The Wealth Counselor

A monthly newsletter for wealth planning professionals

How to Avoid a Basis Management Disaster

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Our firm focuses our practice on Estate Planning, Business Planning, Trust Administration, Probate and Elder Law. We help families preserve and protect assets and values; we help business owners maximize their businesses' value.

Many of us in the legal, financial and accounting worlds discover our new clients' well-intentioned, yet disastrous, plans after the fact. The widow has already transferred her house into her children's names or an inherited IRA is drained to pay for a Porsche. Observing the lost planning opportunity and the financial fallout is universally gut wrenching.

To help get the message out and to illustrate the transformation you provide to clients, you are welcome to use the below facts and scenarios in your own educational materials, presentations and conversations. Consider this a "red flag" list of income tax pitfalls and opportunities so you can be your clients' (and their beneficiaries') basis management hero.

Quick Review:
Many of your clients probably don't understand: how basis is determined, the step-up in basis at death for both separate and community property assets, and the consequences and opportunities associated with low basis assets. They certainly don't understand the rules governing when basis applies to IRAs and when it doesn't, or how to transform separate property into community property to get a full step-up of basis at the death of the first spouse.

Fortunately, there are numerous opportunities to avoid the huge and instant tax bill associated with selling low basis assets outright and for making the most of tax basis rules. Charitable Remainder Trusts, Family Limited Partnerships, Family Foundations, Installment Sales, or trust structures may be appropriate to dispose of highly appreciated assets, lowering the tax bill with reduced tax rates and charitable deductions.

Be sure to ask your clients lots of questions during your counseling interviews so you carefully understand their situation and avoid costly mistakes. If you're just collecting data via email or a five minute phone call, you're likely missing planning opportunities and costing your clients significant tax dollars.

Key Takeaways:

1. *A step-up in basis is a wonderful thing.* Assets get a step-up in basis at death; so, the mom, who wants to makes things simple for her children and avoid her state's inheritance or estate tax by giving away the family home, is likely creating a huge tax bill.

2. *Tax deferred growth is a wonderful thing.* Educating beneficiaries before they inherit can keep more money in their pockets in the long run (and their foot off a Porsche's gas pedal).

3. *Tax minimization is also a wonderful thing*. Use tools such as the Charitable Remainder Trust (CRT) to dispose of low-basis, highly appreciated assets without setting off the IRS's alarms and collection agents.

4. *Counter intuitively, income tax returns are also a wonderful thing.* **Always** review income tax returns annually. They provide a wealth of information that your clients may not know is valuable to basis management. We have found that if the return is not reviewed and basis questions are not asked, carry over basis and loss carry forwards are never mentioned. Thus, tax planning opportunities are lost. Don't miss Wall Street corporate takeovers, rental property, and mutual fund red flags.

5. *Team work is a beautiful thing as well.* Make sure that basis step-up opportunities are always examined. Step-up opportunities will generally require an estate planning attorney's input.

What You Need to Know:

First and foremost, stock or property needs to be held for longer than one year to avoid gains being taxed at ordinary rates for high-income payers. This is only an issue for those with marginal rates greater than 15%. In other words, if the marginal rate is equal to the gains rate --

15% -- there is no practical impact.

Be sure to determine the capital gains tax impact if an asset is sold. Tax planning looks at future years in which income may be reduced (e.g., at the onset of retirement) allowing for a more opportune asset disposition of low-basis stock or property.

The capital gains rate is 20% for income subject to the highest marginal rate of 39.6%; otherwise, it is 15%.

And then there's the 3.8% Medicare surtax, effectively jumping capital gains from 15% to 18.8% (at $250k AGI married) or 23.8% ($450k AGI married).

Low-basis stock or property that has high appreciation is a wonderful thing from a wealth standpoint, but can produce very high capital gains taxes.

· If the stock or property is to be sold, then you must have the client set aside the tax payment from the proceeds.

· If it is not set aside and the full proceeds are spent, when taxes are due, this could require pulling cash from future uses to the present (this is very inefficient and an example of poor execution).

Many of your clients likely own their own homes. Residential real estate has a $250,000 (single) and $500,000 (married) profit exemption from the capital gains tax with the main proviso that the home has been owned and used as a *primary residence* for at least 24 months.

