. Avoiding IRC Section 1014(e): This Code section provides for no step up in basis of gifted assets to donee if donee dies within one year of the date of the gift and the assets are left to the donor/surviving spouse outright or in a QTIP type trust.

Solution: Have donee spouse leave the assets to a credit shelter trust. This is particularly good if both spouses are elderly because then no significant basis step up is lost on the death of the surviving spouse, assuming little appreciation between the death of the spouses.

Kite case: Donee spouse, as beneficiary of a QTIP trust, left the property to a QTIP for the donor/spouse. Held: IRC Section 1014(e) not applicable.

6. Gifting assets vs. holding assets. When does it make sense to hold onto assets to obtain a basis step up?

History: As we know, gifts are tax exclusive whereas property includible in the estate is tax inclusive. Example: client has $1.4M, gifts $1M, pays gift tax of $400,000 (assuming client has utilized his or her entire exclusion amount for prior gifts.

Contrast this with client retaining the $1.4M until death: The estate tax at 40% would be $560,000 netting the beneficiaries $840,000 where with the gift, the beneficiaries received $1M. In effect, this means that

the gift tax rate was $400,000 divided by $1.4M or 28.6% vs. the estate tax rate of 40%.

7. To determine the advisability of gifting vs. holding should be broken down into three components:

(1) Gifts utilizing annual exclusion, tuition and medical exclusions.

(2) Gifts utilizing the lifetime exemption.

(3) Taxable gifts.

(I). Analyzing Annual Exclusion, Tuition and Medical Exclusion Gifts, we should assume that the donor has assets equal to at least to the exclusion amount of $5,340,000.

- If assets are gifted: donee gets 100% of the gifted amount and 100% of the appreciation given the fact that there is no gift tax applicable to these types of gifts.
- If the assets have a zero basis: then donee will pay a 28% effective capital gain tax on all of what he or she has received and will net 72% on the gifted amount and 72% on the appreciation after the date of the gift.
- If no gift has been made: both the gifted amount and appreciation will be subject to an effective federal and Massachusetts combined estate tax rate of 49.6% leaving the donee 50.4%.
- Conclusion - net savings by making the gift: 72% minus 50.4% equals 21.6%. Beneficiaries net 21.6% more by utilizing the annual exclusion, tuition and medical exclusions.

(2) Gifts utilizing the full gift exemption amount of $5,340,000

Assume gift is made: donee gets 100% of the gift amount and 100% of the appreciation.

- If zero basis asset sold by donee, donee pays 28% capital gains tax and nets 72% on the asset and 72% on the appreciation.

If no gift made: donor has 100% of the asset and 100% of the appreciation in his or her estate.

- At death, 100% of the asset goes to the donee and 50.4% of the appreciation (we are talking about the appreciation on the $5,340,000 and assuming no increase in applicable exclusion amount.

Net result - comparing gift to no gift:

- Donee loses 28% of asset amount (100% minus 72%) with a gift and gains 21.6% on the appreciation amount (72% minues 50.4%) with a gift.
- How to determine the break even point: 21.6%E(x) = 28%E

E(x) - appreciation factor
E - asset factor

x equals 129%

129% appreciation on gifted assets makes the gift better than the hold strategy.

(3) Taxable Gifts - assume the donor lives at least three years after making taxable gifts.

Assume the taxpayer makes a gift: the tax exclusive gift nets 71.4% for the donee at a tax exclusive effective rate of 28.6% (see above).

When a gift is made and a tax is paid, the donee gets a basis step up on the gift tax paid amount, which represents 40% of the amount gifted.

60% of the gift (or 60% of the 71.4% net left after the payment of the gift tax) is subject to a capital gains tax of 28%, or a tax of 11.9%, leaving the donee 59.5% (71.4%-11.9%) of the asset gift amount.

There will be no basis step up on appreciation, so 71.4% of it will be subject to 28% capital gains tax netting 51.4% on the appreciation amount.

Assume no gift is made - donor has 100% of the assets and 100% of the appreciation: donee receives 50.4% of both (after estate tax of 49.6%).

Comparison:

	Gift made	No gift made	Result
Asset Amount Left	59.5% -	50.4% =	9.1%
Appreciation Amount Left	51.4% -	50.4% =	1%

This indicates that it is always better for a Massachusetts resident to make a gift when the property gifted had a zero basis.

