Estate Planning Insights

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BASICS OF BASIS

We are going to discuss some "basics" of income tax "basis" in this newsletter.
We are going to discuss this topic in general terms, without regard to technical rules and exceptions.

Capital Gains Taxes. A lot of clients bemoan the fact that they must pay capital gains taxes when they sell a "capital asset" at a gain. While we understand that people do not enjoy paying taxes (of any type), at least if a client has a long term capital gain, it means that he or she made a good investment–i.e., bought "low" and sold high(er). That is not always what happens with investments (unfortunately).

Also, the long-term capital gains tax rates are lower than many other tax rates that people must pay. While the lower tax rate still does not make paying capital gains taxes enjoyable, try to keep long-term capital gains taxes in perspective.

What is "Basis"? When we use the term, "basis," we mean "income tax basis." Income tax basis is also referred to as "cost basis" or "tax basis" or, simply, "basis." You can think of your basis in a "capital asset" as your "investment" in the asset.

What is a "Capital Asset"? The term "capital asset" refers to an "after-tax" investment-type asset, such as real estate, stocks, bonds, mutual funds, business interests and other investments. The following are NOT capital assets: pre-tax IRAs, pre-tax retirement plans (such as 401(k) plans), and cash.

How Does One Acquire a Capital Asset? There are basically four (4) primary ways of acquiring a capital asset: (i) by purchasing the asset, (ii) by receiving the asset as a gift from a living person, (iii) by inheriting the asset upon the death of the prior owner, or (iv) by receiving the asset in an exchange. We are not going to discuss *exchanges* of capital assets in this newsletter.

1. Purchase. When you purchase a capital asset, you have a "cost basis" in the purchased asset equal to what you paid for it. Your cost basis in a capital asset is your investment in that asset. Sometimes additional amounts can be invested in an already owned capital asset. Depending on the type of additional investment, the additional amounts put into the asset can increase your tax basis in the asset. Of course, certain things can decrease your basis in a capital asset also, such as taking depreciation deductions.

2. Gift. In general, when you receive a capital asset as a gift from a living "donor" (gift-giver), you end up with a "carryover basis"–you retain the donor's basis in the asset. In other words, there is no change in basis when you receive a capital asset as a gift from a living donor. Whatever the donor's tax basis was in that asset, that will be your tax basis in that asset, too.

3. Inheritance. When you inherit a capital asset from a person who has died (the decedent), you end up with a "stepped up" basis equal to the fair market value of that asset as of the decedent's date of death. (In certain cases, the asset is valued on the "alternate valuation date," rather than as of the decedent's date of death, but we are going to ignore that nuance in this newsletter.) Also, it is technically a misnomer to refer to an inherited asset as having a "stepped up" basis because the decedent may have paid more for that asset than it was worth at the time of his death. In that case, it would be a "stepped down" basis. Thus, under current law, when you inherit a capital asset from a decedent upon his death, that asset will achieve a new basis equal to its fair market value as of the decedent's date of death. All prior "unrecognized" capital gain is "wiped out" when the

decedent dies. (Note that various people have proposed that various changes be made to the basis and capital gains tax rules.)

It does not matter what *method* the decedent uses to transmit the capital asset to you upon his death. In other words, it does not matter if you are inheriting the asset (i) under the decedent's Will or (ii) pursuant to the decedent's revocable trust or (iii) as a result of a "Right of Survivorship" or "Transfer on Death" arrangement outside the decedent's Will or revocable trust. The important point is that you are receiving the asset from the decedent due to his death. As noted, this longstanding rule–that inherited capital assets receive a new tax basis equal to their fair market value as of the decedent's date of death–may be changed in the future.

Tax Basis Information regarding Inherited Capital Assets. Because of the adjustment to income tax basis that occurs on the decedent's death, the Executor of the decedent's estate (or the successor Trustee of the decedent's revocable trust if there is no Executor–hereafter, both will be called the "Executor") has a duty to prepare a comprehensive spreadsheet listing ALL assets in which the decedent owned an interest at death and valuing each asset at its fair market value according to the valuation rules provided in the Internal Revenue Code and Treasury Regulations. Again, this must be done for ALL estates, not just taxable estates. And, again, the value shown for each capital asset in the comprehensive spreadsheet will become the new income tax basis of that asset in the hands of the beneficiary. Further, in the case of taxable estates (i.e., those estates that are *required* to file a Form 706, U. S. Estate (and Generation-Skipping) Transfer Tax Return), the Executor must now prepare and file new Treasury Form 8971, notifying the IRS of the new income tax basis of each capital asset, and must provide each beneficiary of the Estate with a Form 8971, Schedule A, informing the beneficiary of his or her income tax basis in each inherited asset.

