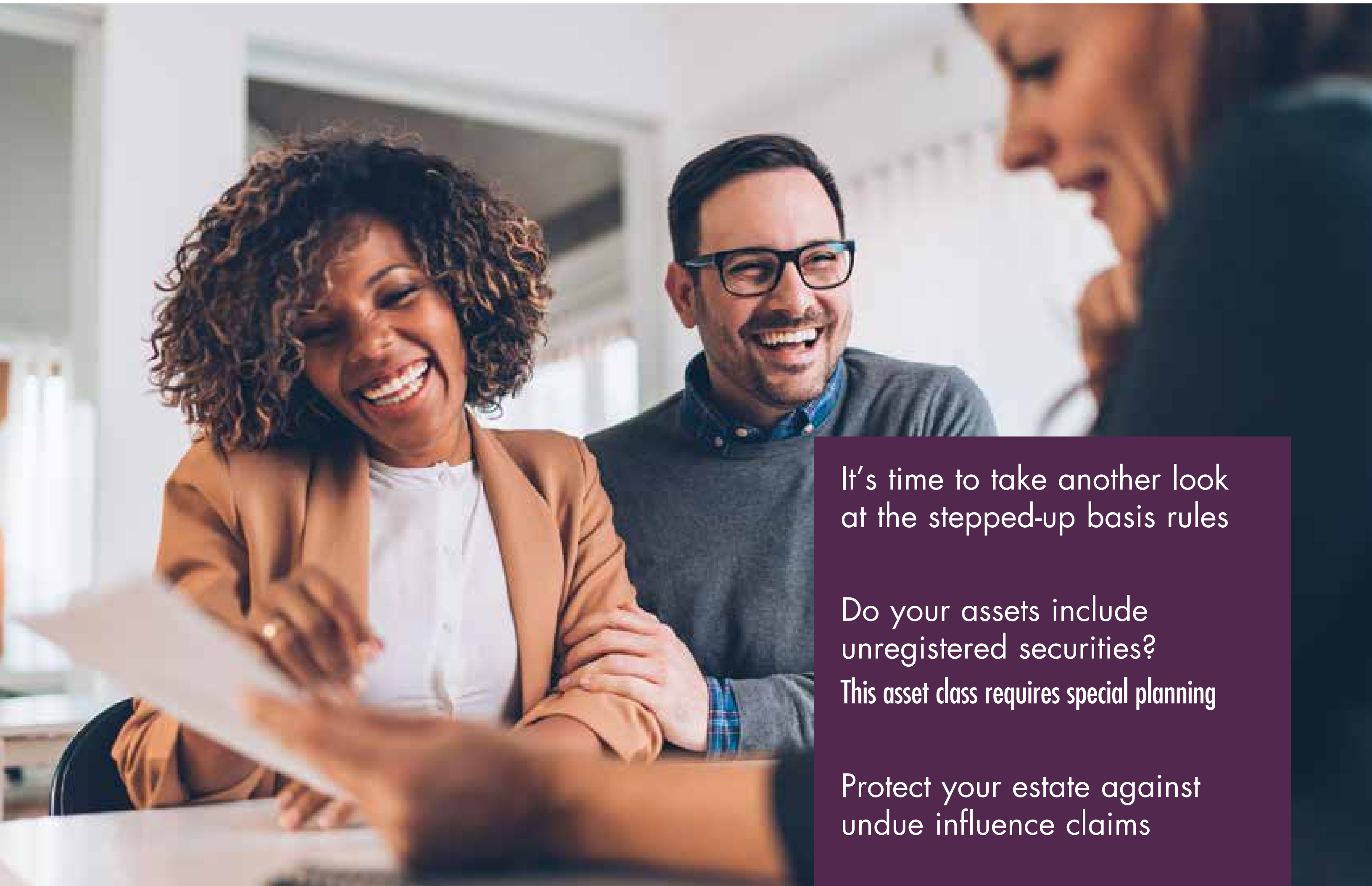
INSIGHT ON ESTATE PLANNING



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ESTATE PLANNING PITFALL
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It’s time to take another look at the stepped-up basis rules

Thanks to a generous federal gift and estate tax exemption amount ($13.61 million for 2024), only the wealthiest of families are exposed to estate tax liability. For many, this means that estate planning now has a stronger focus on income tax planning. And one of the most valuable tax planning areas is the “stepped-up basis” rules.

