Drafting Tips for Estate Planners Who Want to Save Income Taxes Through Basis Step Up for Their Clients

By Neal Nusholtz

This article attempts to give useful tax advice to estate planners who fall into a trance when they see the letters "IRC" followed by the symbol § and three or four numbers.

Basis

When a person sells or depreciates an asset for tax purposes, their taxes are affected by the cost of the asset they are selling or depreciating. For tax purposes, that cost number is referred to as "basis." We use the word basis instead of "cost' because a basis can change over time. Cost is a static number equal to the original purchase price. The depreciable basis of a building might start at its cost of $100,000, but, each year, the amount of depreciation taken reduces the remaining basis until it goes down to zero. The profit on sale of the building will depend in part on how much depreciation has been taken.

When someone dies, the basis of property received by the heirs is the fair market value on the date of death. ("Basis of property acquired from a decedent." IRC 1014(a).)[1] For example, heirs receiving stock worth $150 that was bought years ago for $10 will have a basis of $150 if they sell the inherited stock. That step up in basis could mean no taxable profit on the sale of that stock if it is sold close to the date of death.[2] We refer to that new basis as a basis step up on death.[3]

Estate planning has changed recently because the exemption for estate taxes is $11,580,000 per person ($23,160 per married couple) until after 2025 (indexed for inflation).[4] The tax is 40 percent over the exemption. Years ago, when the exemption was much lower—$600,000.00—tax planners discouraged clients from owning too much property because it could cause higher estate taxes. Nowadays, with the larger exemption, most estate planners do not care how much their clients own for purposes of estate tax liability.

Four Tax Advantages of Basis Step Up

Four advantages of basis step up are listed below:

1. No gain on sale at time of death;
2. More depreciation after a death. See IRC 754 for step up basis for property held by partnerships;
3. Higher 20 percent deduction under IRC 199A(b)(2) [the alternate deduction of 2.5 percent of the unadjusted basis] See Treas. Reg. 1.199A-2 (c)(3)(v); and
4. A fresh start when basis records are missing.

The following four case scenarios are examined:

(1) the young wealthy client with a midas touch;

(2) the typical nuclear family;

(3) situations where the surviving spouse's spending is a concern; and

(4) situations where an heir is likely to have significant unpaid creditors;

The Young Wealthy Client with the Midas Touch

A younger client has $20 million and is about to open a successful manufacturing business. If the client opens the company in his or her own name and it does well, 40 percent of its value could go to estate taxes. On the other hand, if the client keeps it in his or her own name, his or her children could have a basis step up on death. The solution to that predicament is to set up an irrevocable trust for the children where the client retains a "power to reacquire the trust corpus by substituting other property of an equivalent value" (IRC 675(4(c)). Have the trust own the factory before it has any significant value for gift tax purposes.

Grantor Trusts

Code section 675 is part of a series of code sections (IRC 671-678) referred to as the grantor trust rules, which define when a grantor is treated as the owner of a trust for income tax purposes.[5] For one client, I consulted the grantor trust rules to determine if it was the receiver or the debtor who would pay taxes on income earned during a receivership.

Retaining a swap power makes a grantor of a trust the owner of the trust for income tax purposes. In case of the aforementioned factory, it also allows the client to wait until before death to take back the factory from the trust in a nontaxable swap of cash and/or high basis assets. The client can own the factory before death for basis step purposes, if he or she chooses to do so. The children will either receive the cash in the trust or the high basis assets. Since it is a swap of equal value, this can be done without incurring additional estate taxes.

Powers of Appointment

Transactions that result in basis step up are listed in IRC 1014(b). Number 4 on the list is "property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will." A "power of appointment is defined as a power created or reserved by a person having property subject to his or her disposition that enables the donee of the power to designate, within any limits that may be prescribed, the transferees of the property or the shares or the interests in which it shall be received."[6] A general power of appointment is defined under federal and state law as a power, "the permissible appointees of which include the donee, his or her estate, his or her creditors, or the creditors of his or her estate."[7] Any power that is not a general power is referred to under Michigan law as a "special power" ("permissible appointees of which do not include the donee, his or her estate, his or her creditors, or the creditors of his or her estate." (MCL 556.112(i)). Sometimes special powers are referred to in tax rulings as "limited powers." Assets subject to a general power are available to creditors because they are not "solely" for the benefit of a non-debtor*." In re Shurley,* 171 BR 769, 786–87 (Bankr WD Tex 1994), *subsequently rev'd on the issue of trust qualifying as a self settled spendthrift trust under Texas law, sub nom." Matter of Shurley,* 115 F3d 333 (5th Cir 1997). A special power is not available to creditors because it is not a "power in the property which can be transferred to another, or sold on execution, or devised by will.*" In re Peck's Estate*, 320 Mich 692, 700–01, 32 NW2d 14 (1948). Ordinarily, assets of a revocable trust are available to creditors in probate after the death of a settlor (MCL 700.7506)(b)). A trust beneficiary, however, is not considered a settlor merely because of a lapse, waiver, or release of a power of withdrawal over the trust property. (MCL 700.7506(c)). A general power is included in the taxable estate of a decedent (IRC 2041). A special power is not included because it is not a general power off appointment.

