The Kitces Report
Advancing knowledge in financial planning...
Volume 3, 2018

Modern Estate Planning For Affluent Couples: Planning Strategies To Maximize Step-Up In Basis

Executive Summary

- Historically, estate planning, even just for "moderately" affluent families required navigating the Federal estate tax, which just 20 years ago had an exemption of only $650,000. However, with the estate tax exemption having risen more than 1,700% to $11.4M in 2019, the reach of the Federal estate tax has fallen by more than 95%.

- In a world where so few households will be subject to the Federal estate tax, the primary "tax" concern at death is now the *income* tax consequences for beneficiaries, for which the primary planning opportunity is to maximize step-up in basis (especially for couples) to minimize future capital gains, and to avoid forfeiting carryover or unrealized capital losses.

- One of the most straightforward strategies to maximize step-up in basis is simply to transfer assets to an individual before their death so that their assets receive the step-up when he/she subsequently passes away. However, this strategy is often unnecessary and a moot point in community property states (where marital property receives a full step-up in basis at death anyway), and in common-law states couples must be certain to navigate the one-year "boomerang" rule that limits the step-up in basis if a donor inherits property back from a donee within 1 year of gifting it to them in the first place.

- When property has unrealized losses at death, it will typically receive a step-*down* in basis, forfeiting future capital loss deductions. As a result, terminally ill individuals may wish to gift the property to the future beneficiary so they receive a more favorable carryover cost basis treatment instead (or at least dual-basis treatment for non-spouse beneficiaries).

- Because already-recognized carryforward capital losses are themselves "lost" at death, couples may even wish to "create" (i.e., trigger) capital gains before the death of a spouse to absorb (i.e., utilize) the losses.

- A key benefit of credit shelter trusts is the ability to bypass a surviving spouse's estate to minimize future estate taxes. However, with an expanded Federal estate tax exemption, and the rise of portability, couples often no longer need a credit shelter trust to avoid future Federal estate taxes. In which case it's often better to *not* use a credit shelter trust at all, as leaving property outright to a surviving spouse allows for a second step-up in basis that is not receive if the property is bequeathed to a credit shelter trust instead.

- Widow(er)s who already have a credit shelter trust established on their behalf from a deceased spouse should consider trying to *maximize* distributions from the trust if it is no longer needed to avoid estate taxes, as the widow(er)'s own assets will get a step-up in basis at death, while credit shelter trust assets do not. Which makes it better to preserve growth of assets in the widow(er)'s own name, rather than the bypass trust.

- Widow(er)s with existing bypass trusts should consider their asset location decisions, placing assets that may generate substantial capital gains in the widow(er)'s name for a future step-up in basis, while credit shelter trusts can hold the more income-oriented assets not eligible for a step-up in basis anyway.

- The presence of state estate taxes in nearly a dozen states, typically with much-lower exemptions, means households in those states must still balance the *state estate tax* benefits of bypass trusts against the Federal (and state) *income tax* benefits of bequeathing property outright to a surviving spouse.

- More "creative" estate planning techniques emerging in a more cost-basis-driven future include Marital 2038 trusts and "JEST" trusts that seek to cause a couple's joint assets to be fully included in each spouse's estate, regardless of which spouse dies first, ensuring a double-step-up in basis on all of the couple's assets, without needing to time pre-death transfers.

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Introduction: Near- And Post-Death Basis Planning For Couples

In the not-too-distant past, the primary estate planning concern for many mass-affluent and most high-net-worth families was avoiding the Federal estate tax. Notably, over the last 20 years, the estate tax exemption has increased repeatedly, starting with President Bush's Economic Growth and Tax Relief Reconciliation Act of 2001, and most recently under the Tax Cuts and Jobs Act of 2017, cumulatively rising by more than 1,700%, from just $650,000 in 1999, to $11.4 million in 2019.

And thanks to those increases and today's generous estate tax rules, less than one in every one-thousand families is likely to end up owing the tax. In fact, the recent Heckerling Institute on estate planning estimates that there may be no more than about 2,000 to 3,000 decedents in the entire *country* that will die facing a Federal estate tax in 2019.

Yet at the same time, a number of income-tax-related events occur at death as well, from the filing of a final income tax return, to the unwind of various pre-tax "Income in Respect of a Decedent" assets like IRAs, and the popular step-up-in-basis-at-death rules that can provide substantial income tax savings to heirs.

To that end, "tax planning" for one's estate at death in the current environment has become a lot less about *estate tax* planning, and far more about the *income tax* planning opportunities at death… particularly with respect to maximizing available step-up in basis opportunities.

Accordingly, in this issue of *The Kitces Report*, we explore the planning issues and opportunities around "cost basis planning at death", how pre-death asset transfers can help maximize step-up in basis, how other types of pre-death transfers can help avoid the potential for a step-*down* in basis, the disadvantages of traditional credit shelter trusts that emerge in an estate planning environment driven by *income-* (rather than estate-)tax planning, how even those with already-established credit shelter trusts may wish to alter their spending/distribution strategies to maximize step-up in basis opportunities in the future, and the new types of trusts beginning to emerge in the modern era of estate planning to further maximize step-up in basis opportunities (without the need of trying to properly time asset transfers before death).

Step-Up-In-Basis Assets Vs. Non-Step-Up IRD Assets

When an individual dies and leaves assets to an heir, those assets generally fall into one of two categories.

The first group of assets can be categorized as Income in Respect of a Decedent (IRD), while the second group of assets consists of essentially everything *other than* IRD items that are included in the first group.

And the primary difference between the two groups of assets, from a beneficiary's point of view is that *only* assets in the second group receive a step-up in basis, while IRD assets do not.

Income-In-Respect-Of-A-Decedent Assets Get No Step-Up In Basis

IRC Section 691outlines the rules for Income in Respect of a Decedent, which in essence is any type of "pre-tax" asset whose ordinary income tax consequences were not already recognized before the decedent passed away.

IRD assets include a decedent's outstanding accounts receivables for a sole proprietorship or pass-through business, the embedded gains on any U.S. savings bonds, other accrued but unpaid bond interest, embedded gains of a non-qualified annuities, the gains associated with outstanding installment sales payments, net unrealized appreciation, final employment bonuses and paychecks that weren't paid before death, and most commonly, all pre-tax retirement accounts (e.g., IRAs, 401(k) plans, etc.). These IRD-type assets receive no step-up in basis, which essentially means that beneficiaries of the assets step into the decedent's tax shoes after their death.

For example, the beneficiary of a $200,000 401(k) with all pre-tax funds will owe ordinary income tax on every dollar distributed from the account… exactly the same treatment that would have applied to the original account owner during their lifetime. Similarly, the beneficiary of a $500,000 IRA with $20,000 of cumulative nondeductible contributions (4% of the total account balance) carries over the deceased owner's basis in the IRA, but receives *no increase in basis*. As such, the beneficiary is subject to the same IRA pro-rata distribution rule as would have applied to the original decedent if they had taken a distribution during their lifetime. Thus, the beneficiary will owe ordinary income

tax on 96% of their initial distribution (while the remaining 4% will be a return of the decedent's basis).

Notably, though, IRD treatment is not exclusive to just current pre-tax retirement account balances. A beneficiary inheriting a U.S. savings bond would carry over the decedent's initial purchase price as basis, but would owe ordinary income tax on any deferred interest once the bond is redeemed… once again, the same treatment the owner would have received had they taken the same distributions during their lifetime.

Understanding The Income In Respect Of A Decedent (IRD) Deduction

Assets that are considered Income in Respect of a Decedent (IRD) do *not* receive a step-up in basis upon death. This means that any amounts that would have been subject to income tax during the decedent's lifetime, had they "used" the item of IRD (i.e., distributed assets from an IRA, received payment for an accounts receivable, sold shares of stock for which the NUA tax break was used, etc.), will continue to be subject to income tax to the beneficiary. Which is unfortunate, because those same assets IRD assets are *also* included in a decedent's estate and thus, may *also* be subject to estate tax (on top of their future income tax liability).

With the current top Federal income tax bracket at 37% and the Federal estate tax rate at 40%, that's a combined 77% tax rate! And in the past, it's been even worse, with combined rates approaching 95%(!) in the 1990s.

Of course, no one – not even the Bill Gates's and (pre-divorce) Jeff Bezos's of the world – is supposed to be paying tax rates *that* high, so there *must* be some sort of mechanism to alleviate the effects of this double taxation, right? There is, and it's called the IRD deduction.

Plainly stated, the IRD deduction is a Federal income tax deduction that can be claimed by the recipient of an IRD asset (e.g., the beneficiary of an IRA) for any Federal estate tax paid attributable to that IRD asset. Which means if there is no Federal estate tax in the first place – as is the case for the overwhelming majority of estates today – there is no IRD deduction to be had.

By contrast, suppose that an individual's taxable estate consists solely of real estate with a fair market value on the date of death of $11 million, and an IRA worth $2 million. Further suppose that the combined estate is subject to a Federal estate tax of $640,000 (($13MM – $11.4MM exemption) x 40% = $640,000). In this case, the entire $640,000 Federal estate tax bill is attributable to the IRA (since absent IRA, the estate would be below the $11.4MM estate tax exemption), and thus, the IRD deduction would be equal to that amount. Which means the beneficiary is eligible for a whopping $640,000 income tax deduction in the future!

Notably, though, the cumulative amount of the IRD deduction is generally not taken at once. Rather, it is claimed ratably as an individual "uses" the IRD asset, and generates the corresponding income tax bill.

Assuming, for instance, the same $640,000 Federal estate tax bill attributable to a $2 million IRA as outlined above, for every dollar of income distributed from the inherited IRA, the beneficiary would be able to take an IRS deduction of 32 cents ($640,000/$2MM = 32%). If all $2M is withdrawn at once, the entire $640,000 deduction could be claimed. If only $100,000 is withdrawn, only $32,000 of the deduction is claimed. If the post-death required minimum distributions are stretched out over a period of years or decades, so too is the IRD deduction, until a total deduction of $640,000 has cumulatively been received over time (by cumulatively withdrawing the entire $2M that was inherited in the first place).

The dramatic increase in the Federal estate tax exemption over the past two decades has led to a corresponding *decrease* in the number of beneficiaries eligible to claim an IRD deduction. Nevertheless, when the deduction is available, it's often rather substantial, so it's definitely not something heirs should let slip through the cracks.

Thankfully, there's a simple two-question test heirs can use to determine if they're eligible for the deduction. The questions are as follows:

1) Did I inherit an item of IRD?; and
2) Did the estate from which I am inheriting pay any Federal estate tax?

If the answer to both questions is "yes", then the beneficiary is entitled to at least some IRD deduction.