And then there's rental property to consider. Rental property may be entitled to a step-up in basis at the death of one of the spouses. Clients often overlook this benefit.

Installment sales can be used to spread the gains on sales of businesses and rental properties such that gains are spread over a number of years to avoid running up the AGI ladder.

Community Property Trusts for married couples in separate property states are an effective way to get a double step-up in all assets owed by the couple no matter how titled. For larger estates, million of dollars in capital gains taxes can be avoided with this relatively simple trust structure.

In addition, low-basis stock or real property are ideal assets for Charitable Remainder Trust (CRT) funding because the property passes to the trust at full value and without immediate capital gains tax implications.

· The CRT then can sell the property (after it's owned by trust) and monetize the proceeds back to the grantor in the form of income.

· The income stream is four-tiered (return of principle, capital gains, tax-free income, and ordinary income) so the effective tax rate is lower than the ordinary income tax rate.

· The net is higher inside the trust than outside because the charitable exemption allows for the full proceeds to be available for the trust's assets.

· The donor can take a charitable deduction for the donation to the trust, which can be especially valuable in high-income years (such as the last few years of earning employment compensation).

· The CRT income stream can be used to fund a significant life insurance policy (inside an Irrevocable Life Insurance Trust if your clients' estate is federally taxable).

In addition, low-basis stock can also be gifted to Family Limited Partnerships (FLPs) and Family Foundations.

Using the FLP discount, the gift tax hit for the distribution is reduced. Of course, this mostly applies only to those families with wealth greater than the unified gift and estate tax credit (i.e., $11 million for a married couple).

Moreover, so long as the surviving spouse is an American citizen, the marital exemption allows unlimited low basis stock and property to be passed tax free upon the owner's death to that spouse. (Lifetime transfers to an American citizen spouse are also unlimited.)

If these assets do pass through a marital transfer, it is vital that the advisor/estate planning attorney team execute a plan to address the surviving spouse's estate/gift tax exposure.

And, keep in mind that often times, low-basis property or stock has emotional connections (e.g., a family business, a home or vacation home with sentimental value, or a treasured collection).

· Beyond the tax implications, it is important for parents to have not only the asset-disposition plan in place, but to have a family meeting to discuss the broader meanings of the stock and/or property.

· Parents may not want property they gifted to be sold, but the kids may be tempted to do so. If this is a concern, then a trust (with a non-family member as trustee) can be used to carry out parental intent.

· The tax implications for the beneficiaries can be handled by a number of trust structures to ease these worries.

· Property to be shared by siblings (e.g., a vacation home) needs to be discussed and the usage plan and rights be well documented to avoid conflicts before parents become incapacitated or die.

Assets get a step-up in basis at death, but most clients aren't aware of that benefit; so, the mom who gives away the family home or other assets is likely creating a huge tax bill as well as subjecting her home to the creditors and bad acts of her children. In addition, she will be disinheriting any children who are not the recipients of the transfer as to that asset.

Lastly, remember that Porsche? An IRA's basis is the after-tax balance formed by nondeductible IRA contributions as well as rollovers (after-tax amounts). Earnings on IRA contributions are tax-deferred.

Actions to Consider:

1. Include adult children and other beneficiaries in your counseling sessions, so they know the benefits of basis management and the disasters of mismanagement.

2. Offer beneficiary preparation workshops jointly with our office.

3. Invite your clients to come in for an update and 1040 analysis to identify additional planning opportunities.

4. Call our office to create a customized action plan to better protect your clients and their beneficiaries from themselves, keep more assets under management, be the hero, and reduce the number of gut-wrenching basis management disasters you're forced to witness.

5. Explore whether a Charitable Remainder Trust, Family Limited Partnership, Family Foundation, trust structure, or installment sale is appropriate to dispose of highly appreciated assets. We'd be happy to

assist you with this analysis.

6. If your client is the beneficiary or trustee of a non-grantor trust, ask us to analyze the trust to determine whether that trust can be recanted to grant the beneficiary a general power of appointment, bringing trust assets into his or her estate and using up any available federal estate tax exemption.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax adviser based on the taxpayer's particular circumstances.

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