If donor had a full basis, then the calculation would show that it would be better for a Massachusetts resident to make a gift, as well.

> The results will vary state to state. Mitchell A. Drossman at U.S. Trust has done an analysis showing the comparison between gifting and not gifting for a Massachusetts vs. a Florida resident.

Net left to donee:

	Gift	No Gift
Massachusetts	741,830	655,200
Florida	741,830	780,000

8. If the gap has narrowed but has not closed, what can the wealthier client do to have his cake and eat it too? In an article written in the July issue of *Trusts and Estates* by J.D. Waxenberg and Nathan R. Brown entitled "The Narrowing Tax Efficiency Gap", the authors have proposed planning in the same manner as before: set up an intentionally defective income trust (IDIT) make gifts of assets to it and shortly before the death of the donor, substitute appreciated assets in it for high basis assets of the donor.

As an alternative, if the donor does not have sufficient funds or high basis assets, the donor could borrow from a third-party lender and the estate could repay the loan after death.

Transporting into the article the figures for the Massachusetts estate and income tax, the narrowing gap would look as follows:

Massachusetts Considerations
$10 Million Gift, $2 Million cost basis

Scenerio A:	Stock Owned at Death in 2033
Federal Exemption Amount in 2033	$8.95 million
State Exemption Amount in 2033	$1 million
Federal Estate Tax Rate	40%
State Estate Tax Rate	16%
Federal Estate Tax Paid	$13,433,280
State Estate Tax Paid	$7,466,800
Beneficiary's Basis in Stock	$50 million
Capital Gains Rate	20%
Net Investment Income (NIIT)	3.80%
Massachusetts Income Tax Rate	5.2%
Effective Rate	28.00%
Gain on Pre-Death Appreciation	($50 million - $50 million) x .28 = $0
Total Taxes Paid	$20,900,080 + $0 = $20,900,080

Scenerio B:	Gift of Stock in 2014, dies in 2033 with $25 Million, sale of stock by donee in 2033
Federal Exemption Amount in 2033	$8.95 million
State Exemption Amount in 2033	$1 million
Federal Estate Tax Rate	40%
State Estate Tax Rate	16%
Federal Gift Tax Rate	40%
Federal Gift Tax Paid	$10 million - $5.34 million = $4,660,000 x .40 = $1.864 million
Trust Basis in Stock	$2 million + ($1,864,000 x 80%) = $3,491,200
Capital Gains Rate	20%
Net Investment Income (NIIT)	3.80%
Massachusetts Income Tax Rate	5.20%
Effective Rate	28.00%
Capital Gain Tax on Pre-Death Appreciation	($25 million - $3,491,200) x .28 = $6,022,464
Federal Estate Tax Paid	$7,169,280
State Estate Tax Paid	$3,466,800
Total Taxes Paid	$10,636,080 + $1,864,000 + $6,022,464 = $18,522,544

Scenerio C:	Gift of Stock in 2014 with Post-Gift Asset Exchange in 2033
Federal Exemption Amount in 2033	$8.95 million
State Exemption Amount in 2033	$1 million
Federal Estate Tax Rate	40%
State Estate Tax Rate	16%
Federal Gift Tax Rate	40%
Federal Gift Tax Paid	$10 million - $5.34 million = $4,660,000 x .40 = $1.864 million
Trust Basis in Assets after Exchange	$25 million
Capital Gains Rate	20%
Net Investment Income (NIIT)	3.80%
Massachusetts Income Tax Rate	5.20%
Effective Rate	28.00%
Capital Gain TAx on Pre-Death Appreciation	($25 million - $25 million) x .28 = $0
Federal Estate Tax Paid	$7,169,280
State Estate Tax Paid	$3,466,800
Total Taxes Paid	$10,636,080 + $1,864,000 = $12,500,080

Assumptions:

Individual domiciled in Massachusetts has $35 Million, $10 Million of which is highly appreciated stock with a $2 Million cost basis, and $25 Million in cash. Stock appreciates to $25 Milliion in 2033. Time value for loss of monies to pay gift tax in Scenerio B not taken into account. Earnings on cash retained is assumed to be consumed over donor's lifetime.

9.