In addition, IRD treatment applies to any assets that were associated with the decedent's compensation (i.e., compensation that was earned but not recognized before death). Thus, for instance, a decedent's final paycheck (earned before death but paid after death) is still pre-tax income that is taxable to the beneficiary when received, along with pre-tax deferred income compensation, and even final bonuses (or payouts for accrued but unused vacation) paid after death. In fact, the IRD treatment of "employment" income extends so far that a beneficiary inheriting shares of stock that were previously part of a Net Unrealized Appreciation (NUA) distribution will still owe long-term capital gains tax on the NUA of the shares, when sold… the same tax treatment as would have applied to the NUA if the original owner has sold the shares during their lifetime. Because the NUA gain is treated as IRD (since it was a gain associated with employment and a pre-tax retirement plan), and thus is not eligible for a step-up in basis (unlike other types of capital gains).

Step-Up-In-Basis Assets

In contrast to the select group of assets that fall into the IRD category, upon the death of an owner, other assets *do* receive a step-up in basis.

The "step-up in basis rule", as outlined in IRC Section 1014, essentially treats the beneficiary of an asset received due to the owner's death as though they purchased the inherited asset for its fair market value on the date of the decedent's death (or on the alternate valuation date as described in IRC Section 2032, if such an option is elected by the executor of an estate).

Thus, the beneficiary of such assets is generally free to sell such assets immediately without any income tax consequences (assuming no gain/loss since the decedent's death). And from a sheer convenience perspective, means the beneficiary *can* sell the asset and "know" what the cost basis is (fair market value on the date it was inherited), without needing to try to retroactively reconstruct transaction information that may no longer be available after the original owner has passed away anyway.

> **Example #1**: In 1980, Bob bought 1,000 shares of Pineapple Computers in his taxable brokerage account for a total of $25,000. Recently, Bob passed away and, on the date of his death, his Pineapple Computer shares were valued at $3 million.
>
> Bob's Will left all of his assets, including the $3 million of Pineapple Computer stock, to his daughter, Sally. As such, Sally is treated as though she purchased the Pineapple Stock for $3 million upon Bob's death, increasing her basis to match that amount.
>
> Thus, if Sally were to sell her Pineapple Computer stock one month later, when the shares were still worth $3 million, she would owe no income (or capital gains) tax. Similarly, if six months after Bob's passing Sally were to sell the inherited Pineapple Computer stock for $3.3 million, she would owe long-term capital gains tax on only the $300,000 of growth that occurred since Bob's passing. And not the $2.975M of gains that occurred since Bob's original purchase.

(Note: Although the general rule is that an asset must be held for longer than one year to receive long-term capital gains treatment, there is an exception to that rule for assets that are inherited after death. IRC Section 1223(9) dictates that gains on such assets are automatically treated as long-term capital gains, regardless the decedent's original holding period, or that of the beneficiary after inheriting the asset.)

Step-Down In Basis And The "Step-Up-In-Basis" Misnomer

While the phrase "step-up in basis" has become the colloquial way of describing the tax treatment a beneficiary's non-IRD assets receive upon inheritance, the reality is that the phrase doesn't *always* ring true. Instead, as noted above, IRC Section 1014 treats the beneficiary as though they purchased the assets in question for fair market value on the decedent's date of death… whether that amount is higher *or lower* than the decedent's basis in the property prior to death.

Of course, one would certainly *hope* that amount is greater than the decedent's own basis, especially if they've owned the asset for a long period of time, but the unfortunate fact of the matter is that's not always going to be the case. Sometimes investments lose value between their date of purchase and when their own passes away.

Thus, in situations where the value of an asset has declined since a decedent's original purchase, a beneficiary will generally have to *step down* the basis of the inherited property to its value on the date of death.

Example #2: In 2015, Marsha purchases 500 shares of Beverly Hillbillies Oil stock in her taxable brokerage account for a total of $400,000. Recently, Marsha passed away and, on the date of her death, owing to a steep decline in energy prices since their purchase, her Beverly Hillbillies Oil shares were valued at only $150,000. (As far as we know, her death was not a result of losing $250,000 in her portfolio, but a mere coincidence!)

Marsha's Will left all of her assets, including the $150,000 of Beverly Hillbillies Oil, to her son, Andy. As such, Andy is treated as though he purchased the Beverly Hillbillies Oil stock for $150,000 upon Marsha's death, *decreasing* his basis to match that amount.

Thus, if Beverly Hillbillies Oil stock were to have a dramatic turnaround and Andy were to sell the stock one year later for $400,000 – the same amount Marsha initially paid for them back in 2015 – he would owe long-term capital gains tax on the $250,000 gain that occurred after his death (even though neither he nor Marsha ever got a deduction for the prior $250,000 loss!).

Step-Up In Basis Rules For Jointly Held Property Of Spouses

For a variety of reasons, many married couples prefer to hold most, if not all, of their taxable investments in joint accounts. More specifically, those accounts tend to be joint accounts with rights of survivorship.

Under IRC Section 2040, in situations where spouses have a "qualified" joint interest in property – held as joint tenants with rights of survivorship, as well as property held as tenants by the entirety – upon the death of the first spouse, the surviving spouse will generally receive a step-up (or step-down) in basis on *one-half* of the assets. In other words, the deceased spouse is *presumed* to have owned 50% of (and therefore, get a step-up or step-down on 50% of) the assets, regardless of how much each spouse actually contributed to the purchase.

That step-up-in-basis amount (50% of the fair market value) is then added to the surviving spouse's own basis in the inherited property to arrive at the new, total basis.

Example #3: Charlie and Sabrina were a married couple who owned a taxable brokerage account structured as joint-with-rights-of-survivorship. The sole asset in the account was Maple stock, which the couple purchased for $200,000 ten years ago. Unfortunately, Charlie recently passed away, and on the date of Charlie's death, the Maple stock was valued at $500,000.

When the stock was initially purchased in the joint account, Charlie and Sabrina were each allocated 50% of the $200,000 purchase price, or $100,000, as basis (note that there is not any form or action that needs to be taken to make the allocation… it just *happens)*. Furthermore, on the date of Charlie's death, his "share" of the Maple stock was worth $250,000 (one-half the $500,000 total amount).

Per the step-up-in-basis rules, Sabrina is treated as though she purchased Charlie's "share" of the account for its $250,000 value on Charlie's date of death, and can add that amount to her own existing basis of $100,000. Thus, Sabrina's total basis after Charlie's death is $350,000. Which means her remaining capital gains exposure is $500,000 - $350,000 = $150,000… not coincidentally, the same gain she already had on her half of the shares (originally purchased for $100,000 and now worth $250,000).

Note that in order to receive a step-up in basis, the to-be-stepped-up assets must be included as part of a decedent's estate in the first place. Thus, as noted above, typically only one-half of the property owned jointly by spouses will qualify for a step-up… because the deceased spouse is only considered the owner of half of those assets to begin with!

By contrast, if a married individual owns property outright in his/her own name, in an individual revocable living trust, or in a similar manner in which the *entire* value of the property is included in their estate at the time of death, then the *entire* value of the property is eligible to receive a step-up in basis. Conversely, though, this also means that if 100% of an asset is solely owned by the other (surviving) spouse, and the decedent owned 0% of the same asset, then it will *not* get a step-up in basis when the decedent passes away (though it would at the subsequent death of the second spouse who actually did own the property).

Example #4: Max and Tricia are married and live in Virginia, a separate property state that follows the "normal" rules for property ownership. They have three taxable brokerage accounts; one that is

titled only in Max's name, one that is titled only in Tricia's name, and one that titled as a joint account. Each of the accounts contains CPR stock that was purchased for $50,000 (each).

Unfortunately, Tricia has just passed, and on Tricia's date of death, the CPR stock in each of the three brokerage accounts noted above was worth $200,000. Thus, the couple had a total of $600,000 of CPR stock as of Tricia's passing. Notably, however, because of the three different ways in which the stock accounts were owned (titled), there will be three different basis treatments for the stock owned in the accounts.

The stock owned in Tricia's name only will received a full step-up in basis (the basis will be $200,000 on $200,000 of stock). Similarly, half of the joint account will receive a step-up in basis (since it is deemed to be owned 50% by Tricia as a joint account held between a married couple), resulting in a total of $125,000 of basis ($100,000 step-up value for Tricia's half of the account + $25,000 of Max's own existing basis on his half of the account). And finally, the stock owned in Max's name only will receive no step-up in basis at all, because it was fully owned by Max and thus was not included in Tricia's estate to be eligible for a step-up in basis (leaving "only" Max's $50,000 of original basis). Thus, after Tricia's death, Max will have a total of $200,000 + $125,000 + $50,000 = $375,000 of basis on the $600,000 total value of the CPR shares.

Note: The result of the above example does NOT produce $600,000 of CPR shares with a uniform cost basis of 62.5% ($375,000 / $600,000) of the share price at Tricia's death. Rather, there are truly three separate share lots – the first one-third of the shares retain their $50,000 of cumulative original basis (the shares owned in Max's account), the second one-third of the shares have a basis equal to their cumulative $200,000 value on Tricia's date of death (the shares owned in Tricia's account), and the remaining one-third of the shares that were owned jointly are allocated the remaining $125,000 of basis.

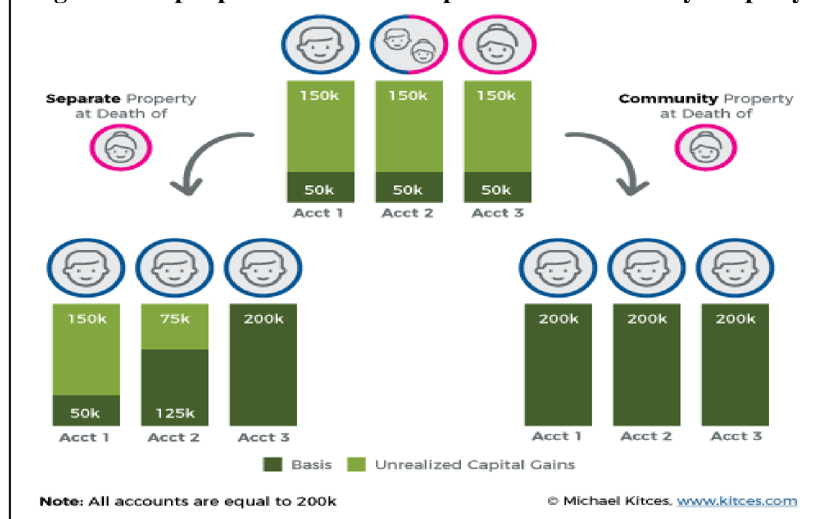
Community Property Twists To The Step-Up-In-Basis Rules

The step-up-in-basis rules apply to assets transferred to a beneficiary by reason of the owner's death. But the rules to determine ownership *of* property in the first place – getting to the answer of the "Who actually owns what?" question – is generally a matter of state law… *not* Federal law.

Thus, in order to understand the tax treatment of assets after death, including which assets are eligible for a step-up in basis, an understanding of *both* state property laws and the Federal income tax laws is necessary. In essence, the Federal Tax Code provides the "how" (as in "How should property be treated upon passing to a beneficiary?"), and state law provides the "what" (as in "What property is treated as having belonged to the decedent?").

The overwhelming majority of states use common law to determine property ownership – where ownership is simply determined by how the property is actually titled – but a number of states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin) use a different system, called community property, to determine ownership of property for married couples.

