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The Stepped-Up Basis Conversation

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> *"Step Right Up. Everyone's a winner, bargains galore."*
>
> *Tom Waits, "Step Right Up" from the 1976 album Small Change*

The largest tax challenge facing the great majority of American families on the death of a loved one will not be a death tax, but a capital gains tax.[1] The increase in this tax from 15% to 20%, with the additional 3.8% Medicare tax[2] for high-income earners makes this a very important topic to cover with clients and their families. Adding to the pain, the vast majority of states, and some localities, also impose a tax on gains.

The primary estate planning goal of most married couples is to provide as well as possible for the surviving spouse, but most of them do not recognize that at least 23.8% of the lifetime appreciation of family investments, including in many cases on a large residence, may have to be paid to the government in order to produce money for the surviving spouse if there are not sufficient liquid assets.

For some survivors, this will be a devastating reality that must be faced when the cost of an adult congregate living facility and proper care is compared to the net proceeds that can be derived from the liquidation of assets.

Even a modest investment portfolio owned by a retired married couple can be significantly impacted by these taxes.

Assume that a married couple, with both spouses in their late sixties, has $500,000 of investments with a cost basis of $100,000 and a home worth $100,000.

If one spouse dies owning one-half of the assets or the assets are jointly owned in a non-community property state and one of the spouses dies, his or her half of the assets will receive an automatic change in income tax basis to its estate tax value (even if no estate tax is due) and the inherent gain in those assets is not subject to tax. That result is known as the income tax free "step up in basis" at death. But the inherent gain in the survivor's half of the couple's wealth will not be sheltered by a stepped-up basis. That means that there is then $200,000 worth of untaxed gain that may cost, depending upon several factors (including whether the couple lives in a jurisdiction with state and local taxes), over $50,000 in capital gains tax in order to liquidate the couple's wealth to provide cash to support the surviving spouse or to buy into a retirement residence. And if most of the couple's wealth was owned by the surviving spouse, then the amount of the remaining gain (and, therefore, tax resulting from liquidation) will be even greater.

[1] *See* §1(h).

[2] *See* §1411. This tax is also sometimes referred to as the net investment income tax.

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Contrast that couple's situation with that of a couple living in a community property state, such as Texas or California. For the latter couple, there is a full step up in basis on all community property, so all of the inherent gain is ''forgiven'' when the first spouse dies. Therefore, the survivor would face no capital gains tax in liquidating the couple's wealth.

A couple with $2,000,000 of assets and a $500,000 home with the same ratios of growth could face a much larger tax, which could be $450,000 or more.

The above assumes that tax rates will not rise and that there will be no state income tax to be paid.

Why do so many planners fail to discuss this with clients, much less put mechanisms in place to assure a complete step up in basis of all of a couple's assets on the first death? One reason is that the full impact of the large capital gains tax increase has not yet been felt by many clients. Another is that the complexity of the recent estate tax changes, and especially the attention given by wealthy clients during 2012 to use their large gift and generation-skipping transfer tax exemptions, have taken the typical estate planner's eyes ''off the ball'' where they probably should be for many couples.

There are three primary ways that the typical non-community property state couple may attain a full step up in basis for assets on the first death (understanding that some assets, such as those in pension plans or IRAs, other than Roth IRAs, never receive a basis step up when the owner dies):

