

Updating 'Old' Estate Plans

Take-Away: With the renewed emphasis on gaining an income tax basis adjustment on the owner's death, 'old' estate planning documents should be reviewed to determine if they are the most tax efficient way to transfer wealth.

Background: The One Big Beautiful Bill Act (OB3) will cause many estate plans to be revisited if the primary goal is to avoid federal taxation. OB3 made permanent a \$15 million per person transfer tax exemption. That \$15 million exemption will be annually indexed to inflation. That means that a married couple could transfer \$30 million of wealth on their deaths and not worry about federal estate taxes. In addition, the unused applicable exemption amount can still be *ported* from a deceased spouse to his/her surviving spouse, if a federal estate tax return is filed on which the *portability* election is made.

(Unfortunately, the deceased spouse's unused \$15 million GST exemption cannot be *ported* to the surviving spouse.) Finally, the OB3 made no change to IRC 1014 which means that if a decedent holds an asset until death, that asset will receive an income tax basis adjustment to that asset's fair market value at the date of death. All of which means that they're going to be a shift in the focus of estate planning for most Americans away from avoiding federal estate taxes (less than 1% have taxable estates for federal estate tax purposes) to income tax basis planning, so that heirs can sell inherited assets without incurring much capital gain tax exposure. If an existing estate plan was drafted with a goal of avoiding federal estate taxes, that *stale* plan might now unintentionally lead to a higher overall tax liability. A couple of simple examples follow.

Valuation Discounts: Over the past quarter century one popular estate planning technique was for appreciating assets to be *wrapped* in a family limited liability company (FLLC) or a limited partnership (FLP) where fractional interests were conveyed to family members, with a smaller fractional interest retained by the parent. On the parent's death a valuation discount was claimed for the retained FLLC or FLP interest due to a lack of marketability or a lack of control reflected in the parent's retained fractional interest. This the valuation discount 'game' was designed to lower the retained asset's value, and lead to a smaller federal estate tax liability due to the lower fair market value assigned. Now, with federal estate taxes being less of a concern for most Americans, the goal might now be to have as much value attached to the decedent's retained assets to gain a full income tax basis adjustment on the owner's death. Existing FLLC's and FLP's should be reexamined;

do they need to be *unwrapped* to expose asset values to a full income tax basis adjustment on the owner's death?

GRATs and QPRTs: These estate planning devices, authorized in the Tax Code [IRC 2702], leverage lifetime transfers of appreciating assets. The device's goal is to shift future appreciation of an asset out of the transferor's taxable estate at little or no gift tax exposure. The GRAT/QPRT strategies worked well if the transferred asset actually did appreciate in value over time (the asset appreciation was not subject to estate taxation), but because they were the result of a lifetime gift, the asset's existing income tax basis was transferred, or *carried over*, as well. Consequently, when the remainder beneficiary of the QPRT or GRAT later sold the transferred asset, he/she would pay the capital gain due to the *carryover* income tax basis rule resulting from the lifetime gift. Perhaps these lifetime transfer devices specifically designed to avoid future federal estate taxes on expected asset appreciation should be reexamined if they are no longer needed with a \$15 million applicable exemption amount..

Credit Shelter Trust: These trusts are prevalent if created when the federal applicable exemption amount was \$600,000 or \$1.0 million, as they assured that the exemption available to the first spouse to die was not wasted, by removing the assets from the survivor's taxable estate. Now, with an applicable exemption amount of \$15 million, and likely to increase with inflation, along with *portability*, the value of a credit shelter trust is diminished. The loss in an income tax basis adjustment on the surviving spouse's death now needs to be carefully factored into the decision whether to continue to use a credit shelter trust.

Example: Decades ago, Fred and Ethel purchased a home for \$200,000 on the water. It is worth \$2.0 when Fred dies. After the home's purchase, when the applicable exemption amount was \$1.0 million, Fred and Ethel adopted 'reciprocal' credit shelter trust arrangements. 50% of the home was transferred to each of their revocable trusts, which was intended to exploit a valuation discount of the 50% tenant-in-common interest held in each trust, i.e., \$500,000 was held in each trust. On Fred's death, his one-half tenant-in-common interest in the home held in his trust receives a step-up in basis to the fair market value of that one-half interest: \$1.0 million for the trust's tax basis. That interest in Fred's trust will not receive a second basis adjustment on Ethel's later death. Ethel lives another 20 years after Fred's death. The home is now worth \$3.0 million. On Ethel's death, her trust

hold's the other 50% tenant-in-common interest, and its tax basis will be adjusted upward to \$1,500,000. Assume that Fred and Ethel's children inherit the home, and they decide to sell it shortly after Ethel's death. The home sells for \$3.0 million. The children's basis in the inherited home is \$2.5 million (\$1,000,000 Fred's trust's basis, and \$1,500,000 Ethel's trust's basis.) Thus, the children when they sell the home for \$3.0 million will face a capital gain tax on \$500,000. If the one-half interest in the home had not been held in Fred's credit shelter trust for Ethel's lifetime, the home would have received a full income tax basis adjustment on Ethel's death, thus eliminating the capital gain that their children face.

Joint Trusts: Joint revocable trusts are popular with married couples who are not concerned about federal estate taxes. However, the assets held in a joint trust will receive only a 50% basis adjustment on the death of the first spouse to die. [IRC 204(b.)] Accordingly, if the surviving spouse is going to sell an asset in the joint trust after his/her spouse's death, a capital gain might be incurred. If an asset is likely to be sold by one spouse after the death of the other, e.g., hunting property; an heirloom stock, it might be wise to hold that asset outside of the joint trust and transfer it to the joint trust on the owner's death.

Example: Nick inherited Ford Motor Company stock from his grandfather 35 years ago. Nick has held onto that Ford stock all these years, in part as a memory of his grandfather who wanted him to have it, and also because any sale of the stock by Nick would cause a substantial capital gain to be incurred. Nick and his wife Nora have a joint trust. If Nick transfers the Ford stock to the joint trust and then dies, there will only be a 50% basis adjustment to the Ford stock, and Nora has made it clear to Nick that she would sell the Ford stock shortly after his death. Instead of transferring the Ford stock to the joint trust, Nick instead holds his Ford stock in a transfer-on-death (TOD) beneficiary arrangement, where the Ford stock is immediately transferred on his death to the joint trust. The Ford stock will receive a 100% basis adjustment on Nick's death, not just a 50% basis adjustment had the stock been held in the Nick Nora joint trust.

Conclusion: While I won't go so far as to say that federal estate taxes are not an afterthought, it is clear that with an escalating \$15 million transfer tax exemption, along with *portability*, more attention will now be given to avoiding capital gains. Estate planning will now be about maximizing what beneficiaries actually receive after all taxes, whether those taxes are estate, GST, inheritance, income, or capital gains.

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