

Step-Up Basis Rules and Planning



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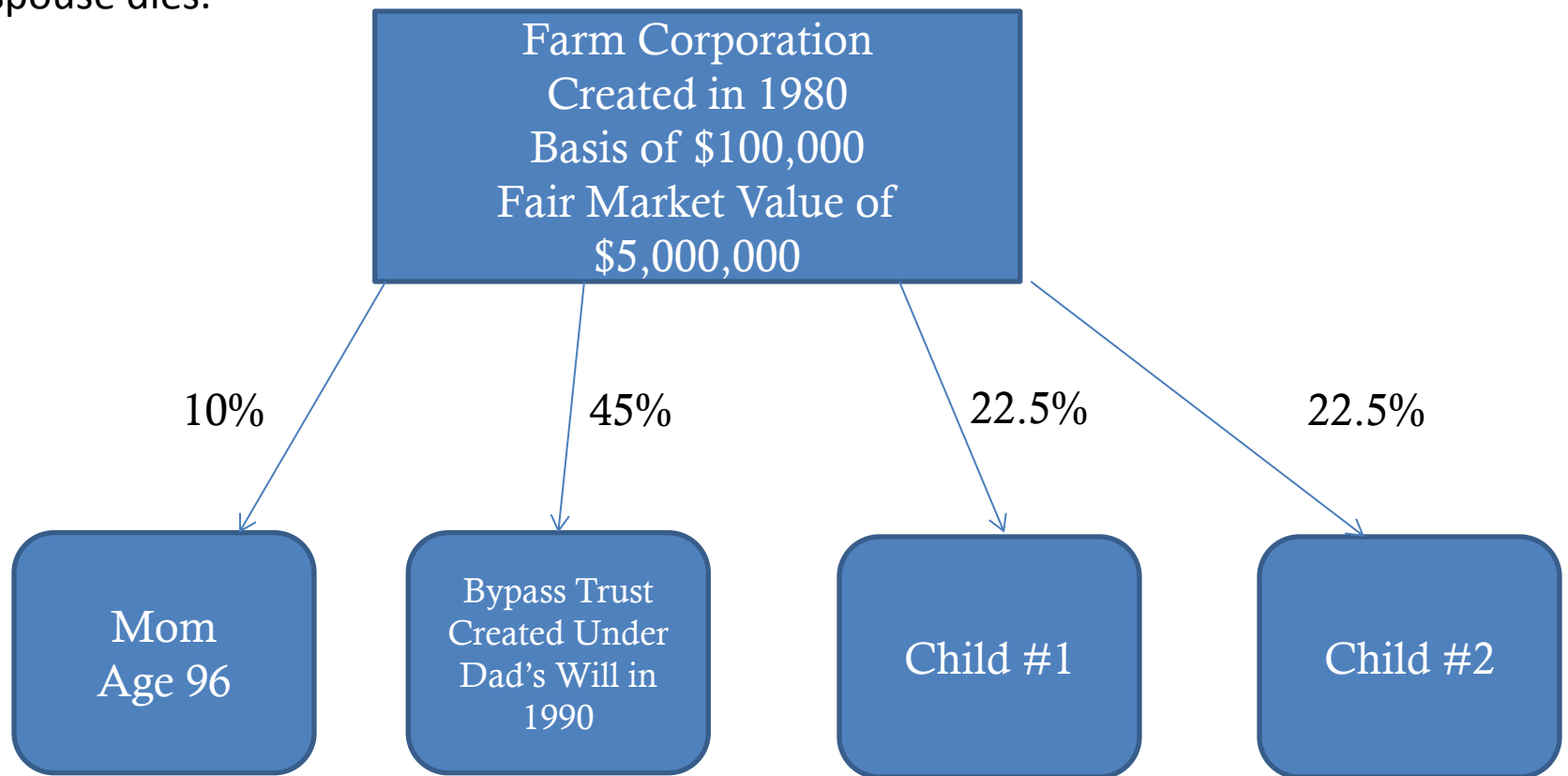
Addressing Existing Trusts/Corporations

- The shift in focus to income tax planning and to maximizing the assets included in an estate to receive a step-up in tax basis at death may raise questions about prior planning that focused on excluding assets from the estate.
- What can be done to address prior estate planning that frustrates the client's tax planning goal?
- Goal is to minimize the tax burden to the family. This must always be considered in light of 1) the future tax landscape is hard to predict and ever changing, and 2) the non-tax motivations driving a client's estate plan.
- The examples that follow will attempt to highlight the options available to address existing estate plan devices that are now frustrating the tax goals of the family.



Addressing Existing Trust— Example

- Example - Irrevocable (Bypass) Trust created at dad's prior death for the benefit of surviving spouse may be frustrating rather than advancing the goal of tax-efficiency. Should consider whether such Trusts can and should be terminated or modified to make it possible to obtain a step-up on the tax basis of the assets when the surviving spouse dies.