Why Is Tax Basis Important? A taxpayer's basis in a capital asset determines the amount of gain or loss on a future sale or other disposition of that asset. In general, if a capital asset is sold, the capital gain or loss will be determined by subtracting the tax basis from the sales price. If the sales price exceeds the tax basis, there will be a gain on the sale. If the sales price is less than tax basis, there will be a loss on the sale. Thus, each owner of any capital assets must know his/her tax basis in each of those assets.

Long-Term Versus Short-Term. In general, under current law, a long term capital gain results when a capital asset is sold after being held for more than one year. The short term capital gains tax rate applies when a capital asset held for less than one year is sold. Note that when one inherits a capital asset, one is deemed to qualify for the long-term capital gains tax rate even if the inherited asset is held for less than one year by the beneficiary before being sold.

Long-Term Capital Gains Tax Rates. Per the American Taxpayer Relief Act of 2012 passed in January 2013 ("ATRA"), the top long-term capital gains tax rate was set at 20% (5% higher than under the George Bush administration). However, for many taxpayers, the long-term capital gains tax rate is 15%.

In general, taxpayers who are in the top income tax bracket, i.e., 39.6% (in 2016, this applies to single filers with adjusted gross income [AGI] above $415,050 and married filers with AGI above $466,950), pay 20% on net capital gains. Taxpayers who are not in the top bracket pay 15% on net capital gains. However, the 3.8% net investment tax (sometimes referred to as the "Medicare Surtax") also applies to certain taxpayers (at $250,000 for married filers and $200,000 for single filers). Therefore, the top long-term capital gains tax rate in 2016 is 23.8%.

Compare Long-Term Capital Gains Tax Rate to Estate Tax Rate. From a tax standpoint, is it better to receive a capital asset as a gift from a living donor or better to inherit a capital asset from a decedent? The answer depends on a number of things. First, you want to know whether the asset has appreciated in value above its basis (or not). If the asset has appreciated in value, the "step up" in basis at death will be a factor. Second, you want to know whether the current owner has a taxable estate or not. In general, if you can achieve a higher income tax basis without paying any estate taxes to get it, that's a good deal. On the other hand, if you have to pay estate taxes to get a higher tax basis, that's not a good deal.

Obviously, you, as the recipient, are not responsible for paying estate taxes owed by the decedent's estate. However, if you are one of the major beneficiaries of the decedent's estate, estate taxes will impact the net amount you receive. There are other considerations as well, such as future tax rates, future appreciation in the value of the asset, how long the donor will live, whether the asset will be held or sold, etc.

Example 1. Assume taxpayer ("TP") owns a capital asset ("Asset") currently worth $300,000 but having a tax basis of $200,000. TP has owned the asset for more than 1 year. Assume TP is in the highest income tax bracket. What will TP pay in long-term capital gains taxes and net investment taxes if he sells Asset? We are going to "isolate" that sale and ignore all deductions and credits available to TP. Based on the capital gain of $100,000 ($300,000 - $200,000), TP will pay $23,800 in taxes on the sale (23.8% x $100,000).

Assume TP doesn't sell Asset while living, but dies in 2016 still owning Asset. Assume TP has a taxable estate. Assume Asset is worth $300,000 as of TP's date of death. Per TP's Will, Asset passes to Son. Just to focus solely on capital gains taxes versus estate taxes, assume TP made taxable gifts during life that used up his entire exemption from estate and gift taxes ($5,450,000 in 2016), so that TP has no exemption left at death. Ignore all estate tax deductions and credits available at death. How much in estate taxes will TP's estate pay on Asset as a result of TP's death? Under current law, the federal estate tax rate is 40%. Therefore, TP's estate pays $120,000 in federal estate taxes with respect to Asset (40% x $300,000).

So, which tax is worse–the long term capital gains tax (and net investment tax, if applicable) on the gain when Asset is sold during life or the federal estate tax on the fair market value of Asset at death? In this example (where TP has a taxable estate), the answer is clear–the estate tax is "worse" than the capital gains tax. NOTE: the capital gains tax applies solely to the gain, or appreciation, in the value of an asset above its basis at the time of sale, while the federal estate tax applies to 100% of the fair market value of an asset at death. A 23.8% tax on gain is less than a 40% tax on the entire value.