Capital gains rules

Normally, when assets such as securities are sold, any resulting gain is a taxable capital gain. If the assets have been owned for longer than one year, the gain is taxed at favorable rates. The maximum tax rate on a long-term capital gain is 15% but increases to 20% for certain high-income individuals.

Conversely, a short-term capital gain is taxed at ordinary income tax rates, as high as 37%. Gains and losses are accounted for when filing a tax return, so high-taxed gains may be offset wholly or partially by losses.

The amount of a taxable gain is equal to the difference between the basis of the asset and the sale price. For example, if you acquire stock for $10,000 and then sell it for $50,000, your taxable capital gain is $40,000.

These basic rules apply to capital assets owned by an individual and sold during his or her lifetime. But a different set of rules apply to inherited assets.

Tax angles of making lifetime gifts

One way to reduce estate tax liability is to make lifetime gifts to family members. Under the annual gift tax exclusion, you can give each recipient gifts valued up to $18,000 in 2024 without any gift tax ($36,000 per recipient for joint gifts by a married couple).

However, a carryover basis rules regime applies to lifetime gifts. If you give appreciated property to a family member, their basis for income tax purposes is your initial cost. For example, Charlotte bought XYZ stock for $10,000 and gives it to her son Daniel when it’s worth $15,000. Daniel sells it for $16,000, so he owes tax on a gain of $6,000.

Conversely, if gifted property is sold at a loss, the basis is the lesser of the carried over basis or the value on the date of the gift.

Stepped-up basis rules

When assets are passed to the younger generation through inheritance, there are no income tax implications until the assets are sold. For these purposes, the basis for calculating gain is “stepped up” to the value of the assets on the date of death. Thus, only the appreciation in value since the individual inherited the assets is subject to tax. The appreciation during the deceased’s lifetime goes untaxed.

Assets affected by the stepped-up basis rules include securities, artwork, bank accounts, business interests, investment accounts, real estate and personal property. However, these rules don't apply to retirement assets such as 401(k) plans or IRAs.

To illustrate the benefits, let's look at a simplified example. Alan bought XYZ Corp. stock 10 years ago for $100,000. In his will, he leaves all the XYZ stock to his daughter, Barbara. When Alan dies, the stock is worth $500,000. Barbara's basis is stepped up to $500,000.

When Barbara sells the stock two years later, it's worth $700,000. Thus, she must pay a maximum 20% rate on her long-term capital gain. On these facts, Barbara has a $200,000 gain. With the 20% capital gains rate, she owes $40,000. Without the stepped-up basis, her tax on the $600,000 gain would be $120,000.

What happens if an asset declines in value after the deceased acquired it? The adjusted basis of the individual who inherits the assets is still the value on the date of death. This could result in a taxable gain on a subsequent sale if the value rebounds after death or a loss if the value continues to decline.

Take caution when using a grantor trust

An intentionally defective grantor trust (IDGT) is a popular estate planning tool that allows you to remove assets from your estate for estate tax purposes while continuing to be treated as their owner for income tax purposes. As a type of irrevocable trust, an IDGT allows you to shield all future appreciation in the assets' value from estate tax, while continuing to pay the trust's income taxes, further reducing the size of your taxable estate.

Some experts have argued that because assets gifted to an IDGT remain taxable to the grantor for income tax purposes, they're entitled to a stepped-up basis in the hands of beneficiaries. However, in Revenue Ruling 2023-2, the IRS clarified that assets in an IDGT aren't received by bequest, devise or inheritance and, therefore, aren't eligible for a stepped-up basis.

An uncertain future?

The stepped-up basis rules can be complex. And it's worth noting that in 2021, the Biden administration tried, but failed, to eliminate what it called the "stepped-up basis loophole" for single taxpayers with capital gains greater than $5 million. If President Biden wins reelection in 2024, the rule may again be in question. Turn to your estate planning advisor to answer your stepped-up basis rules questions. •

Do your assets include unregistered securities?