Figure 1. Step-Up In Basis Rules: Separate vs. Community Property



A complete discussion of community property is beyond the scope of this white paper, but in general, community property for married couples includes assets that are acquired *during marriage* while living within a community property state (with some exceptions, such as assets acquired during the marriage but received via gift or inheritance), *and* other assets that are "converted" to community property via mutual agreement, *and* any other property that otherwise

clearly can't be identified as an individual spouse's separate (i.e., non-community) property. But what exactly *is* community property?

Conceptually, for post-death basis planning purposes, you might think about community property as property that is simultaneously owned 100% by both spouses, regardless of whose name(s) is/are actually on the account. Thus, community property of spouses is generally eligible for a full step-up (down) in basis on the *entire* value of the property at *both* deaths… automatically!

> **Example #5**: Recall Max and Tricia, the married couple from the previous example. Suppose that, instead of living in Virginia, a separate property state, they instead chose to marry and live in a community property state.
>
> Further recall that Max and Tricia have three taxable brokerage accounts: one that is titled only in Max's name; one that is titled only in Tricia's name; and one that titled as a joint account. Now imagine that each of the accounts contains CPR stock that was purchased for $50,000 (each) with income the couple earned while married (i.e., "community property" funds). Thus, although all three accounts have different registrations, they are *all* considered to be community property.
>
> On Tricia's date of death, the CPR stock in each of the three brokerage accounts noted above was worth $200,000. Thus, the couple had a total of $600,000 of CPR stock as of Tricia's passing. Amazingly – at least to the majority of people who are more familiar with common-law-state rules – since each of the accounts was considered community property, Max will receive a full step-up in basis on *all* three accounts (i.e., the basis of the stock will increase to $200,000 in *each* account, for a total basis of $600,000)... even the account that was *only* in Max's name to begin with!

Compared to example #4, in which all the facts were the same *except* for the fact that Max and Tricia's assets were considered separate property in a common law state, there is an additional $225,000 of stepped-up basis in a community property state! And sometime in the future, when Max dies, those same shares will all be eligible for *another* step-up. In this regard, community property rules can appear rather attractive as compared to the rules for separate property.

That said, the community property rules cut both ways. Any community property assets that have a fair market value less than their original basis on the first-to-die spouse's date of death receive a step-*down* in basis that can increase the surviving spouse's capital gains tax liability when/if those assets are later sold at a higher value.

It's also worth noting that community property laws are *not* the only wrinkle in basis planning at the State level. State income taxes can also present some unique challenges and considerations.

Pennsylvania, for instance, does not allow a step-up in basis for *State income tax purposes* for assets left to a surviving spouse. Thus, in such situations, a surviving spouse may have to keep track of two basis amounts… one for Federal income tax purposes and one for State income tax purposes!

Maximizing Step-Up In Basis Opportunities By Transferring Assets Between Spouses Before Death

Clearly, the community property rules and the "double-full-step-up in basis" they offer – one step-up after the death of the first spouse, and then another after the second spouse – offer a real advantage with respect to minimizing capital gains taxes. But what about couples living in the other 40+ states that use common law to determine property ownership and *not* community property rules? Can they get double step-ups too?

Maybe, but it will generally take a bit more proactive planning.

One simple "trick" to try and get a double-step-up in basis is to do some pre-death movement of appreciated assets between spouses. More specifically, to move appreciated assets from assets held in joint accounts or in accounts held in the to-be-surviving spouse's name only, to accounts in only the first-to-die spouse's individual name.

The idea of this strategy is that by having all the assets owned outright by the first-to-die spouse, that spouse's assets – which are now most/all of the couple's assets after the transfers – receive a full step-up in basis. Those assets can then be left back to the surviving spouse, who receives back via inheritance her original share of the assets (along with the decease spouse's share). And upon that "surviving" spouse's passing, *another* step-up

in basis will be available on all of her assets for future beneficiaries as well.

Example #6: Norman and Irma are married, live in a common-law property state, and have three taxable brokerage accounts; one that is titled only in Norman's name, one that is titled only in Irma's name, and one that titled as a joint account. Each of the accounts contains stock of CLP stock that was purchased for $200,000.

CLP stock has performed well for the couple, and today, the CLP stock in each of accounts noted above has risen to $500,000. Thus the couple owns a total of $1.5 million of CLP stock with a combined basis of $600,000.

Now suppose that Norman is not in the best of health, and that doctors have given him about two years to live. Irma, on the other hand, is still in excellent health and according to Norman, "will live to be 150."

Suppose that the couple take no action and that, like clockwork, two years to the day later, Norman passes. Furthermore, for simplicity sake, assume that the CLP stock in each account is still worth $500,000.

If, like most couples, Norman has left all of his assets to Irma (and visa-versa), Irma will receive the following treatment (akin to Example #4, earlier):

- A full, $500,000, step-up in basis for the CLP stock that was held in the account in Norman's name only; and

- A half step-up in basis on the CLP stock ($250,000) in the joint account, to be added to her own existing basis ($100,000) for a total of $350,000 of basis; and

- No step-up in basis for the CLP stock held in the account that was in her name only, leaving her with the original $200,000 of basis.

Thus, Irma now has cumulative basis in CLP stock of $1,050,000 ($500,000 + $350,000 + $200,000 = $1,050,000). Notably, that means that if she were to liquidate her total $1.5M position in the investment after Norman's passing, she would still be "stuck" with long-term capital gains on $450,000 of gain, which could easily create a $100,000+ tax bill when factoring in Federal capital gains rates, the 3.8% surtax on net investment income, and state income taxes.

Suppose, however, that if instead of taking no action upon Norman's diagnosis, the couple had engaged in some savvy planning and transferred all the CLP shares into an account in his name. The result of such actions would have been that, upon Norman's passing, Irma would have inherited the entire $1.5 million of CLP stock with a full step-up in basis to $1.5M. Thus, a sale of the stock by Irma after Norman's passing would have resulted in *no* capital gains, potentially saving Irma $100,000 or more in unnecessary taxes, and netting her the full $1.5 million proceeds!

Of course, like nearly everything tax-related, there are exceptions, "gotchas" and contraindications to be aware of, and to watch out for.

One-Year Holding Period "Boomerang" Rule

One of the most critical issues to be aware of with this type of planning is the one-year holding rule that applies in certain situations, which can limit eligibility for a step-up in basis.

Specifically, under IRC Section 1014(e), if within one year of a gift of assets, those assets pass *back* to the original donor (or the original donor's spouse) on account of the donee's death, there is no step-up in basis, and the original basis of the asset will continue to apply. In essence, the rule is prevented for the exact scenario of everyone in the family gifting assets to someone who is about to pass away, only to receive them back shortly thereafter with stepped-up basis (by imposing a 1-year waiting period instead).

Thus, while the strategy of transferring appreciated assets to a first-to-die spouse's account can work well *if* there is enough lead time between planning and death, the strategy does not work well in situations where there is very little warning of an impending death, or it comes as a surprise.

Example #7: Richard and Ester are married and live in a common law property state. 30 years ago and prior to getting married, Richard bought shares of Homerun stock for $25,000. Since then, Homerun has lived up to its name, and the stock is now worth $1 million.

Suppose that, for whatever reason, Richard never changed the ownership of his account and the stock is still held in his name only. Furthermore, suppose that Richard and Ester get some bad news… Ester is terminally ill.

At times like this, the *last* thing that's probably on Richard or Ester's mind is tax planning… understandably so. But that's one of the main reasons that couples like Richard and Ester might engage the help of a professional… to help them remove emotion from the equation and help them make sound financial decisions, even in the toughest of times.

Thus, even in light of the stressful situation, Richard and Ester manage to take the steps necessary to open an account in Ester's name and to transfer the Homerun stock to her account.

If Ester manages to hold on for at least a year after the transfer, upon her passing she can bequeath the stock back to Richard, and he would be entitled to a full step-up in basis and could then sell the $1 million of Homerun stock tax-free.

Conversely, if Ester passes away within the one-year window, Richard will not receive a step-up in basis and instead, will simply carry over (or really, carry back) his original basis of $25,000. Thus, a future sale of the stock would result in a substantial amount of capital gains, but no worse than having not tried the strategy in the first place.

Loss Of Control Over Gifted Assets

It's nice to think of a world where every couple gets along perfectly and is completely open, honest, and transparent with one another at all times. Yes, it's nice to think about… but it's not the world we (always) live in.

With that in mind, prior to engaging in a gift-and-get-back-after-death strategy, donors of such property living in common law property states should have a *high* level of trust in the receiving spouse that, upon their passing, they will actually complete the second half of the equation and leave the assets back to the initial-donor-surviving spouse. Because once the assets are transferred, there's nothing to prevent the receiving spouse from leaving the assets to someone *else* (e.g., another family member, a friend, or even a charity). Which means there's a risk that the surviving spouse may end up with nothing!

Example #8: Charles and Karen are married and live in a common law property state. Many years ago, Karen inherited shares of JKL stock, which at the time was valued at $50,000 (her basis). Today, the stock is still owned in Karen's name only, but has ballooned in value to $2 million.

Unfortunately, Charles has just been diagnosed with cancer, for which the typical prognosis is three to five years. Suppose that in an effort to make the best of a bad situation, Karen transfers the shares of JKL to an account only in Charles's name in order to try and get a step-up in basis upon his passing. Fast-forward a year and half…

Having made it past the year mark, Charles can now leave the stock back to Karen, who would then receive a full step-up in basis. Imagine though, that as Charles's condition deteriorated, he was moved into an assisted living facility, and that while he was there, he fell in love with one of the nurses.

Sensing the end is near (but still of legally sound mind and body), Charles calls up his estate planning attorney and changes his will to leave all of his assets to his new-found-love nurse.

Sketchy? Yes.

Morally repulsive? Yes.

But legal? You betcha!

Once Karen has gifted the assets to Charles, they are *his* assets, and as such, she *does not* get a say to whom they are left. Thus, she may be largely, or even entirely, disinherited from "her own" assets!

Clearly, this result would present a problem for anyone in Karen's shoes. And that's why supreme trust between spouses is such an important element when engaging in this type of planning (and particularly in second marriage situations where it's not uncommon for spouses to *not* leave assets to each other, and instead leave bequests to children from their first marriages instead).

Note: Many common law property states incorporate a provision known as a "right of election", also known as "electing against the estate", for surviving spouses who are largely or entirely disinherited. Such provisions, when they exist, vary from state to state, but often allow

a surviving spouse to elect to receive at least a minimal (often one-third) portion of the deceased spouse's estate, regardless of to whom it was left.

Transferring Assets To Potentially Medicaid-Eligible Spouses

An additional complication that individuals must be aware of is when the spouse likely to die first is currently enrolled in Medicaid, or may otherwise be planning to apply for (and hoping to become eligible for) such benefits in the future.