Basis Planning for the Typical Nuclear Family

Community Property Trusts

States can be divided into two types: (1) common law states, like Michigan, which have entireties property; and (2) community property states where property is owned one-half by each spouse. Common law states Alaska, Tennessee, and South Dakota have optional community property statutes, where spouses can elect to treat their property as community property. The reason those states have passed optional community property statutes is because under IRC 2020(b), in common law states a spouse is considered as receiving one-half of entireties property from their deceased spouse, but under IRC 1014(b)(6) a *surviving* spouse is considered to have received from their deceased spouse, the share of community property that they *already* own. Consequently, an inheriting spouse in a common law state gets a new basis equal to one-half of the fair market value and one-half of the original cost. But a spouse in a community property state gets a full step up in basis equal to the fair market value of the property. The Michigan Probate and Estate Planning Section has crafted a Michigan Optional Community statute, which has not been enacted into law.

Spouse's with Limited Powers of Appointment

In two circumstances, estate plans for married couples have commonly included only limited powers of appointment for surviving spouses. Years ago, when the estate tax exemption was much smaller, it was common practice to leave the surviving spouse a trust where the surviving spouse had only a limited power of appointment so that half of the estate and any growth thereon was outside of the estate of the surviving spouse.

A second example where limited powers of appointment in spouses occurs would be in blended or second marriages where each spouse has their own children. Any money left by one spouse to the other spouse will likely end up going to the children of the surviving spouse and, possibly, disinheriting the children of the first spouse to die. Often, in those cases, the result is a limited power of appointment in the surviving spouse.

The problem with leaving a surviving spouse a limited power of appointment is that there will be no step up on the second death. If twenty years goes by before the second death, there could be significant appreciation in assets that would not be used for basis step because the assets were not in the estate of the surviving spouse. Two solutions to obtain basis step up on the death of the surviving spouse are:

1) giving the spouse a general power of appointment in the trust assets which is (a) limited to the surviving spouse's unused estate tax exemption; and (b) designed to get the most bang for the buck by automatically selecting assets based on the largest percentage difference between basis and fair market value; and
2) in situations where there is no fear of estate taxes, making the limited power qualify for a QTIP Election and then making the QTIP Election. Heirs get a step up basis on property upon which there is a QTIP Election. IRC 1014(b).[8]

Limited Powers of Appointment for Non-Spouses Where Creditors Are an Issue

Situations can occur where a beneficiary should not have a general power of appointment because it exposes trust assets to creditors, but we want a basis step when say, a spendthrift child dies and we want the heirs to get a basis step up. There is a way to have a limited power of appointment qualify as a general power of appointment for basis step up purposes. A limited power can be treated as a general power for basis step up if the limited power creates "another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power." (IRC 2041(A)(3)).

The preceding complicated language in IRC 2041(A)(3) is the Delaware Tax Trap. It resulted from Delaware passing a law in 1933 that would allow estate planners to string together limited powers of attorney to avoid the estate tax indefinitely (it would not avoid the current generation skipping tax). For purposes of explanation, consider a wealthy client whose estate plan consisted of a huge trust where income only would be paid to the heirs and limited powers of appointment could be strung together for generations. An heir in each generation could decide who would have income from the trust in the next generation and who it would be that would be able to make the same decision in a subsequent generation.

Such an arrangement would violate the rule against perpetuities. The 1933 Delaware solution to that rule against perpetuities problem was to restart the clock on the rule against perpetuities every time a limited power created a new limited power:

> …the validity of an interest in trust which is created by the exercise of a power of appointment is measured from the date the power of appointment is exercised to create the appointed interest rather than from the date the power of appointment is created.

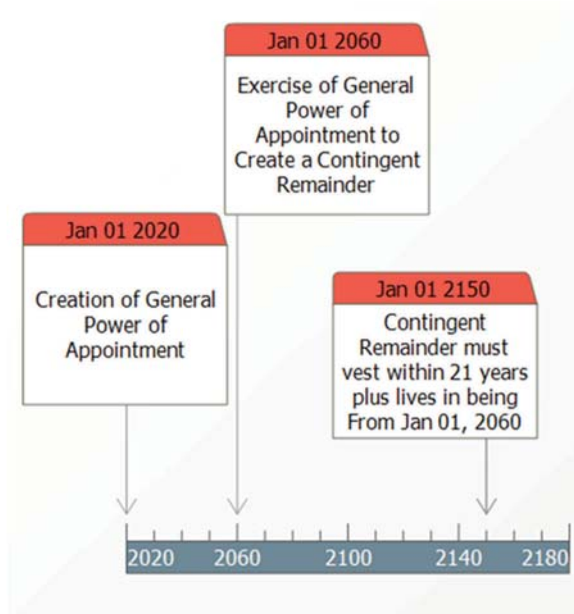
The response from Congress in IRC 2041(A)(3) was to convert a limited power into a general power for estate tax purposes if the limited power creates another power which, under the applicable local law, can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

If you trigger the trap, a limited power is treated as an estate includible general power and that can cause estate taxes. To avoid triggering the trap (1) do not exercise a first power to create a second power; or (2) exercise the first power to create a second power but measure and require vesting from the date of creation of the first power.