	2001	2014	2014 (gift of art)
Federal and Massachusetts Effective Estate Tax Rate	62%	49.6%	49.6%
Capital Gains Tax Rate	15%	28%	35.8%
	47%	21.6%	13.8%

The above illustrates the effect that different asset classes may have on the tax efficiency gap.

Paul Lee of Bernstein Global Wealth Management has put together the following chart which clearly indicates the difference different assets have on the tax efficiency gap. In other words, some assets benefit more than others from basis step up:

Copyrights, trademarks, patents and art work of artists	0 basis & taxed as ordinary income
Negative basis commercial real property, LPs	Ordinary income and long-term gain
Gold, artwork, collections and other collectibles	28% capital gain rate
Low basis marketable securities	20% long-term gain
Roth IRAs	Tax free
High basis stock and fixed income	Minimal gain
Cash	No gain
Stock at a loss	Capital loss erased
Traditional IRAs and qualified plans	100% IRD

10. Issues to consider:

- As alluded to above the domicile of the decedent/donor is important. The article by Waxenberg and Brown and Paul Lee and others indicate the effect that state income taxes has on the narrowing gap.

- The time horizon for holding the asset - when it will be sold? Is it a family vacation home to be kept for generations? If so, is basis step up that important?

- The life expectancy of the client: if gifts are made and the client dies shortly thereafter, you lose the basis step up and gain little in terms of appreciation.

- The size of the gross estate: if it is under $10.6M and not expected to appreciate in the near future, then why worry about the estate tax at all?

11. Planning Ideas

(Some of these have already been alluded to above, but let's recap).

- If asset has appreciated substantially, consider borrowing against it as collateral and gift the loan proceeds instead.
- Create an irrevocable IDIT, name the "poor" grandparents as discretionary beneficiaries and give them a general power of appointment to cause inclusion of low basis assets gifted into the trust and their estate.

  - limit the general power of appointment to creditors of the power holder.
  - make the exercise of the power of appointment conditioned on the consent of a non-adverse person.

- Create IDITs with the power of substitution so that high basis assets of the donor can be swapped into the IDIT for the low basis assets.
- Dissolve entities that have a low basis that were set up to obtain discounts or simply have the parent liquidate his/her interest (but be careful of the 7-year diversification to avoid the triggering the recognition of gain).

12. <u>Marital Deduction Formula Planning Options</u>

1. Outright bequest to surviving spouse with a reliance on portability.

The advantages: simplistic, easy to administer, least costly from a planning point of view, and easy for the client to understand.

The negatives:

- Loss of use of state estate tax exemption
- No creditor protection
- No ability to control where assets go on death of surviving spouse - particularly crucial in second marriage cases.

2. Outright bequest to surviving spouse with possible disclaimer into a by-pass trust

- Will survivor actually disclaim for tax planning purposes (must be done within 9 months of the death of the first to die or else the disclaimer will be non-qualified, which may not be so bad, as discussed below)
- Disclaiming spouse cannot be granted any powers of appointment over the disclaimed assets (contrast this with a Clayton QTIP)
- The advantage is that the planning becomes optional to the surviving spouse; no mandatory by-pass trust

3. Mandatory state exempt by-pass trust with remainder outright to surviving spouse

- Only creditor protection on the by-pass trust amount
- Only assurance of the by-pass trust amount going to the first-to-die's intended beneficiaries

4. Mandatory state exempt by-pass trust with remainder of federal exemption amount to Ma QTIP/federal by-pass trust and excess outright to spouse (or to a general power of appointment trust) or to a QTIP trust

- This has been for the last several years the plan of choice for many estate planning attorneys and clients
- The portion that goes into the Ma QTIP/federal by-pass trust could be elected not to qualify for QTIP treatment for federal purposes if portability and the importance of the basis step-up on the death of the last to die are more important
- The distribution of income is flexible only for the state exempt by-pass trust amount

5. Outright bequest to spouse followed by gift to descendants utilizing the DSUE (Deceased Spouse's Unused Exemption).

- Should be done before surviving spouse remarries, otherwise, if new spouse dies first, first spouse's DSUE will be lost
- In Massachusetts this will avoid estate tax as there is no gift tax complication for state purposes.
- However, gifted assets get no basis step up on surviving spouse's death.

6. Outright bequest to surviving spouse followed by gift from surviving spouse to a grantor trust to use the DSUE and to preserve the right to swap assets.