1. Have the assets owned by the first dying spouse more than one year before he or she dies, or if the one-year period cannot be met, have the spouse leave the assets to a trust that may benefit the surviving spouse and not trigger the one-year rule under §1014(e), which denies a step up in basis with respect to assets that the spouse dying first received by gift from the survivor within a year of death and that are inherited back by the spouse who made the gift. Trying to guess who dies first and even having to talk about this can be a difficult and risky proposition. Also, some married persons may feel uncomfortable giving all of their assets to their spouses before they die even if it is understood the assets will be bequeathed back to the spouse who gifted them.
2. The couple can amend their estate planning documents to either provide that each of them will have a testamentary power of appointment over assets held in one another's separate revocable trusts or form one ''joint exempt step-up trust'' (JEST), in which event PLRs 200101021, 200210051, and 200403094 and TAM 9308002 support the proposition that assets owned jointly under a JEST or under the revocable trust of a surviving spouse may be considered to have passed through the ''taxable estate'' of the first dying spouse, although there are §1014(e) one-year rule and fundamental issues associated with this.[3] This technique has its downsides, as illustrated in the chart below but the JEST itself has no annual cost associated with it unless there are changes in the client's estate plan. Many clients prefer to have their assets under a single trust, and preexisting separate trusts can be amended and restated to be considered a part of the single JEST so that retitling of assets is not required. As with any joint trust, the JEST entails a number of drafting concerns. Practitioners may wish to review sample trust documents and client letter explanations that the authors have prepared.
3. The most reliable way to achieve a full basis step up on the first death, with very effective incidental asset protection features, is to establish a conventional Alaska community property trust with an Alaskan co-administrative trustee. The Alaskan community property statute was enacted in 1998 to allow both Alaskan couples and non-Alaskan couples to form trusts there to comply with §1014(b)(6), which provides that the entire community property will receive a full basis step up on the death of one spouse. This technique has been endorsed by not only Jonathan Blattmachr, who originated the concept, but also by Howard Zaritsky and a number of other well respected experts. The Alaska Trust Company provides the trust form to professionals who use these, and an Alaskan lawyer is available to review and approve the trust document for only approximately $1000.

A chart of considerations and factors is as follows:

[3] These issues are discussed at length in LISI Newsletter No. 2086 and in articles in the October and November 2013 issues of *Estate Planning* that were co-written by Alan S. Gassman, Tom Ellwanger, Christopher J. Denicolo, and Kacie Hohnadell.

Basis Step Up Planning for Married Couples in Non-Community Property States

	No Planning	**JEST or Special Power of Appointment Trust Arrangements**	**Alaska Community Property Trust**

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Drafting and Design Time to Implement	None.	Requires sophisticated drafting and implementation.	Can be simple to install.
Creditor Protection Attributes	No effect.	Will typically expose assets to creditors to each owner spouse unless further planning is effectuated.	Alaska creditor protection law applies.
Annual Maintenance Costs	None beyond what client is already paying.	None but best to review assets and allocation within JEST periodically.	$3,000 per year payment to Alaska trust company and requiring that the clients follow appropriate formalities if they want to have creditor protection attributes.
Administration After Death of First Spouse	No special provisions needed.	Must meet with qualified planner to decide how to allocate assets between one or two credit shelter trusts and administration issues.	Can simply dissolve trust or maintain trust and step up has occurred.
Degree of Tax Certainty	Nonapplicable.	The Service may challenge the stepped-up basis and funding of a credit shelter trust from the assets of the first dying spouse.	Statutory support and over decades of community property case law eliminates stepped-up basis and full credit shelter trust funding issues.

The following represents what could happen in a situation where family members would expect an estate planner to ensure that there is a full step up in basis for marital assets on the death of one spouse. First, is a letter from a child to the advisors, and then a letter from the advisors to the child:

Dear Lawyer, CPA and/or Trust Officer:

Thanks for all the work you did for Mom and Dad over the years. As the result of Dad's recent death, we are having to sell their joint investment account assets to pay for Mom's care. My accountant says that we have to pay a 23.8% income tax on a lot of the gains as the result of this. Was there any way that this could have been avoided?

On a $400,000 portfolio, this is costing over $71,000 in taxes.

Thanks for helping our parents to avoid probate, but what about all these income taxes?

[Signed Son/PI Atty]

And here is the response from the lawyers, CPA and/or trust officer:

Dear Son of Clients Who Is a Personal Injury Lawyer:

I am glad to hear that your Mom is getting good care.

We suggested consideration of a JEST or an Alaska community property trust, but they decided against this. If you could wait to sell the assets after your mother dies you will not have the income tax. Maybe you could loan the money to your mother and let her hold the appreciated assets.

You and your siblings may consider doing this type of planning for yourselves now. I can see that you are doing very well based upon the billboards and television advertising. Keep up the great work!!

[/s/]

CONCLUSION

Planners need to become accustomed to stepped-up basis planning being in the forefront of objectives and structuring. The Alaska community property trust is extremely under-utilized, and the JEST or stepped-up basis power of appointment arrangements can be considered for those clients who, for whatever reason, would not prefer to use an Alaska community property trust.

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