Because, as most advisors are aware, Medicaid is a means-tested program and generally requires that individuals spend down their assets to extremely modest levels prior to being eligible to receive benefits under the program. And in such scenarios, transferring assets *to* a Medicaid beneficiary, or a potential Medicaid beneficiary, is almost *never* a good idea, as it can partially or fully disqualify them from Medicaid (and effectively "force" them to spend down the assets they just received, such that there may be little or nothing left to bequeath back at the end!).

In fact, to the extent possible, assets should generally be transferred *out* of such person's estate, even if it means giving up tax benefits. After all, a step-up in basis isn't worth much if there's no assets left to step-up (because Medicaid required them to be spent down first)! Or viewed from the other side – it's better to have some of the assets go to Uncle Sam in the form of taxes, than to have most or all of the assets consumed for medical expenses while waiting to qualify for Medicaid instead.

On the other hand, in many states a "well spouse", sometimes referred to as a "community spouse", is only allowed to keep a certain moderate level of assets so as to avoid "impoverishment" themselves, with the rest of the community spouse's assets being spent down for care as well. For 2019 this inflation-adjusted amount is capped at $126,420. Which means a couple with sizable assets – hoping to receive a step-up in basis – may be compelled to spend down at least most of the value of the assets waiting to qualify for Medicaid, even if it's *not* transferred to the ill spouse and remains with the healthy spouse instead.

However, it's important to note that Medicaid is a Federal-State partnership, and therefore the exact rules vary substantially from state-to-state. And in some states, there are additional options – such as "spousal refusals" – that allow a well spouse to keep more assets. Alternatively, enrollment in a long-term care partnership program may allow a Medicaid beneficiary to retain more assets without requiring them to be spent, which in turn (re-)opens the door to transferring assets into that ill-spouse's name for cost basis step-up opportunities as well.

The bottom line… it's important to be mindful of how Medicaid eligibility (or a desire to qualify for Medicaid in the foreseeable future) could impact the gift-and-get-back-after-death strategy. And that means having a sound understanding of the local state laws that factor into the equation.

Preserving Capital Losses By Transferring Assets Between Spouses

With any luck, planning to "maximize" capital losses isn't something you have to worry too much about… because there simply aren't many capital losses for which to plan!

Oftentimes, however, individuals approaching "the end" will have either existing carryforward capital losses, or unrealized capital losses. And in such cases, pre-death basis planning centers around making the most of those losses to make sure that at the owner's death they aren't… well… lost!

The Importance Of Identifying The "Owner" of Capital Losses

Couples filing joint tax returns often think that everything on their tax return is theirs… as in "it belongs to both of them". The reality though, is that while a joint tax return reports a couple's income, deduction, credits, etc., on a common return, the building blocks of that return still largely belong to the *individuals* making up the couple, themselves.

Case in point… carryforward capital losses. That is to say, losses that have already been "locked in" by the sale of "loser investments", but which

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have not yet been "used up" in previous tax years.

In general, taxpayers are allowed to offset capital losses against any capital gains, plus an additional $3,000 of ordinary income. Any losses in excess of those amounts (net capital gains plus $3,000 of ordinary income) cannot be deducted in the current year, but may be carried forward to future years, up to and including the year of death.

Capital loss carryforwards are reported on Schedule D, *Capital Gains and Losses*, which like the Form 1040 that most people are familiar with, records the combined amounts of a couple (and not the gain and losses of each member of the couple separately). However, the "building blocks of gain and loss" that are used to complete that form still belong to each member of the couple separately.

Thus, and as Revenue Ruling 1974-175 made clear over 40 years ago, the capital loss associated with one individual from a couple dies with the death of that person who owned the asset producing the loss, and *not* upon the "death of the couple".

> *"In the absence of any express statutory language,* ***only the taxpayer who sustains a loss is entitled to take the deduction****. See Calvin v. United States, 354 F. 2d 202 (10th Cir. 1965). Therefore, the business loss and the capital loss sustained by the decedent for the period ending with the date of his death are deductible only on his final income tax return. Thus,* ***no part of such net operating loss or capital loss is deductible by the decedent's estate or carried over to subsequent years****." (emphasis added)*

In recent years, the Tax Court has come to similar decisions with respect to other deductions and credits claimed by a couple on their joint tax return but belonging to one individual *of* the couple. For example, in *Nadine L. Vichich v. Commissioner* (U.S. Tax Court, 146 T.C. No. 12), decided on Apr. 21, 2016, a surviving spouse (Nadine Vichich) was denied the ability to use an alternative minimum tax (AMT) credit that the IRS, and subsequently the Tax Court, determined had "belonged" to her deceased husband.

It is, therefore, a well-settled matter that while a married couple can use each other's income and deductions to offset one another when electing to file a joint return, the actual items of income and deductions (and credits, etc.) remain the "property", if you will, of the person (or persons) generating them (or of the assets that person held). And since you can

Transfers To Maximize A Step-Up In Basis Are Not Limited To Spouses

The strategy of gifting appreciated assets to an individual and having that person "return" the investment with a step-up in basis after their death (assuming the one-year holding period requirement is met) is *not* an approach that is limited to spouses.

Thus, for example, a child with a highly appreciated piece of real estate could transfer the deed to their terminally ill parent, and have that parent leave the property back to them in their Will. Indeed, *any* two people can engage in such a strategy, though given the potential contraindications outlined earlier – the risk that the terminally ill individual does *not* actually leave the property back to its original donor – means it's probably best to limit the strategy to only those relationships where the utmost trust can be placed.

In addition, there are often more complications to consider when using the gift-to-get-back strategy with non-spouses. Notably, the default for many spouses' Wills is to leave everything to the other spouse at death. Thus, if one spouse transfers another spouse property, the transferee's Will typically *already* dictates that the transferor spouse property will get the property back upon their passing. In contrast, if a child, for instance, gives a piece of real estate to a parent in order to get it back with a step-up in basis after that parent's death, the Will may have to be updated or other estate planning measures taken. And failure to make a timely update *to* the Will can in turn cause (or ensure) that the gifted property will *not* go back to its original donor.

Furthermore, transfers of assets between U.S. spouses do not require the filing of a gift tax return, regardless of the amount being transferred. However, if amounts in excess of the annual gift tax exclusion ($15,000 for 2019) are transferred between non-spouses, then a gift tax return will generally need to be filed. And while only the largest gifts of $11+ million would likely result in an actual gift tax liability, the individual will still at least use up some portion *of* their lifetime $11.4M exemption (which may or may not matter in their own financial future).

Thus, the cost of filing extra returns and/or updating legal documents can at least reduce the benefits otherwise available when using the give-and-get-back strategy for non-spouses. And the potential that the terminally individual might not make it a full year could result in all those additional costs and complications becoming completely fruitless. That said, in situations where a large capital gain may be avoided using such a strategy, the risk may be worth the reward.

only file a joint return for up to the year in which your spouse passes away, after that, any unused deductions, credits, or other tax benefits attributable to the deceased spouse will, unfortunately, generally die with them.

> **Example #9**: Bruce and Pearl are married and have filed a joint income tax return for each year since their wedding. Sadly, Bruce died on January 15, 2019. At the time, there had been no trades (realized gains or losses) in any of Bruce's taxable accounts in 2019.
>
> In 2000, Bruce met with a broker and purchased $250,000 worth of RonEn stock. Only Bruce attended the meeting, and so "to keep things simple" and to avoid delaying the account opening process waiting for Pearl's signature, the account was opened only in Bruce's name. Unfortunately, as "luck" would have it, in 2008, RonEn went bankrupt while Bruce still owned the stock in only his own name. Thus, Bruce became the not-so-proud (sole) owner of a long-term capital loss of $250,000.
>
> Over the course of the following decade and until his death, via both the sale of some investments with capital gains and the $3,000 annual capital loss amount allowed to be written-off against ordinary income, Bruce's long-term carry-forward capital loss was whittled down to "just" $120,000.
>
> In light of Bruce's death, if Pearl takes no action with respect to investments in her own taxable account(s) before the end of 2019 – the year of her carryforward-capital-loss-bearing-husband's death – she will be able to use the $120,000 carryforward capital loss to offset $3,000 of her 2019 ordinary income (since she will be able to file a joint income tax return for 2019), but the remaining $117,000 capital loss *cannot* be carried over. And since it cannot otherwise be used as well – if there are no other capital gains that year – its tax-saving power is lost forever.

Clearly, this is *not* an optimal result. For *planning purposes*, a carryforward capital loss should be viewed as an asset on the personal balance sheet, since it generates real economic value (in the form of tax savings when offset against a capital gain). Notably, this is why businesses *actually do* report a carryforward loss as a deferred tax *asset* on its balance sheet.

Thus, for instance, if a taxpayer is in the 15% long-term capital gains tax bracket and has a capital loss of $117,000, it is reasonable to consider the capital loss an "asset" of $17,550, since it can save that much in future taxes. In example #9 above though, through her inaction, Pearl let that capital loss (and the $17,550 tax asset) "evaporate" into thin air, effectively giving away her capital loss tax asset.

Planning for Already-Realized Carryforward Capital Losses And Current Year(-Of-Death) Realized Capital Losses

So what *should* be done in situations where a spouse dies with a capital loss? The first goal is rather straightforward: if the capital loss carryforward has effectively become "use-it-or-lose-it" in the year of death… find a capital gain, *any* capital gain, that can be realized and used against the available capital loss.

Accordingly, when a carryforward-capital-loss-bearing spouse's death has *already* occurred, the first thing that should be done is to survey the surviving spouse's remaining assets. Notably, this survey should focus only on those assets that the *surviving* spouse already owned that have unrealized gains (as capital assets inherited *from* the deceased spouse will generally receive a step-up in basis, eliminating any gain existing at the time of death).

Once this inventory has been completed, the surviving spouse should aim to liquidate enough of their own investments with capital gains so as to completely use up the capital loss in the year of death. In selecting which investments the surviving spouse should sell to "fill up" the capital loss with available gain, preference should be given to those assets the surviving spouse was most likely to liquidate anyway in the future (as any assets the surviving spouse intends to hold indefinitely may get a future step-up in basis at her death anyway). Although bear in mind that assets which are *already* tax-preferenced on sale – e.g., real estate gains already deferred using a 1031 like-kind exchange, or the sale of a primary residence with the up-to-$500,000 capital gains exclusion – cannot be used to offset against the available capital loss, since the gains aren't recognized in the first place.

On the other hand, selling an asset to absorb a deceased spouse's available capital loss doesn't *necessarily* require the surviving spouse to part with an asset they

otherwise intended to keep. Thus, while the sale and immediate repurchase of real estate would likely be viewed as a sham transaction and deemed invalid by the IRS, there is nothing preventing a surviving spouse from liquidating stocks, bonds, mutual funds, and similar investments with a gain and then *immediately* buying the investments right back in order to realize gains that can be applied against and be offset by the soon-to-be-lost-anyway capital loss, increase the sold-and-repurchased asset's basis, and lower the future capital gain that will be owed when/if the investment is finally liquidated for good.