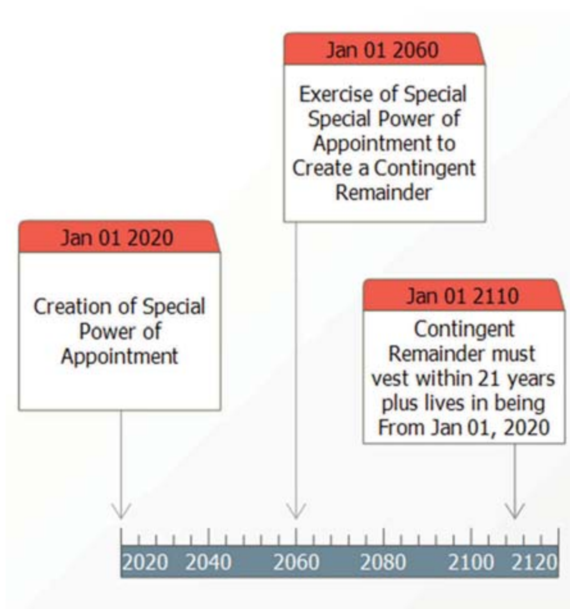
Using the Delaware tax trap to have a limited power be treated as a general power allows heirs to get step up basis from a limited power of appointment. Under IRC 1014(b)(9) there is basis step up on "property acquired through the exercise or non-exercise of a power of appointment, if by reason thereof the property is required to be included in determining the value of the decedent's gross estate."

Under MCL 556.124(1), the period during which the vesting of a future interest may be suspended or postponed by an instrument exercising a power of appointment begins on the effective date of the instrument of exercise in the case of a general power presently exercisable, and, in all other situations, at the time of the creation of the power. Below is an illustration of how the two-timing provisions work:

General Power of Appointment



Special Power of Appointment



Under Michigan law, the trap is triggered if a limited power creates a presently exercisable general power, such as a power of withdrawal under MCL 700.7103(f). A "Power of withdrawal" means a presently exercisable general power of appointment … .(*Id.*) Under the above rule, when a special power creates a presently exercisable general power, it creates a nonvested future interest that triggers the trap because the rule against perpetuities runs from the date of exercise of the second (general) power and not the first power.

Michigan has an anti-trap statute, which invalidates future interests in personal property created by a second power if the future interest does not timely vest as measured from the date of the creation of the first power. MCL 554.93(3). The anti-trap provision does not apply to the creation of second power, which is a presently exercisable power like a power of withdrawal. MCL 554.92(e). "Second power" means a power of appointment over personal property held in trust, other than a presently exercisable general power … .(*Id.*). The Michigan Probate and Estate Planning Section has drafted a new anti-trap statute that allows the trap to be triggered with the creation of a special power as the second power.

For drafting purposes, the beneficiary with a limited power of appointment does not need to actually create a new power, as long as there is a default taker who triggers the trap. Under Treas. Reg. 20.2041-1(d), "a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment." Language to trigger the trap could say that the beneficiary has a limited power of appointment to grant powers of withdrawal to A, B or C and to do so only by identifying the trust and indicating the percentages in which A, B, and C have a power of withdrawal. If the beneficiary does not exercise that limited power or withdrawal, the default taker could be the creation of a power of withdrawal power of appointment in D, E and F equally. Such language would trigger the trap even if the decedent was not competent to make a will. The article is over. Wake up!

Notes

1. A different carryover rule applies to gifts. For gifts, the donee's basis will be the basis of the donor. IRC 1015.
2. The basis of an heir must match the estate tax return or, if no estate tax return is filed, then the amount shown on Form 8971 supplied by a Trustee or a personal representative (IRC 1014(f)).
3. A death bed transfer to a decedent who bequeaths the asset back to the donor will not qualify for basis step up, IRC 1014(e) prevents Step up When Donor receives Appreciated Property Gifted to Decedent Within 1 Year of Death.
4. IRC 2010.
5. A sale by a Grantor to a Grantor Trust is not taxable. Rev. Rul. 85-13. Taxes paid by the grantor on Trust income that belongs to trust beneficiaries is not a gift by the Grantor to the beneficiaries of the Grantor Trust. Rev. Rul. 2004-64.
6. MCL 556.112(c)
7. MCL 556.112(h) and IRC 2041(b)(1).
8. QTIP elections qualify for the unlimited marital deduction. A surviving spouse must have a requisite income interest. IRC 2056 b(b)(7)(B) and must include the QTIP property in his or her estate. Rev. Proc. 2016-49, removed a prohibition on making a qualified terminable interest property (QTIP) election when the election would have been null and void because the estate had a zero estate tax liability.

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