This asset class requires special planning

When it comes to estate planning, addressing all your assets should be a priority. However, certain assets require greater attention than others. For example, if your assets include unregistered securities, such as restricted stock or interests in hedge funds or private equity funds, you must consider the securities law implications of various estate planning strategies.

Securities law 101

The federal securities regulation regime consists of four main laws:

- The Securities Act of 1933, which is designed to protect investors by imposing registration and disclosure requirements on public offerings of stock. Several exemptions from the requirements exist, including private placements that meet certain specifications.
- The Securities Exchange Act of 1934, which applies to trading of securities in the secondary market and prohibits some activities, including insider trading, fraudulent trading and market manipulation.
- The Investment Advisers Act of 1940, which requires investment advisors to register with the U.S. Securities and Exchange Commission (SEC) and comply with certain regulations designed to protect investors.
- The Investment Company Act of 1940, which obligates investment companies (such as mutual funds, closed-end funds and unit investment trusts) to register with the SEC and comply with applicable regulations. There's an exemption from these demands — typically relied on by hedge funds and private equity funds — for companies that don't make public offerings of their securities and limit participation in the fund to either 1) no more than 100 investors, or 2) qualified purchasers.

To avoid the time and expense of registering a securities offering with the SEC, many companies take advantage of an exemption that allows them to raise capital in an unregistered offering. The most commonly used exemption is Regulation D, Rule 506, which exempts offerings of an unlimited amount of securities, provided several conditions are met. These include limiting purchasers to 1) any number of "accredited investors" (see below), plus 2) up to 35 nonaccredited, "sophisticated investors." Purchasers in these transactions receive "restricted securities," sales of which are subject to holding periods, volume limitations and other restrictions.

Transferring securities

Transfers of unregistered securities, either as outright gifts or to trusts or other estate planning vehicles, can raise securities law issues. For example, if you gift restricted securities to a child or other family member, the recipient may not be able to sell the shares freely. A resale would have to qualify for a registration exemption and would likely be subject to limits on the amount that can be sold.

If you plan to hold unregistered securities in an entity — such as a trust or family limited partnership (FLP) — be sure that the entity is permitted to hold these investments. The rules are complex, but in many cases, if you transfer assets to an entity, the entity itself must qualify as an "accredited investor" under the Securities Act or a "qualified purchaser" under the Investment Company Act. And, of course, if you plan to have the entity invest directly in such assets, it will need to be an accredited investor or qualified purchaser.

Accredited investors include certain banks and other institutions, as well as individuals with either 1) a net worth of at least $1 million (excluding their primary residence), or 2) income of at least $200,000 ($300,000 for married couples) in each of the preceding two years.

A trust is an accredited investor if:

- It's revocable, the grantor is an accredited investor, and certain other requirements are met,
- The trustee is a bank or other qualified financial institution, or
- It has at least $5 million in assets, it wasn't formed for the specific purpose of acquiring the securities in question and its investments are directed by a "sophisticated person."

FLPs and similar family investment vehicles are accredited if 1) they have at least $5 million in assets and weren't formed for the specific purpose of acquiring the securities in question, or 2) all its equity owners are accredited.

Turn to your advisor

As you've read, securities laws can be complex, and a full discussion of them is beyond the scope of this article. If your assets include unregistered securities, your financial and estate planning advisors can be invaluable resources to help ensure your plan follows all the rules. •

Protect your estate against undue influence claims

It's your will, so you can say whatever you want to say in it, or change any part of it, whenever you want to, right? Well, not quite. First, you're bound to follow the prevailing laws of your state. Second, your will could be contested based on a claim that someone exercised "undue influence" over your decisions. Thus, your estate planning intentions, valid or not, may be defeated.

Undue influence defined

Undue influence is an act of persuasion that overcomes the free will and judgment of another person. It may include exhortations, insinuations, flattery, trickery or deception.