> **Example #10**: Recall that Pearl, from the previous example #9 had $117,000 of carryforward capital losses that went unused after her husband Bruce's death. Suppose, however, that at the time of Bruce's passing, he and Pearl also had a joint account with $1 million of Nile River stock with a cost basis of $200,000. The stock has been a solid performer for Bruce and Pearl, and prior to his death, Bruce suggested that Pearl hold on to the stock "for the long run" since it had served them so well.
>
> Due to the joint ownership at the time of Bruce's death, Pearl would generally be entitled to a step-up in basis on one-half of the account. Thus, after Bruce's death, Pearl would have a total cost basis of $600,000 ($500,000 cost basis due to step-up in value on Bruce's half of the account + $100,000 of her own cost basis at the time of Bruce's passing = $600,000).
>
> If Pearl decides to liquidate the entire $1 million of Nile River stock to travel around the world, Bruce's $117,000 of otherwise unused carryforward capital losses would offset an equivalent amount of gain, limited the total taxable capital gains to "just" $283,000. But recall that Bruce told Pearl to hold on to the stock for the long run prior to his death, a wish Pearl would like to honor (at least for the time being).
>
> Well… unless Pearl is particularly attached to the exact shares of Nile River stock she owns – which are likely held electronically and are completely undiscernible from *any* other shares of the same company anyway – she can sell $146,250 of Nile River stock in Bruce's year of death to generate $117,000 of capital gains (assuming the cost basis is $0.20-on-the-dollar for each share given the $100,000 cost basis and $500,000 current value)… and then to honor Bruce's wishes, she can buy the same amount of stock right *back*. The end result would be the same $1 million of Nile River stock, but with a combined cost basis of $746,250, as opposed to the $600,000 of basis that Pearl would have absent any action.
>
> If Pearl then holds the Nile River stock until *her* death, the move will largely be meaningless, as her heirs will receive a full step-up in basis anyway. But there's no guarantee that Pearl will hold on to the stock that long, and so by making this move now, she could save herself tens of thousands of dollars in unnecessary future taxation without any downside (except, perhaps, for some nominal transactions costs to sell and repurchase the shares).

Note as well that the "Wash Sale" rule has *no impact* on Pearl's decision to sell and repurchase the shares. The Wash Sale rule *only* deals with taxpayers selling investments with a *loss* and repurchasing the same (or a substantially identical) investment within a 30-day window before and after the sale. It *does not* impact the sale of an investment with a gain, as is the case for Pearl. Congress doesn't have a rule that says "you owe capital gains taxes, but since you repurchased the stock, you don't have to pay your bill" (but if you choose to offset that bill with your capital losses instead, that's your prerogative!).

In addition to making sure that any of a decedent's carryforward capital losses don't go wasted, it's also important to review a decedent's year-of-death transactions. Any capital losses resulting from these transactions must also be "used up" in the year of death, or they too will be lost.

Though at the same time, it's important to remember that the sale of an asset with gain *must* be *completed* in the deceased spouse's calendar year of death to offset against year-of-death capital losses (or carryforward losses that will be forfeited beyond the year of death). Thus, a death early in the year may give a surviving spouse ample time to grieve and to revisit tax planning later in the year, whereas an unexpected death late in the year may require the surviving spouse to take action much sooner than one would like in order to avoid the potential loss of available tax savings.

Planning For Unrealized Capital Losses Of A Soon-To-Be-Deceased Spouse

When evaluating near-death basis planning strategies, it clearly important to maximize any already-realized losses that have already been "locked in" through sales

prior to a spouse's death. But the planning shouldn't stop there. It's also important to maximize any potential *unrealized* losses that a soon-to-be-deceased spouse may have in their account as they approach the end of life.

Because, as noted earlier, upon the death of an individual, the basis of the assets that they transfer to heirs steps to the value at the date of their death… regardless of whether that value is a step higher *or a step lower* than their own pre-death basis (i.e., it can be a step-up or a step-down in basis). Thus, if an asset has decreased in value since purchase and has unrealized losses at death, the unrealized capital loss is generally *lost* via a step-down in basis.

In some cases, though, terminally ill individuals can attempt to preserve embedded but unrealized losses by gifting their investments with losses, in order to take advantage of the so-called "double basis" rules of IRC Section 1015. While the double-basis rules don't fully permit the recipient of the gift to claim the losses of the original owner, those losses can effectively be applied against future gains of the recipient (see sidebar for further details).

> **Example #11**: Rhonda is 70 years old and is engaging in Medicaid planning. As part of that process, Rhonda transfers $100,000 of HereUGo stock to her son, Max. Rhonda had purchased HereUGo stock several years ago for $180,000, and that was her basis in the stock at the time of its transfer to Max.
>
> If HereUGo stock continues to decline in value and Max sells it when it is worth "only" $80,000, he will be entitled to a $20,000 capital loss; the difference between the $100,000 value of the stock on the date of transfer and its ultimate sale price.
>
> If, on the other hand, HereUGo stock has a tremendous recovery, and sold it when it had increased in value to $200,000, he would be would owe capital gains tax on $20,000 of gain; the difference between the sales price of $200,000 and Rhonda's original, carried over basis of $180,000.
>
> However, if the stock has only a mild recovery, and Max sells it for $150,000, he can walk away with the full amount. There is no capital gain owed because the sales price is less than the $180,000 Rhonda initially paid for the investment. Max, however, will *not* be able to

A Closer Look At The Double Basis Rules When Gifting Investments With Losses (To A Non-Spouse)

In general, when an asset is gifted from one person to another, the recipient of the gift takes the previous owner's basis as their own (i.e., basis is "carried over" from the donor to the recipient).

For example, suppose that John buys shares of Banana, Inc. for $30,000 and later gifts those shares to his son, Ronald when they are worth $50,000. There is no income tax due on the transfer, but Ronald will retain John's initial $30,000 basis. Thus, if Ronald sells the stock in the future for $65,000, he will have a capital gain of $35,000, even though only $15,000 of gain occurred while he was the owner of the stock.

There is an exception to the general carryover basis rule, however, when an individual transfers property that has a fair market value *below* its adjusted cost basis (i.e., an unrealized loss). In such situations, the recipient of the property is treated as though they have *two different* cost basis amounts, depending on whether the future sale itself will be a gain or a loss.

Under these so-called "double basis" rules, the recipient of the property uses the value on the date of the gift as the basis amount to determine a potential capital loss (i.e., the basis is effectively stepped *down* when gifted with a loss). However, for purposes of determining a potential capital gain, the recipient of the property uses the donor's higher original (carried-over) basis.

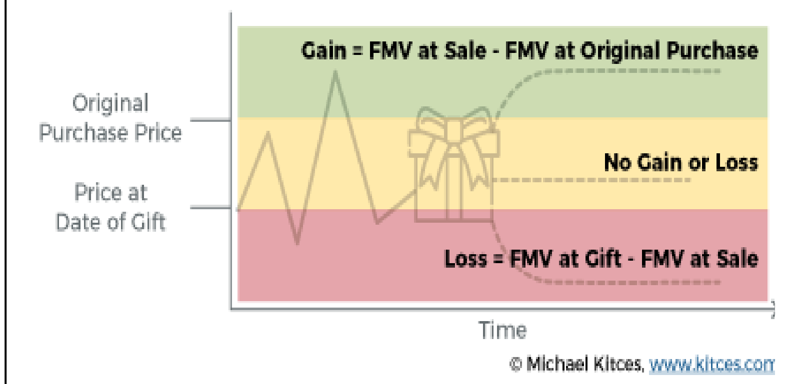
The ultimate result of these double basis rules is that there are actually three potential tax outcomes for the donee when/if they eventually sell the gifted investment, depending upon the value of the asset at that time. These consequences can be summarized as follows:

- If the gifted asset is sold for less than the fair market value on the date of the gift, then the recipient of the gift is entitled to claim a capital loss equal to difference between fair market value on date of gift and sale price.
- If the gifted asset is sold for more than the original owner's carried over basis, then the recipient of the gift will have a capital gain equal to the difference between the sales price of the asset and the original owner's carried over basis.
- If the gifted asset is sold for an amount *between* fair market value on date of the gift and original owner's carried-over basis, then the recipient will not owe any capital gains tax, nor will the recipient be able to claim a capital loss, either.

claim any capital loss, either, because the sales price is *more* than the $100,000 value of the HereUGo stock on the date of its transfer.

As Example #11 highlights, the $50,000 of Rhonda's original losses applied against Max's $50,000 gain since receiving the gift, although the remaining $30,000 loss from Rhonda's original purchase to the current value is itself lost.

Figure 2. Double-Basis Rules For Gifted Investments With Losses



But in the case of spouses, the planning opportunity of shifting investments with unrealized losses to a healthy *spouse* is even more appealing, as there is an exception to the general double-basis rules when it comes to gifts of investments with embedded losses to spouses.

Specifically, IRC Section 1015(e), entitled "Gifts between spouses", states: "In the case of any property acquired by gift in a transfer described in section 1041(a), the basis of such property in the hands of the transferee shall be determined under section 1041(b)(2) and not this section". And Section 1041(b)(2) plainly states "the basis of the transferee in the property shall be the adjusted basis of the transferor."

Thus, if one spouse transfers an asset with an unrealized loss to the other spouse, the receiving spouse has only one basis – the original spouse's basis – and the full unrealized capital loss can be preserved.

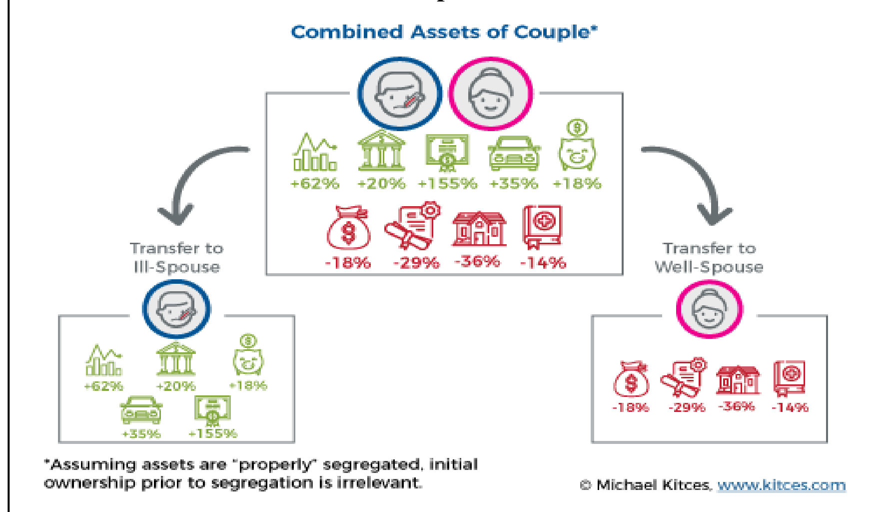
Example #12: Earnest, who has chronic health problems, is married to Ida, who is in excellent health. Earnest has a brokerage account with various investments, some of which have unrealized gains, and some of which have unrealized losses. In total, Earnest has positions with $70,000 of unrealized losses in the account.

