Basis Planning Going Forward

Take-Away: With the One Big Beautiful Bill Act (OB3) far more attention will be given to positioning assets to obtain an income tax basis adjustment on a decedent's death, more so than shifting asset appreciation out of an owner's estate with lifetime gifts to avoid federal estate taxes.

Background: The OB3 increased an individual's applicable exemption amount for federal gift and estate taxes to $15 million starting in 2026. That amount will be indexed to annual inflation increases. The same can be said for the federal generation skipping transfer tax exemption. In addition, the OB3 did not change the *portability* rules so that any unused applicable exemption amount left by a deceased spouse can be ported to a surviving spouse if that election is made on a timely filed Form 706 federal estate tax return. (However, there is no *portability* of a deceased spouse's unused applicable GST exemption amount.) All of which means that for most Americans, they will not worry much, if at all, about avoiding federal estate tax exposure on their deaths with such a large, and growing, exemption amount.

Capital Gain Taxes: Instead, the focus of planning for the next few years will be to gain an income tax basis adjustment on the asset owner's death [IRC 1014] so that their descendants can liquidate inherited assets without recognizing capital gain taxes, i.e., a 20% capital gain tax plus possibly the net investment income tax of 3.8%, or a combined tax (ignoring state income taxes) of 23.8% [IRC 1411 and IRC 1223(9).]

IRC 1014: While usually referred to as a basis *step-up* rule, it is important to remember that tax basis can also go down. The law provides that the cost basis for most assets the decedent owns on death is adjusted to fair market value of those assets on the date of the decedent's death. [IRC 1014(a).] The adjustment is either up, or it can also go down, if the asset declines in value.

Example: Donna purchased stock at $1,000 a share that is now valued at $10,000 a share. Donna decides to give the stock to her niece Abby while alive. The stock value declines to $200 a share when held by Abby. Abby dies. $200 is the basis of the stock that is included in Abby's estate on her death. That results in a step-down in income tax basis, not a step-up.

Originally the stock basis was $1,000 but since it was included in Abby's estate, the basis on her death was its fair market value of $200. Abby's kids inherited her stock. After Abby's death the stock appreciates again, back to $1,000 a share. Abby's kids sell the inherited stock for $1,000 a share. Abby's kids will pay a capital gain tax on $800 a share. Had the stock remained in Donna's trust until her death, Abby's basis in the inherited stock would be $1,000 which Abby, and later her children, would have benefited from by avoiding capital gains.

Fixing Basis? Consider how many trusts were funded with appreciating assets since 2017 as part of the 'use it or lose it' motivation for lifetime gifts (that I am equally guilty of advocating) since the donor's incredibly large applicable exemption amount that was set to expire on December 31, 2026. With hindsight, perhaps many of those settlors now wish that they had held onto their appreciating assets until death to expose those appreciated assets to a basis adjustment on their death, which will now be lost with the assets held in an irrevocable trust. Some planning thoughts follow.

***String* Provisions:** The Tax Code might provide some 'relief' (I use that terms loosely, with tongue-in-cheek) in the form of IRC 2035, 2026, or2037. Those are the 'string' provisions of the Tax Code that bring back into the transferor's gross estate the value of lifetime transferred assets if too much control was retained over the transferred assets. In a truly awkward scenario, a settlor's estate might search for a reason to claim that one of these Tax Code 'string' sections was actually violated by the settlor, such that the entire value of a funded trust is included in the settlor's gross estate, thus causing a tax basis adjustment to the trust's assets. When there is a will, maybe there is a way, though I confess I cannot image too many estates that will go out of their way looking for estate inclusion.

***Grantor* Trusts:** If the irrevocable trust was funded with appreciating assets, like a spousal lifetime access trust (SLAT), the highly appreciated assets in the SLAT might be swapped for the trust's low basis assets, which will then be included in the settlor's estate on death and receive a basis adjustment. A SLAT is normally a *grantor* trust. [IRC 677.] These swapped assets might be funds that are borrowed by the settlor, which funds will have a basis equal to their value-and the debt incurred by the settlor's borrowing should be tax deductible to the settlor's estate. [IRC 2053.] With the swap between the settlor and his/her *grantor* trust no gain will be triggered since transactions between the settlor and his/her *grantor* trust will be disregarded for income tax purposes. [Revenue Ruling 85-13.]

If the settlor does not own the asset that is desired to be shifted to the *grantor* trust and their spouse owns it, the spouse can transfer the asset to the settlor-spouse (unlimited marital deduction), and the asset is then exchanged by the settlor with his/her *grantor* trust. However, with a swap of assets, or a sale and exchange of assets with the *grantor* trust, a reasonable time should be allowed to pass between transfers to the settlor from his/her spouse, and from the settlor to the *grantor* trust, to avoid implicating the IRS's *step transaction doctrine*.

Unwrap Asset 'Wrappers: To exploit valuation discounts many appreciating assets were 'wrapped' in entities like family limited partnerships or family LLCs, where lack of control and lack of marketability valuation discounts were claimed. Now, with the emphasis shifting to avoiding capital gain taxes more so than avoiding federal estate taxes, those entity 'wrappers' should be discarded so that the interest in the entity retained by the decedent will not be subject to valuation discounts with the IRS will now claim, not the decedent's estate. A higher fair market value of the retained asset will be sought by the decedent's estate at death, not a lower fair market value.

Delaware Tax Trap: Suppose appreciating assets are lodged in an irrevocable trust, which is not a *grantor* trust, so it is difficult to re-acquire the appreciated assets without incurring a capital gain, e.g., a sale of the appreciated assets by the trust. The trust might be decanted to a new trust which gives one or more of the trust beneficiaries a special power of appointment. If that special power of appointment is exercised in a manner that provides more flexibility and the power is in fact exercised to move the appointed assets to a resulting trust that impermissibly extends the rule against perpetuities, that exercised power will then trigger the Delaware Tax Trap and cause the powerholder to include the value of the trust assets in the powerholder's taxable estate, which warrants an income tax basis adjustment of the assets that were the subject of the exercised power. [IRC 2041(a)(3).]

Divide a Trust: Not all assets that are transferred to an irrevocable trust will appreciate in value. Yet some of the techniques just described will cause *all* trust assets to be subject to a basis adjustment, perhaps including a step-down in the basis for some of the trust assets. A trust that holds some appreciating assets might be divided, relocating the appreciating assets into one resulting trust, and the non-appreciated assets, or

depreciating asset values, into a second resulting trust. The swap or power of appointment strategies would be applied solely to the resulting trust with appreciating assets, leaving the other resulting trust alone with its high(er) basis assets.

Conclusion: The OB3 with its (allegedly) *permanent* high applicable exemption amount and the new income tax rules have changed the way most Americans will view estate planning, especially with regard to irrevocable trusts. More non-grantor trusts will be created to exploit the IRC 199A and SALT deductions, not to mention the 'stacking' of trusts to exploit the $15 million qualified small business stock (QSBS) exemption from capital gains taxes. For existing irrevocable trusts, some steps might be intentionally taken to expose trust assets to an income tax basis adjustment. For *grantor* trusts, many will look closely at swapping assets with the trust to bring low basis assets back into the settlor's name for a tax basis adjustment at death.

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