Frequently, undue influence occurs when an older individual is convinced by an heir to change provisions in his or her will that suddenly reward the family member. This type of deceit often is alleged by the children of a divorced parent who claim that the spouse of a second marriage has convinced the parent to "cut them out of the will" or reduce their inheritances. It may also arise when a caretaker starts to call all the shots for an ailing patient.

Conversely, not all influence is "undue." For instance, it's perfectly reasonable for a child or close friend to advise an elderly person to sell off assets that have peaked in value or a vacation home that's no longer being used. In the event of a challenge, it's usually up to a court to decide if the "suggestion" constitutes undue influence.

Assuming you're still of sound mind, there are steps you can take now to protect your estate against undue influence claims.

Elements of undue influence

Generally, an interested party with legal standing lodges a claim for undue influence when a deceased person's will is being probated. To be successful, the claimant must prove certain elements, such as:

- The will distributes assets in a way that wouldn't be reasonably anticipated. For instance, the will might leave out close family members without any explanation, while including virtual strangers.
- The deceased relied on or trusted the person who allegedly exerted undue influence.
- The deceased's physical or mental condition made them susceptible to undue influence.
- The accused person benefits from changes in the will or some other suspicious transaction.

Assuming you're still of sound mind, there are steps you can take now to protect your estate against undue influence claims. These suggestions may ensure that the objectives in your will are met:

Transfer assets to a revocable living trust. Because this trust type is exempt from probate, it's less likely that its provisions will be challenged than bequests made under a will. In addition, the trust can accomplish additional estate planning objectives.

Establish your competency. The best way to do this is to create your estate plan while you're still in reasonably good health. Arrange for a physical examination around the time your will is being drafted. This is equivalent to a physician "signing off" that you're competent (at least at that time).

Discuss your intentions with your family. Claims of undue influence may arise when relatives are blindsided after you're gone. Let them know your intentions as soon as possible and explain your reasoning. Your will or a letter of instruction detailing your wishes can corroborate these discussions.

Consider the optics. Be sure to distance yourself, when appropriate, from someone who might be accused of undue influence. For example, if you're leaving money to a caretaker who's not a relative, don't have that person witness the signing of your will or other estate planning documents.

As a last resort, add a "no-contest clause" to your will. This provision penalizes someone for unsuccessfully contesting the content of your will.

There are no guarantees

If your estate plan leaves any family members less of an inheritance than they expect, there's a risk they'll contest it. Although there's no guaranteed way to protect your plan, the strategies discussed above can minimize the chances that a disgruntled beneficiary will challenge your plan in court. •

ESTATE PLANNING PITFALL

You don't file a gift tax return

Thanks to the annual gift tax exclusion, you can systematically reduce your taxable estate with little effort. Plus, you typically don't have to file a gift tax return. However, in certain situations, a gift tax return may be required or recommended.

The annual gift tax exclusion for 2024 is $18,000 per recipient (up from $17,000 for 2023). So, for example, Jane can give each of her three children and seven grandchildren $18,000 in 2024, for a total of $180,000, without any gift tax liability. No gift tax return is required for these gifts.

Furthermore, if your spouse consents to a "split gift," you can jointly give each recipient up to $36,000 in 2024. However, when making split gifts, you must file a gift tax return (unless you reside in a community property state). Similarly, if your gift exceeds the annual gift tax exclusion amount, the federal gift and estate tax exemption ($13.61 million for 2024) may shelter the excess from tax if a gift tax return is filed.

The failure to file a required gift tax return may result in a penalty of 5% per month of the tax

due, up to 25%. Bear in mind, though, that you might file a gift tax return even if you're technically not required. The return establishes the value of assets for tax purposes and provides a measure of audit protection from the IRS.

If you file a gift tax return and honestly disclose the value of the gifts, a safe-harbor rule prohibits audits after three years. But the safe-harbor rule doesn't apply in the event of fraudulent statements or inadequate disclosure.

The due date for filing a gift tax return for 2023 is April 15, 2024, the same due date for filing individual income tax returns. (If you file for an extension, the filing due date is October 15, 2024.)

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