Given the fact that if Earnest dies without taking any action, his $70,000 unrealized capital loss will disappear once the assets receive a step-down in basis, it is likely advisable for Earnest to consider a more proactive approach. If Earnest and/or Ida have generated other capital gains during the year, tax-loss harvesting Earnest's loss-assets to offset against the already-realized capital gains would certainly be one viable approach.

But in absence of other realized gains, there are really only two viable approaches for Earnest to consider. One option would be for Earnest (or Ida) to "manufacture" gains now by selling other investments with unrealized gain in order to create the "need" for tax-loss harvesting. That said, this is often not the best option though, as any capital gains may be wiped away anyway via a step-up in basis after Earnest's death anyway.

With that in mind, the better option, likely, is to transfer just the positions in Earnest's accounts with the unrealized losses to an account in Ida's own name (and to make sure that the property is not subject to community property rules). She can then "hang on to them" for the future, while avoiding a step-down in basis in the process.

Figure 3. Splitting Assets Between A Well-And-Ill Spouse To Maximize Use Of Realized And Unrealized Capital Losses



As Example #12 shows, it's important to examine accounts granularly for this purpose. Thanks to the historic bull market run following the financial crisis of 2008, most individuals' brokerage accounts are far more likely to have cumulative built-in capital gains than capital losses. However, it's not the cumulative total of these amounts that matters. It's the individual positions in the investment accounts. Any position with an unrealized loss in a terminally ill spouse's taxable account should be earmarked for possible transfer to the healthy spouse in order to preserve the potential loss for that position!

Recapping "Basic" Near-Death Basis Planning For Spouses

Ultimately, the basic basis-planning strategies for couples, where one spouse is near-death, are as follows:

- Move investments with gains into the ill spouse's name only to try and secure a step-up in basis (keeping in mind the one-year "boomerang" rule).
- Move investments with an unrealized loss into the healthy spouse's name only.
- If at all possible, use up any existing carryforward capital losses or current-year realized gains (and other favorable tax attributes) by/in the year of death.

Revisiting Credit Shelter Trusts To Maximize Step-Up in Basis Opportunities

When most people think about the Federal estate tax, they think about a tax on "rich people" at the time of their death. Today, thanks to a massive $11.4 million Federal estate tax exemption (not to mention portability of a deceased spouse's unused Federal estate tax exemption allowing up to $22.8M to be sheltered) that's largely true.

But it wasn't that long ago that the estate tax impacted far more individuals. Go back in time just 20 years, to 1999, and the Federal estate tax exemption amount was "just" $650,000 (as shown in Figure 4). And while $650,000 in 1999 was certainly not an insignificant amount of money, it was low enough that it was a real concern for many families.

Figure 4. Estate Tax Exemptions: 1999-2019

Year	Estate Tax Exemption
1999	$650,000
2000	$675,000
2001	$675,000
2002	$1,000,000
2003	$1,000,000
2004	$1,500,000
2005	$1,500,000
2006	$2,000,000
2007	$2,000,000
2008	$2,000,000
2009	$3,500,000
2010	$5,000,000*
2011	$5,000,000
2012	$5,120,000
2013	$5,250,000
2014	$5,340,000
2015	$5,430,000
2016	$5,450,000
2017	$5,490,000
2018	$5,490,000
2019	$11,400,000

*there are/were special rules for decedents dying in 2010

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Source: irs.gov/businesses/small-businesses-self-employed/estate-tax; thebalance.com/exemption-from-federal-estate-taxes-3505630

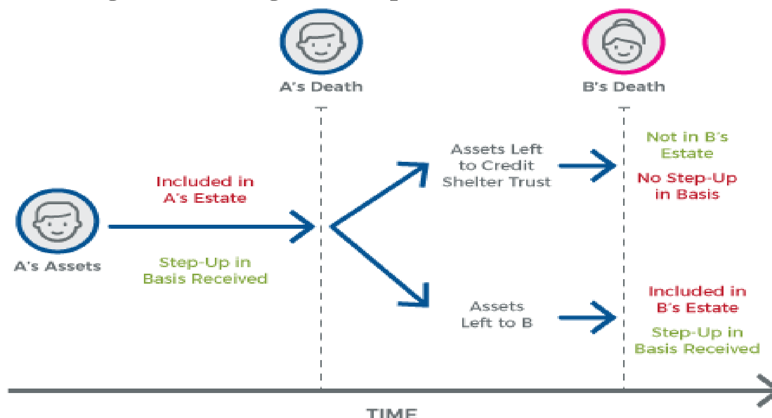
For context, in 2001 (the last year the Federal estate tax exemption was less than $1 million) the Federal estate tax exemption was $675,000 and nearly 110,000 estate tax returns were filed. In contrast, while there will likely be about 13% *more* deaths in 2019 (thanks to population growth), there will only be about 4,000 Federal estate tax returns filed. That's only about 3.5% the number of returns filed in 2001 with roughly 13% *more* deaths! (And only about half of those will even be taxable estates, as the rest include bequests to surviving spouses or charities eligible for the marital or charitable deduction!)

But what does any of this have to do with cost basis planning for spouses?

Simply put, in the not-too-distant past, many families were more concerned with Federal estate taxes than they were with Federal income taxes. That lead them to take

certain measures to minimize or avoid exposure to that tax, even if it meant giving up certain income tax benefits. And for many years, the "bread and butter" of many estate tax attorneys – and the focal point of many estate tax plans – was the credit shelter trust (also known as a "bypass trust" or the "B" portion of an A/B trust).

Figure 5. Basis Step-Up Implications Of Using A Credit Shelter Trust Vs. Leaving Assets Outright To A Spouse



By using a credit shelter trust, a deceased spouse was able to use their exemption amount to fund a trust that could support their surviving spouse during the surviving spouse's lifetime… but by not actually leaving the funds outright to the surviving spouse (and instead to a trust), the assets would "bypass" the surviving spouse's estate, effectively passing on to other heirs after the second spouse's death entirely free of estate tax.

At the same time, the surviving spouse could also pass on his/her own assets to the same heirs estate-tax-free using their own Federal Estate tax exemption. Which was often far better than leaving all property to a surviving spouse, who would then try to pass on 2 people's assets (the first spouse to die, and his/her own) with only that surviving spouse's own estate tax exemption… an outcome that often resulted in some (additional) estate taxes (and thus why the credit shelter trust became so popular).

Yet while there are still a number of potential reasons that an estate plan may include a trust today (i.e., for creditor protection, to ensure the future line of succession, to protect a special needs beneficiary's means-tested benefits, etc.), thanks to the increased exemption amount and the portability feature of the estate tax law (which was first introduced in 2011, see sidebar), trusts of the credit shelter type are *rarely* needed anymore to avoid Federal estate tax.

Here's the problem though… many people have estate plans that are so old they might as well have been written on stone tablets! And many of those "old" estate plans – particularly from prior to 2011 – include Wills or revocable living trusts that create credit shelter trusts that are funded using a formula that essentially says, "Put as much money in here as can pass free of Federal estate tax", and any remainder can flow over to my surviving spouse directly. Well today, that means the "first" $11.4 *million* will go to the credit shelter trust… which for most people, is

The Meaning Of Portability

Since 2011, the Federal estate tax exemption has been "portable" between spouses, and the portability rules were made permanent by the American Taxpayer Relief Act of 2012.

Portability functions as a de facto credit shelter trust by allowing a deceased spouse's executor – often the surviving spouse him/herself – to transfer any of the Deceased Spouse's Unused Exemption Amount (also known as DSUEA) to the surviving spouse via *Part 6 – Portability of Deceased Spousal Unused Exclusion (DSUE)* of Form 706, the *United States Estate (and Generation-Skipping Transfer) Tax Return.*

Thus, the first member of an affluent couple to pass away no longer needs to worry about the risk of "stacking" the couple's combined assets on a single surviving spouse's exemption amount – which in the past necessitated *not* leaving the assets to a surviving spouse, and instead to a credit shelter trust for his/her benefit in order to "bypass" the surviving spouse's Federal estate tax exposure. With portability, it's feasible to simply leave a surviving spouse all of the first spouse's assets… *and* his/her unused estate tax exemption along with it (and given an unlimited marital deduction, leaving all assets to a surviving spouse *will* result in leaving all of Federal estate tax exemption available to be bequeathed as well).

The end result is that portability effectively allows a couple to maximize the use of both spouse's available Federal estate exemption amounts, and to do so directly (without the use of credit shelter trusts). In 2019, this means that a married couple can effectively pass $22.8 million to heirs Federal-estate-tax-free, without the use of or need for a trust. (Though a trust may still be used for other non-Federal-estate-tax purposes, of course!)

everything they own! Everything is set to go into the credit shelter trust!

From an estate tax perspective, this "excess" funding of the credit shelter trust is unnecessary, but isn't particularly problematic. From an income tax perspective though, the funding of the credit shelter trust can become an issue because it reduces the number of potential step-up in basis opportunities that are available.

Because normally, when the assets of the first spouse to die are left to the surviving spouse outright (i.e., free of trust), there is a step-up in basis at *both* the first death *and* the second death. The assets get a step-up in basis when the first spouse passes away under the normal rules, and then at the second spouse's death, all assets owned outright – including those previously inherited – receive a step-up in basis as well (which means a *second* step-up in basis for the assets originally owned by the first spouse to die).

By contrast, the whole *point* of a credit shelter trust is that it will *not* be included in the surviving spouse's estate. Which means it will *not* be eligible for a step-up in basis in the surviving spouse's estate, either! That's the outcome when a credit shelter trust allows the trustee to provide for the surviving spouse using a more restrictive (e.g., HEMS for health, education, maintenance and support) distribution provision. Sheltering those assets from the surviving spouse's estate means forfeiting a step-up in basis for those assets from the surviving spouse's estate as well.