Addressing Existing Trust– Example, *cont.*

Facts: Dad died in 1990, and left a Bypass Trust for Mom, who is now 96.

- The Bypass trust holds low-basis shares of a farm corporation (45%).
- Children own another 45% of the Farm Corporation. Mom owns 10%.
- In 2026, Mom would be 104.
- The shares in the Bypass Trust will not receive a step-up in basis at Mom's death.
- Kids' shares will not receive a step-up in basis at Mom's death.
- The Bypass Trust allows distributions of income but not principal.
- Mom's remaining shares should theoretically be valued at a discount.
- There is no way that Mom's assets, augmented by the assets of the Bypass Trust and augmented by the Children's shares of the Farm Corporation, will exceed \$11,400,000. The Bypass Trust that was important when created no longer serves any purpose.



Addressing Existing Trust– Example, *cont.*

Potential Strategy to Obtain Step-Up in Basis:

1. Change Standard for Distributions - Have the Court amend the Bypass Trust to allow distributions of Principal to Mom for her general welfare and happiness, in the discretion of the Trustee. The Trustee would then make a distribution of all Trust property to Mom.
 - A. All beneficiaries (after being informed of the risks) will need to consent to the Trustee distributing all assets of the Bypass Trust to Mom for her General Welfare and Happiness. If desired, ask the Court to approve the subsequent distribution.
2. Add General Power of Appointment - Have the Court amend the Trust to grant Mom a general power of appointment over the largest share of the Bypass Trust that would not cause estate taxation in her estate which would result in a basis step-up on that portion of the Trust assets.
3. Exercise Existing Rights to Distribute - If the Bypass Trust already allows distributions of Principal to Mom for her health, education, maintenance, and support (HEMS), consider a family agreement that Mom needs all assets for HEMS and releasing and indemnifying the Trustee for exercising its discretion to make such distribution. This would avoid court involvement.



Addressing Existing Trust– Example, *cont.*

Potential Strategy to Obtain Step-Up in Basis:

4. Disclosure of Risks – Many of the aforementioned options will require the beneficiaries of the Bypass Trust to consent. Need to disclose risks to beneficiaries (Mom could change her ambulatory estate planning documents, she could remarry, she could be a victim of elder abuse or end up with creditor issues, such as medical expenses).
5. Update Mom’s Estate Plan - If necessary, amend Mom’s will/revocable trust to ensure that the shares passing to her from the Bypass Trust pass to the beneficiaries of the Bypass Trust in similar shares (and if on different terms, on terms the beneficiaries accept).
6. Permit Gifts to Mom - Consider amending Mom’s will/revocable trust to provide that any shares of the Farm Corporation gifted to her after January 1, 2019 will be bequeathed to the party that makes the gift. Children can then be given the opportunity to gift shares to Mom if desired to obtain a step-up in basis, and each can make his or her own decision independently.



Addressing Existing Trust– Example, *cont.*

Results:

1. Bypass Trust shares should receive a step-up even if Mom dies immediately after receipt of them.
2. Shares gifted by children to Mom will obtain a step-up if she lives more than a year after receipt of such gifts.
3. Mom will die owning all of the Farm Corporation, avoiding issues related to potential discounts being applied, and optimizing the step-up on assets and the potential for a sale or liquidation/dissolution following her death (particularly if this is a S corporation).
4. Children will have to file a gift tax return related to their gifts of stock to Mom, and a wealthy child might choose to prioritize preservation of exemption over capital gains planning. Children should consult their own advisors regarding whether their consent to the application to amend the trust has gift tax implications for them.
5. There will be a happy ending unless Mom changes her Will and disinherits one or all of the kids, or develops creditor problems, or remarries without a prenup.



Addressing Existing Trust– Example

What if the Mom is Likely to Live until 2026?

- If Mom is only 70 (especially if her assets are such that there might be an estate tax issue if the exemptions revert to 2017 levels (\$5,700,000 per person or so)), consider waiting 5-7 years and revisiting this issue closer to 2026.
- Changed tax law could impact the need or desirability of doing this, and the tax law will likely change at least once more before Mom dies;
- At 70, there is a greater chance that Mom could remarry or other life events could occur that would result in the assets in Mom's estate not being the best outcome and disappointed remainder beneficiaries. There needs to be a balance of tax and non-tax factors bearing on these decisions.
- If decided to take action to have the Bypass Trust asset in Mom's estate, then better to grant Mom a general power of appointment, as opposed to an outright distribution of assets to Mom.

Other Planning Ideas:

- Revisit Irrevocable Life Insurance Trusts (ILITS) and other Irrevocable Trusts that no longer serve a tax purpose (terminate or amend).