- Depends on surviving spouse swapping before he/she dies to get basis step up on previously gifted assets.

7. Set up an all QTIP Trust

- Some clients have actually been doing this for the past several years for the sake of simplicity.
- However, no flexibility to spray income.
- It does allow for a fair degree of flexibility given the fact that a different QTIP election can be made for federal estate tax purposes and for Massachusetts purposes. Therefore, some or all of the QTIP trusts can be elected for federal purposes, depending on the desire to rely on portability in order to generate a second basis step-up.

8. Use a QTIP/credit shelter trust format and rely on Clayton election.

- The Clayton case established the principal that property not elected for QTIP treatment by the executor of the estate could flow into a credit shelter type trust.
- The advantage of this over a disclaimer of assets into a credit shelter trust is that the surviving spouse can be given a broad special power of appointment in the credit shelter trust where the Clayton election is relied on, whereas the surviving spouse cannot have that power of appointment upon the exercise of a disclaimer.

13. The Interplay of Portability and Basis

Old regime: marital/by-pass trusts

New regime: surviving spouse can benefit from first-to-die's exemption without the need for a by-pass trust and assets passing to or for the benefit of the surviving spouse get a second basis step up.

1. Yet, leaving it all to the surviving spouse outright has disadvanges.

- No portability of state death taxes
- No portability of GST exemption
- No creditor protection
- Appreciation on credit shelter amount will be includible in surviving spouse's estate

2. When is the second basis step-up important - is it always true that assets will not be sold after first spouse dies and before second spouse dies?

- Maybe this is true for closely-held family businesses and residences.
- But may not be true for a portfolio of marketable securities.

3. Yet, portability will change our thinking on some assets:

a. for example, retirement accounts - no need to "waste" credit shelter amounts on retirement account - to extent exemption not fully utilized on death of the first to die, it will be useable on the death of the second-to-die.

b. another example: residences - awkward to hold in a credit shelter trust. Also, the home sale exclusion of $250,000 could be lost if the residence is in a credit shelter trust.

c. to preserve the gst exemption of the first spouse to die, if a credit shelter trust is not used (so as to get second basis step up), then a reverse QTIP trust could preserve that benefit.

d. For decoupled states, like Massachusetts, the most likely plan is to use credit shelter trusts for the first million and a QTIP for the balance.

14. Planning at Different Levels

The $4M or Under Couple - Just make sure each spouse has $1M to maximize the use of the Massachusetts estate exemption to save an additional $100,000 of estate taxes.

The Couple with $5M-$10M - Consider a credit shelter trust and/or non-QTIP marital trust for more than $1M, especially for younger clients where potential for appreciation is greater and keeping more out of surviving spouse's estate may help to avoid a federal estate tax on death of surviving spouse.

Maintaining Flexibility - Retain the ability to utilize the disclaimer by the surviving spouse to fund credit shelter trusts.

15. Some Take Aways

- If a family-type credit shelter trust is used in the planning to absorb not just the Massachusetts exemption but the federal exemption as well, then all appreciation in the credit shelter trust will avoid estate taxation at the death of the surviving spouse. The obverse of this is that if portability is elected for the entire estate, then the appreciation on all the assets would avoid capital gains tax but depending on the amount of the appreciation, there could be some estate tax payable on the death of the survivor.
- To maintain maximum flexibility, one would leave the entire estate to a QTIP trust to keep open the option of deferring all Massachusetts estate taxes and you would have 15 months after the death of the first to die to decide how much of the first-to-die's federal exemption you wanted to port to the surviving spouse.
- For basis step-up planning, it will be important to consider in what state the surviving spouse is likely to be domiciled at the time of his or her death.

- Planning now will need to consider how much portfolio turnover will occur between the death of the first to die and the second to die. To the extent a fair amount of the assets are sold between the two deaths, then the realized gain will not benefit as much from a step-up in basis on the second death.
- Remember, assets can depreciate in value. If assets are placed into a credit shelter trust soaking up the remaining federal estate tax exemption at the death of the first to die, and the assets between the first to die and the surviving spouse depreciate in value, some of the exclusion applied to the trust at the first death will effectively be wasted. Contrast this result with that if portability had been chosen and the ported exclusion amount remains fully available at the survivor's death.

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