> **Example #13**: Timothy and Georgia are married and have roughly $4 million in assets. While the couple maintains a joint checking and savings account, most of their other assets have been owned separately since they first saw an estate planning attorney in the early 2000s.
>
> Timothy has a rental property in his name that is fully depreciated, but valued at $1 million. In addition, he owns a variety of securities in an individual brokerage account that are valued at $1.2 million and have a cumulative cost basis of (just) $300,000.
>
> Timothy and Georgia have identical Wills that include the use of a credit shelter trust for each other's benefit. Specifically, each Will leaves their respective assets to the credit shelter trust created by their Will, up to the amount of the current Federal estate tax exemption, while leaving the balance of the assets to the spouse outright. Further, each of the credit shelter trusts calls for the surviving spouse to receive distributions from the trust for purposes of their health, education, maintenance and support. Finally, upon the "survivor's" death, the trust is to be terminated and the assets are to be distributed to the couple's child.
>
> Now suppose that Timothy dies, and the estate plan is implemented as initially intended. The entire $2.2 million value of Timothy's estate will be placed into his credit shelter trust because that amount is far less than the current $11.4 million Federal estate tax exemption, while none of the assets will go to Georgia outright.
>
> The "good news" is that when the $2.2 million goes into the credit shelter trust, it receives a step-up in basis on account of Timothy's death. The bad news, though, is *that* step-up in basis is the *only* step-up in basis that the assets will receive before they are passed to the couple's daughter.
>
> Suppose, for instance, that Georgia lives another 10 years, and that over the course of those 10 years the trust assets grow annually at a not-unrealistic 7.2%. The result would be that by the time of Georgia's passing, the $2.2 million originally left to the credit shelter trust will have doubled to $4.4 million!
>
> Upon Georgia's passing, per the terms of the credit shelter trust created by Timothy's Will, the credit shelter trust will terminate and the $4.4 million of assets will pass to the couple's child. The "problem" though – at least from an income tax perspective – is that even though Georgia died, the credit shelter trust did not die with her. It merely terminated upon her death. Thus, the assets inside the trust get no step-up in basis upon Georgia's passing, and they are simply distributed to the next-in-line heir.
>
> In other words, the couple's child will inherit the $4.4M of trust assets with "only" a $2.2M cost basis (presumably in addition to any remaining assets Georgia still owned outright)… whereas if Timothy's assets had passed to Georgia directly, at her death, those $4.4M of assets would have received a (second) step-up in basis at Georgia's death to $4.4M (in addition to any of Georgia's own assets that received a step-up in basis at her death).

This bypass trust outcome is sub-optimal – to say the least – from an income tax perspective, for a host of

reasons. First and foremost, there's the obvious "slaps-you-in-the-face" fact that if the couple's child sells the assets inherited from the credit shelter trust, they may generate a substantial capital gain. But there are also less obvious income tax consequences. For instance, the lack of a step-up in basis, for instance, minimizes the depreciation deduction that the child can receive for the rental property, both because there is already depreciation on the asset, *and* because that depreciation is based on a lower cost basis amount.

Taking things a step further, a second step-up could have a material impact on the heir's ability to maximize any potential 199A deduction. A higher cost basis, for instance, could help a high-income beneficiary from losing some or all of their potential 199A deduction by increasing their depreciable property value for purposes of the 199A wage-and-depreciable-property test. Furthermore, a step-up basis resets the depreciable period "clock" which controls how long property can be included in the 199A wage-and-depreciable-property test to begin with!

Bottom line… missing out on that second step-up can *really* hurt from an income tax perspective. Of course, if it saves 40% in Federal estate taxes, it may still be appealing. But as the example above illustrates, many individuals, even with fairly substantial wealth, might have been exposed to the Federal estate tax when their Wills were first drafted, but simply aren't even close anymore.

Fixing The Credit Shelter Trust "Problem"

With Federal estate tax no longer being a big concern for most taxpayers, the estate *planning* focus needs to shift towards minimizing *income* taxes instead of *estate* taxes (at least and especially for those who aren't exposed to state estate taxes, either). Oftentimes, that means figuring out the best way to deal with a no-longer-necessary credit shelter trust.

Note: The purpose of this information is to highlight the tax issues that can potentially arise when unnecessarily leaving assets to a credit shelter trust. However, as noted earlier, there may be viable non-tax reasons why a trust may still be desired. While taxes are an important consideration, the ultimate decision of what estate planning vehicles and strategies a client should (or should not) make use of should consider the individual's entire tax and non-tax planning concerns.

Ditch The Credit Shelter Trust

The most obvious way of dealing with a credit shelter trust that is no longer necessary is to simply get rid of it! This may be done by just removing the credit shelter trust language from a person's Will (or revocable living trust) altogether.

By contrast, an alternate approach would be to leave the credit shelter trust language in the Will (perhaps to account for future changes in the estate tax law that reduce the exemption amount and/or eliminate portability), but to change the funding formula – i.e., where assets are allocated after death by default – to make the surviving spouse the primary beneficiary and the credit shelter trust the *contingent* beneficiary instead… and then let the surviving spouse decide at the time of the first spouse's death whether to disclaim and have the assets revert to the credit shelter trust (or not).

Alternatively, it's also feasible to leave assets bequeathed to the credit shelter trust and plan for the trustee of the credit shelter trust to disclaim assets instead. However, before making such a disclaimer, it's important to check the line of succession if the credit shelter trust isn't used, to make sure assets really do stay with the surviving spouse (if desired). In addition, if there are multiple beneficiaries *of* the credit shelter trust, the trustee also runs the risk of a fiduciary breach by disclaiming assets that future remainder or contingent beneficiaries didn't want disclaimed (and might no longer receive if the assets don't go to the credit shelter trust). Thus, for those who prefer the disclaimer approach, it's generally still advisable to alter the beneficiaries to make the surviving spouse the primary and credit shelter trust contingent, as the surviving spouse has more flexibility to disclaim his/her own assets than a trustee does to disclaim the assets of the trust beneficiaries.

Use Credit Shelter Trusts Assets First If The First Spouse Already Passed

While some credit shelter trust problems may be avoided before they occur – e.g., by not leaving assets unnecessarily to a credit shelter trust in the first place – there are situations in which a spouse has *already* passed away and funded a now-unnecessary credit shelter trust for the benefit of their surviving spouse.

In such circumstances, strong consideration should be given to using the funds *in* the credit shelter trust as the first source of spending and distributions for the surviving spouse whenever possible.

Historically, the optimal strategy was typically the opposite – a surviving spouse would use his/her *own* assets first, and leave the assets in the credit shelter trust alone to grow. In fact, that was the whole *point* of the estate planning strategy… to shelter as much from Federal estate taxes inside of a credit shelter trust, and leaving the trust intact as long as possible and continuing to compound estate-tax-free (while the surviving spouse's assets that were still exposed to estate taxes would be spent down).

Now, however, preserving credit shelter trust assets is no longer necessary for Federal estate tax protection, and spending the trust's assets (for which no step-up in basis will generally be available upon the "surviving" spouse's death) preserves as many assets *in* the surviving spouse's own name (for which a step-up in basis will generally be available).

For instance, suppose that a surviving spouse who needs $50,000 per year for living expenses is the beneficiary of a credit shelter trust *and* owns assets outright, in their own name. Traditionally, the favored course of action would have often been to have the spouse generate the $50,000 needed for living expenses by spending down his/her *own* assets first, so as to minimize the potential for future estate taxes.

Given the current exemption amount and the heightened emphasis on income tax planning, it will often make sense to reverse that planning. Instead of the surviving spouse spending through their own assets first, the trustee of the credit shelter trust should give strong consideration to using the trust assets to fund as much of the $50,000 of living expenses as possible. This way, more assets can be preserved in the surviving spouse's estate, resulting in a larger cumulative step-up in basis upon that spouse's passing (as there's no risk to allowing the surviving spouse's assets to grow if the value is still far below the now-greatly-increased Federal estate tax exemption).

Notably, the trustee *does* still have to honor the actual terms of the trust, and some credit shelter trusts are more flexible than others when it comes to distributions. However, the typical "health, education, maintenance and support" language included in credit shelter trusts gives trustees a fairly wide berth when it comes to deciding which of a surviving spouse's expenses are potential eligible to be paid via credit shelter trust distributions.

Make Use Of Asset Location Strategies

Despite the fact that an estate may not be subject to Federal estate tax, individuals may wish to continue to use a credit shelter trust as part of their estate planning for a variety of reasons. Many states, for example, continue to impose a state estate tax with an exemption amount that is far less than the Federal estate tax exemption amount. Furthermore, as of this writing, only Hawaii and Maryland allow portability of the *state* estate tax exemption amount. Thus, in many states, couples may still benefit from a credit shelter trust to protect against state estate taxes at the second spouse's death.

When such trusts are necessary, asset location can have a marked impact on the tax liabilities (and basis step-up opportunities) of future heirs. In general, in such situations, it would be advisable to place those assets which generate their returns as ongoing ordinary income inside the trust, and to have those assets which generate returns in the form of capital gains outside of the trust (especially if those capital gains assets will likely be held for the long-run or otherwise have very low turnover).

Example #14: Yani and Laurel are married and live in Minnesota. Together, the couple have $8.1 million of assets, evenly comprised of $2.7 million of rental real estate, $2.7 million stock, and $2.7 million fixed income investments.

Minnesota has a state estate tax, but has a state estate tax exemption amount of $2.7 million (in 2019). To minimize exposure to this tax, Yani and Laurel have divided each of their assets equally and own them as "tenants in common", ensuring that each can leave the $2.7 million Minnesota state

Out and About

- Jeff will be speaking on "Advisor's Guide to the New 20% Pass-Thru Deduction" for the Investments & Wealth Institute in a March 13th webinar

- Michael will be presenting on "Expanding the Framework of Safe Withdrawal Rates" for FPA St Louis on February 7th

- Jeff will also be providing a tax planning update for NAPFA National in Atlanta on March 4th

Interested in booking Jeff or Michael for your own conference or live training event? Contact them directly at speaking@kitces.com, see their calendars at www.kitces.com/schedule, or check out the list of available sessions at www.kitces.com/presentations.

estate tax exemption amount to a credit shelter trust. The credit shelter trusts are to be used for the health, education, maintenance, and support of the surviving spouse, and any amounts in excess of the available Minnesota state estate tax exemption amount are simply left outright to the surviving spouse.

Suppose though, that Laurel visits that doctor and receives some bad news. She is sick and is not expected to live more than another two or three years. Given the circumstances, it would likely make sense to immediately shift ownership of the couple's assets.

Instead of owning all assets 50/50 via a tenants-in-common registration, the stock and the rental real estate should likely be moved entirely into Laurel's name as soon as possible so as to allow for the highest probably of reaching the one-year mark and allowing for a full step-up in basis on those assets that have and should continue to generate the most appreciation (i.e., making the "bet" that Laurel will die first). At the same time, it would likely make sense for Yani to retitle all of the fixed income assets into his own name, as doing so would ensure that in the unlikely event he were to predecease Laurel, there would still be enough assets left in his name to fully fund his credit shelter trust.

Suppose, however, that things go "as planned". Laurel is the first to die, and upon her death, her estate is comprised of $2.7 in stock and $2.7 in rental real estate, all of which will receive a full step-up in basis. To continue to maximize potential step-up in basis opportunities in the future, Laurel's executor (presumably Yani) might opt to fund her credit shelter trust with the $2.7 million of stock, and give Yani the $2.7 million of rental real estate outright.

But wait! That's backwards! Why would you fund the credit shelter trust – which will likely get no step-up in basis – with the asset that is likely to appreciate the *most* in the future!?

Because you won't keep it that way!

The $2.7 million of stock used to fund the credit shelter trust can be sold. At the same time, Yani can liquidate the fixed income investments that were moved into his name when Laurel first became ill. Given the nature of these investments, it's likely that any capital gains will be fairly modest (and owing to the recent uptick in interest rates, may, in fact, produce some capital losses!).

Finally, in the last overture of a beautifully coordinated symphony of tax planning moves, Yani can repurchase the stock sold in the credit shelter brokerage account in his own name, and the credit shelter brokerage account can repurchase the fixed income investments in its own trust account that Yani sold in his taxable account. (Note: If sales of any fixed income investments in Yani's account did produce a loss, he would likely want to purchase alternate fixed income investments so as to avoid the wash sale rule.)