Addressing Land Holding Corporations

S Elections and Basis Step-Up Planning

- For clients who have corporations that primarily hold land, consider making an S Election.
 - Pass through taxation, avoids double tax on distributions, and qualifies for QBI deduction. Helps provide cash flow to older clients during retirement years and will make future co-ownership by the client's children easier. Provides a better tax structure if land in the corporation will be sold in the future or if corporation is going to be liquidated/dissolved in the future.
 - Conversion period is 5 years for both federal and state (starting in 2019)
 - If corporation has “hot assets” that would otherwise be sold during conversion period, corporation will need to “bleed off” the hot assets before converting
 - If the corporation has accumulated E&P from C corporation years, the passive income limitations will apply during S corporation years (if passive income represents more than 25% of gross receipts, excess passive income could be subject to a 35% corporate passive income tax rate). If the accumulated E&P and excess passive income persists for three consecutive years, the corporation could lose its S Corporation status.



Addressing Land Holding Corporations

S Elections and Basis Step-Up Planning

- For clients who do not want their children to have to deal with the corporation in perpetuity or for clients who want to have specific parcels of land in the corporation pass to different children, consider making an S Election and also ensuring all stock of the corporation obtains a basis step-up at client's death.
 - If the client's estate plan is properly structured so that all of the corporation stock receives a basis step-up (preferably at the same time) and a timely S Election is made, the corporation will be well positioned following the death of the client to liquidate/dissolve and distribute its assets in-kind to its shareholders (all in the same tax year) virtually tax-free. The land will then be owned outside the corporation with a stepped-up basis.



Addressing Land Holding Corporations

S Elections and Basis Step-Up Planning, *cont.*

- Other Planning with Corporations:
 - Footprint Leases when the Ownership of Land and the Ownership of the Structures on the Land is Different. Under the Lease, Structures revert to Landowner after Term of Years and Facilitates Basis Planning (Corporate Structures revert to Personal Landowner). A similar lease can be used when client's children own structures on client's land (Child's Structure revert to Parent Landowner).
 - Annual exclusion gifting of entity ownership to all Children (rather than just those Children involved in the Business) may not be the Best Plan. Annual exclusion gifting (for estate planning purposes) no longer necessary in general for many clients.



Portability and the Impact to Estate Administration



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Portability

- Allows the personal representative (or executor/trustee) of a deceased spouse to elect on the decedent's Form 706 (Estate Tax Return) to transfer such deceased spouse's unused estate tax exemption to the surviving spouse.
- Does not apply to GST-exemption.
- History:
 - First available for decedents dying in 2011 and 2012.
 - Became a permanent in 2013.
 - Not schedule to be impacted in 2026 and will still be in effect perpetually.



Living in a Time of Ambiguity

- Estate tax exemptions are scheduled to automatically drop down to pre-2018 levels beginning in 2026 (assuming Congress does not act).
- There have been numerous changes impacting estate tax exemption over the last decade, and there will likely be substantial changes in the future.
- Given the growing federal deficit it is unlikely to see further increases to the estate tax exemption after 2025.
- Overall Conclusion: the estate exemptions of today (and for all upcoming years through 2025), are likely higher than they will be after 2026.
- For individuals with estates between \$6-\$11.4M, planning is difficult as whether they have an estate tax issue will depend on when they die and the estate exemption available at their death.
- There may be ambiguity as to what a client's estate exemption will be when they die, but if a client has received a spouse's unused exemption then the ported exemption is locked-in and will not change.



Things to Keep in Mind

- New Estates - Best practice to discuss portability with the personal representative/executor/trustee and surviving spouse, regardless of the size of estate.
- With the involvement of the surviving spouse, the personal representative/executor/trustee should make an informed decision as to whether or not to file a 706 to elect portability. The attorney should make a contemporaneous record of the conversation and the decision that was made.
- For example: If in 2030 Congress reduces the estate exemption to \$1M, you don't want clients complaining that they did not elect portability or have an opportunity to do so.
- In many estates where the estate and the anticipated surviving spouse's estate will be of minimal value, filing a Form 706 is not likely justified (given its costs), but the attorney should still have the conversation and have the client make the final decision.
- The decision as to whether to file a Form 706 for portability is dependent on the current estate and the surviving spouse's anticipated estate.



Most Likely Candidates for Filing for Portability

- Need to File - Where the surviving spouse is anticipated to have estate tax (need to run it under the current exemptions and whether there could be estate tax if the spouse survives through 2026, if in doubt the client is better advised to file).
- Should Seriously Consider Filing:
 - Surviving spouse is young with good income potential;
 - Surviving spouse has significant assets or has the potential for substantial income generation;
 - Surviving spouse anticipates receiving significant assets in their lifetime (through an inheritance or otherwise).





Questions?

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