Remember that if TP gives Asset to Son during life, Son will have a "carryover basis" in Asset. This means that, if TP gives Asset to Son and Son sells Asset shortly thereafter, Son will have a capital gain of $100,000 ($300,000 - $200,000). If Son is in the highest tax bracket, Son will incur $23,800 in taxes on the sale. Even if Son is *not* in the highest tax bracket, Son will pay capital gains taxes of $15,000 on the sale (15% bracket x $100,000 gain).

Example 2. Suppose TP does *not* have a taxable estate. (In this regard, note that, if elected [and if enough Democrats are elected to Congress], Hillary Clinton proposes to reduce the estate tax exemption amount to $3,500,000 and to increase the top estate tax rate to 65%.) If TP does not have a taxable estate, from a pure tax standpoint, it is better for TP to retain Asset (i.e., not sell it and not give it away) until his death. In that way, when TP dies, Asset will obtain a new income tax basis equal to its fair market value as of TP's date of death. Assume Asset is worth $300,000 when TP dies. Asset gets a new income tax basis equal to $300,000 as a result of TP's death. Because no estate taxes are payable by TP's estate, this is a "tax-free step up in basis"–something very valuable under the current tax laws (although, again, these rules are subject to change in the future). Thus, Son inherits Asset with a $300,000 tax basis. If Son sells Asset for $300,000 shortly after TP's death, Son will have no capital gain and no capital gains taxes to pay ($300,000 - $300,000 = $0).

Example 3. TP has a taxable estate, but has not used any of his $5,450,000 exemption yet. Asset is worth $300,000 now, but is likely to be worth $500,000 when TP later dies. TP may wish to give Asset to Son now, so that all growth in value of Asset *after* it is given away will be outside TP's estate. TP will be making a gift worth $300,000 to Son and will use $300,000 of his $5,450,000 exemption amount. Son will have a carryover basis in Asset of $200,000, but all future growth in the value of Asset will escape "transfer tax" (i.e., gift and estate taxes) in TP's estate. Son holds Asset until TP's death when Asset is, in fact, worth $500,000. Because of the lifetime gift, TP's estate avoided paying transfer tax on $200,000 (the gain above the $300,000 value of Asset when given to Son). At the current estate tax rate of 40%, this amounts to a transfer tax savings of $80,000.

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Bypass Trust Issue. Many people have Wills and Trusts that create a "Bypass Trust" on the first spouse's death. As we have explained before, a Bypass Trust is used primarily by couples with a taxable estate to avoid "wasting" the estate tax exemption of the first spouse to die. ATRA made two significant changes to the estate tax laws: (i) it made portability "permanent" and (ii) it increased the estate, gift and GST tax exemption amount to $5 million, indexed for inflation. We previously sent two newsletters that discussed and compared Bypass Trust versus Portability. *See* our January 31, 2016 and April 30, 2016 newsletters. Many couples no longer have a taxable estate and no longer need a Bypass Trust for estate tax reasons. Some couples who still have a taxable estate may no longer want a Bypass Trust due to the ability to make the portability election, which is a second way to avoid "wasting" the estate tax exemption of the first spouse to die. One factor to consider is that appreciated capital assets held in a Bypass Trust do not obtain a *second* "step up" in basis when the surviving spouse dies (those assets do obtain a "step up" in basis on the first spouse's death, however). So, is this detrimental enough to do away with the Bypass Trust? The other consideration, however, is that the assets still held in the Bypass Trust when the surviving spouse dies "bypass" estate taxes in the surviving spouse's estate. This is true no matter what those assets are worth at that time. So, we are back to capital gains taxes versus estate taxes. The capital gains tax is a tax on the gain in the value of a capital asset, while the estate tax is a transfer tax on the full fair market value of all assets, including capital assets, owned at death.

Bottom Line. From a pure tax standpoint (ignoring all non-tax reasons for making the transfer), giving a low basis, appreciated capital asset to a beneficiary as a gift during life does not make sense if the donor will *not* have a taxable estate at death. However, if the donor will have a taxable estate at death, giving away capital assets that are likely to appreciate in value in the future can be beneficial.

Contact us: If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know, feel free to contact us by phone, fax or mail at the address and phone number shown above, or by email sent to:

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