Years later, when Yani passes away, his heirs will receive a second step-up in basis on both the rental property (in his name) and the stock (repurchased in his name shortly after the credit shelter trust was funded). The assets in the credit shelter trust will likely *not* receive a step-up in basis at that time, *but* given the nature of the investments located in the trust (the fixed income investments), any capital gains exposure should be limited.

Notably, though, there is an important caveat to this strategy: Yani must weigh the benefits of any income tax savings against the potential for any increases in State estate tax liability. After all, Yani has ended out with $5.4M of assets in his own name, for which the Minnesota state estate tax exemption is only $2.7M… which means that a significant portion of Yani's assets will be subject to Minnesota estate tax, likely at a 12% rate. And if Yani accelerates the growth of his estate – by literally owning the "growthiest" of assets in own name, outside the bypass trust – he will only compound his State estate tax problem, and potentially pay more in State estate taxes (on all his assets above the $2.7M exemption) than he was able to save in long-term capital gains taxes (as a step-up in basis applies only to the growth on those assets, and furthermore only to the growth that isn't otherwise taxed along the way due to turnover, dividends, ordinary rental income, etc.)!

Thus, Yani might consider yet *another* alternative. For example, chances are that if Yani's rental property is a solid investment, he may plan to "hang onto it" for the foreseeable future. And Yani's beneficiaries may have similar desires. If the rental property is expected to increase in value at a significant "clip", but also generate ongoing rental income that will be taxed anyway, it may make sense to explore ways of having the credit shelter trust acquire *that* asset after Laurel's death.

Income tax on the rental income, at least initially, would likely be minimal, thanks to healthy depreciation deductions that could be taken on the property's newly stepped-up value. Plus, having the credit shelter trust purchase the asset from Yani would keep future appreciation of the property out of Yani's estate.

Clearly, there's a lot of potential variables in this sort of decision-making process. Ultimately, the best course of action can only be determined through careful analysis of many factors, including State income tax rates, State estate tax rates, Federal income tax rates, Federal estate tax rates, expected growth on investments, expected turnover of investments, and expected yield on income-generating investments.

At a minimum, though, it's important to recognize that when an estate will *not* be subject to (Federal or state) estate taxes, then maximizing step-up in basis can only be positive. But when estate taxes remain involved – whether it's Federal estate taxes, or state estate taxes – maximizing step-up in basis must still be weighed as a trade-off against the estate tax consequences as well.

The Next Generation Of Estate Planning Trusts (For Maximizing Step-Up In Basis)

As noted earlier, the notion of estate planning focusing more on the minimization of a person's income tax as opposed to potential estate tax is still a fairly recent development. As such, practitioners are still thinking up new and creative ways of trying to "beat the system", or to resolve problems that remain with simpler planning.

For instance, one of the challenges with the "move appreciated assets into the first spouse to die's name and move assets with a loss into the surviving spouse's name" approach is that you don't always know who is going to die first! Sometime both spouses appear to be well until the last moment. Sometimes death truly is sudden, unexpected, or purely accidental. And occasionally, a sick spouse will outlive the spouse that everyone thought was healthy!

To that end, if there was some way to ensure that *all* of a married couple's assets would receive a full step-up in basis upon the death of the first spouse, that would be a significant improvement over the guess-and-hope-you're-right-about-who's-going-to-die-first approach. Some creative trust planning solutions *appear* to be recently innovated to accomplish this… but still may not always be worthwhile because they can add a substantial amount of cost and complexity to an estate plan.

Using IRC Section 2038 Marital Trust To Enhance Basis Planning

One advanced technique to try and secure a step-up in basis for all marital assets upon the passing of the first spouse is known as an IRC Section 2038 Marital Trust.

Such trusts are generally established by one spouse as an irrevocable trust with the opposite spouse being a discretionary beneficiary of the trust (akin to a credit shelter trust, but established while both spouses are still alive), and with trust benefits payable to the beneficiary-spouse's estate upon the beneficiary-spouse's passing. The trust will also be drafted to intentionally include language (e.g., a power to terminate the trust early) that causes the trust assets to be including in the establishing-spouse's estate upon their passing as well.

Thus, in essence, the assets of the trust will be included in the estate of either/both spouses – regardless of which spouse passes away first – which in turn means all the assets in the trust will get a step-up in basis, regardless of which spouse dies first! Which also means that it doesn't actually matter *which* spouse sets up the Section 2038 Marital Trust in the first place… because the whole point is that *both* spouse's assets will be pooled together into the trust, and *all* assets will receive a step-up in basis (regardless of which spouse dies first).

> **Example #15**: Lou and Mary are each age 80, married, and have assets with a substantial amount of unrealized capital gains. They would like to liquidate the assets as soon as possible, but without incurring any capital gains tax. Even at the age of 80, both Mary and Lou appear to be in good health and there is no way of knowing who will be the first spouse to die.
>
> Given the nature of the situation, Lou and Mary could consider incorporating the use of an IRC Section 2038 Marital Trust into their planning. To put the plan into action, Lou might create an irrevocable trust naming Mary as the discretionary income beneficiary, and indicate that upon her passing, the trust assets should be distributed to her estate. Clearly, if Mary were to pass first and the trust assets were distributed to her estate, they

would be *included* in her estate, and therefore eligible for a step-up in basis.

At the same time, Lou's attorney could include a provision in the trust that would *also* cause the trust to be included in *his* estate, such as the power to terminate the trust early. Such a power forces inclusion in Lou's estate under IRC Code Section… you guessed it… 2038. And by virtue of the trust's assets in Lou's estate, they would seem to be eligible for a step-up in basis if Lou dies first.

Of course, it's important to bear in mind in the above example that if all the assets are distributed to Mary's estate at the time of her passing through the 2038 Marital Trust, then *her* Will controls the future of those assets. Thus, like the "gift-to-get-back" strategy discussed earlier, there needs to be a strong level of trust between spouses to ensure that the surviving spouse is actually bequeathed the assets back and is not partially or completely disinherited!

Accordingly, some estate planning practitioners have tried to create more complex trust structures, that can accomplish the goal of obtaining a "dual step-up" in basis regardless of which spouse passes away first, but without the risk that a surviving spouse may be subsequent disinherited (or that the surviving spouse can alter where the first spouse's assets are ultimately bequeathed).

For instance, the "Joint Exempt Step-Up Trust", or JEST, typically forms a single joint trust with separate shares for both the husband and wife, where each spouse retains the right to revoke his/her share of the trust until their death. Further, each spouse provides the other with a general power of appointment over trust assets, which causes the full value of the trust to be include in either spouse's estate, regardless of who dies first. By triggering estate inclusion with a general power of appointment – rather than leaving the assets outright to the surviving spouse – it is then feasible with a JEST to convert the separate trust shares to multiple credit shelter trusts (one for each share) and potentially multiple QTIP trusts (if assets in the trust shares exceed the available exemption amounts) after the first spouse passes away (retaining greater control).

Unfortunately, though, there isn't 100% clarity as to whether such trusts actually work, as IRS Private Letter Rulings (PLRs) and other guidance have yielded mixed results. Notably, one risk of using a JEST is the potential for the lifetime marriage deduction under IRC Section 2523 to be disallowed. There are other, perhaps less critical but still relevant risks as well, such as the potential for the credit shelter trusts to be unwittingly included in the estate of the surviving spouse due to the breadth of the powers of appointment. Which means, to say the least, persons interested in engaging in such planning should be encouraged to seek the advice and opinions of *multiple* qualified professionals before moving forward, given the ample amount of ambiguity and the (obvious) complexity surrounding JESTs (and similar vehicles).

Summary And Conclusion

Death is an unfortunate fact of life. In the end, as they say, Father Time remains undefeated. Certainly no one would wish death upon a close family member, such as a spouse. And no one should "look forward" to near-death planning. But when that time ultimately comes, there *are* steps that can be taken to ensure that a surviving spouse be afforded all the tax benefits available to them under the law.

Until just two decades ago, the primary focus of maximizing those "tax benefits" was minimizing the Federal estate tax, as with rates north of 50%, *that* tax was understandably a real concern (and with relatively low estate tax exemptions, applied to a wide swath of relatively-middle-class families). But with massive increases in the Federal estate exemption – which has ballooned the exemption more than 1,700% over the past 20 years to a whopping $11.4 million per person for 2019 – and portability – just a few thousand estates per year now face the prospects of a Federal estate tax. For those select group of families, it's still mostly an estate-tax-minimization-first world, but what about for everyone else?

For everyone else, the focus shifts from estate tax mitigation at death to *income* tax mitigation at death (or at least, for beneficiaries after death) instead. Which brings the availability of step-up in basis to the center of modern estate planning.

For couples with substantial amounts of community property, basis planning strategies are often quite limited… but only because the community property rules generally afford them the benefits of a "double-step-up in basis" without any substantial planning anyway. Though that unfortunately renders strategies to preserve losses largely ineffective for these couples as well.

By contrast, couples in states that follow separate property rules – which is the overwhelming majority of states – can often benefit from both step-up in basis strategies and strategies to preserve capital losses… but *only* if the right proactive steps are taken!

"Simple" strategies for such couples to consider are the shifting of positions with gains into an expected-to-die-first spouse's name only, and shifting positions with losses into an expected-to-die-second spouse's name only. Such couples should generally revisit estate plans to analyze whether existing strategies, such as credit shelter trusts, still offer the maximum expected benefit. Additionally, in certain situations, more advanced strategies, such as a 2038 Marital Trust, can be considered to mimic the potential "double-step-up in basis" potential of community property spouses.

Of course, as with all aspects of planning, it's important to look at the whole picture and to avoid falling victim to "Shiny Object Syndrome". Minimizing capital gains, for example, may *sound* great, but if that minimization comes at the expense of increased estate taxes – even "just" state-level estate taxes – it may not be worth it. Similarly, the idea of using a trust to enhance step-up opportunities may have a nice "ring" to it. But when factoring in the cost of preparing the trust, administering the trust, and the added complexity and time it may take to fund the trust, the benefit may simply not be worth the extra time and expense in the end.

Ultimately, it's important to consider all of this planning in the larger context of where we are today. After a world-wide economic crisis a decade ago that included the S&P 500 dropping by more than 50%, a real estate market that was decimated by an unprecedented amount of foreclosures, and plummeting international markets, we've enjoyed a *relatively* pain-free and historical march higher for more than 10 years. Thus, many individuals today have more built-in gains in their portfolios than at any other time in history. Which means near- and post-death basis planning for couples has *never* been more important.

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Hopefully you found this latest issue of The Kitces Report to be of value to you. However, since it is produced for you, the reader, we would like to hear from you about how the style, format, and content of the newsletter could be further improved to make it more valuable for you.

Please let us know what you think by emailing us at feedback@kitces.com! Thanks in advance for sharing your thoughts!