Halliday Private Trust
Integrated Trust Solutions for Clients

Trust Connection

A Monthly Report of Trust News and Information

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Welcome to *Trust Connection*, our monthly newsletter highlighting Trust news and information. Each month we will feature timely articles of interest.

About Us

At Halliday Private Trust, it is our mission to assist our clients in the process of providing solutions, specifically through a wide range of financial advice.

Since 1982, we have utilized a full spectrum of financial services to help our clients navigate every major hurdle in their financial lives. Because we are an independent financial services firm, we utilize an open architecture approach to locating the most suitable investment options for our clients.

Our role is to help clients make smart decisions about their money. We understand that each client has unique needs and requires personalized solutions based on their goals, objectives and concerns.

The Basis of All Things: How and When Cost Basis Transfers

Cost basis awareness and management has recently risen dramatically in importance for a number of reasons. Among those reasons is the quick rise of the estate tax exemption, which now stands at $5,450,000 and shields 99.87 percent of Americans from the prospect of having an estate tax. Additionally, the virtual parity of the top estate tax rate and income tax rate proposals to raise capital gains to the levels of the top income tax rate as well as the effects of the Net Investment Income Tax could actually tax capital gains at a higher rate than the estate tax. Even at current rates, with no taxable estate, the capital gains tax has become the only tax to manage in intra-family transfers.

So What is Basis?

Essentially, cost basis in property is one's financial investment in property. One's labor and efforts are generally not counted toward this number, but cost of materials and hiring others to do the work is added to basis. This gives us the concept of adjusted cost basis, because the original "cost" of acquisition may be adjusted for capital changes made to the property. This would not include maintenance, but does include capital improvements. Likewise cost basis can "adjust" downward, through depreciation or depletion. With these changes and adjustments, one can understand that records need to be kept and certain events need to be recorded to ensure one can prove correct cost basis on property for determining capital gain or loss. Working with experienced tax professionals is recommended.

Gifts

When assets are given away during life, the cost basis of those assets generally stays the same from the donor to the donee, but there are notable exceptions, such as when the donee has no cost basis information. The 709 Federal Gift Tax Return, a tool that can be used to record the basis, has a column devoted to requesting the basis of property given away. It has no function in determining the gift tax; it is simply a recording device to help donors.

The general rule that cost basis of gifted assets is carried from the donor to the donee may not apply when property is given at a loss. When property has a cost basis higher than the fair market value on date of gift, the cost basis will depend on the sale price. If the property is sold at a value above the donor's cost basis, then the donor's original basis is used. When the property is sold below the fair market value on date of gift, then that lower value is used. When the sale is between the donor's original value and the value on the date of the gift, there is neither gain nor loss. In that instance, the cost basis is not known until the sale of the property. As a result of this rule, it would generally be better to sell the property so the donor can take the loss and

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give away the proceeds. This may not be desirable when the asset is a family business or heirloom with which the parties do not wish to part.

The Gift Tax Return

Filing of form 709 is required when a potential taxable gift is made. No gift tax return is required to report gifts fully covered by the annual exclusion, tuition and medical expenses exclusion, the marital deduction, or the charitable deduction. When a combination of these is utilized, however, a return is required. For example, a charitable remainder trust may be created with no taxable transfer if the donor and spouse are income beneficiaries and a charity is the remainder beneficiary. However, a return must be filed to value each interest. The same would apply for marital gifts where an election is required, such as a lifetime QTIP trust, or a QDoT for a non-citizen spouse. And, while not basis related, a gift tax return must be filed when funding a 529 plan with five years' worth of annual exclusion gifts. It may be advisable to file, even when not required, in order to start the statute of limitations running on the value of hard-to-value assets, or assets discounted for valuation purposes, such as minority interests in a Family Limited Partnership. This could also be true to substantiate the use of numerous annual exclusion gifts made in the same year.

Treatment in the Estate

When property is acquired from a decedent, we often say it "steps up" in basis, which is true if we assume the property has risen in value. In fact, it can "step down" in basis as well. The cost basis becomes the estate tax value, which may cause several traps as well as reveal several opportunities. As with the gift tax return, there are times when filing the return is recommended, even when not required. Hard-to-value assets and discounted assets are two easy examples of when it's recommended to file a return; another example is filing a gift tax return to establish the cost basis, commence the running of the statute of limitations and allow an election to use a spouse's exemption amount under portability rules. Moreover, filing a gift tax return provides a record to the heirs, who otherwise may have no documentation of cost basis when they eventually sell the gifted property. That said, the basis adjusts at death regardless of whether a return is due, filed, or required to be filed. In other words, the assets of non-taxable estates still receive a basis adjustment. In addition, even property not subject to U.S. estate tax gets a basis adjustment at the death of the owner (e.g. property in the estate of non-U.S. resident, non-U.S. citizen with no U.S. ties, who leaves their estate to their children in the U.S.).

In community property states where both spouses' shares step up in basis upon the death of one spouse, the shares will be subject to cost basis rules at the death of that spouse. The same is true for elective community property in states where a couple in a non-community property state places assets in another community property state and elects to treat it as community property under that state's statutes. This can create opportunities to reduce or eliminate capital gains tax on a subsequent sale. Additionally, when death appears imminent and when property may step down in basis at the death, the sale of that property prior to death would capture the loss for use on a final income tax return. There are also potential issues related to the use of Alternate Valuation Date and the Special Use Valuation Rules to reduce the estate tax valuation. While reducing estate tax, the lower reported figure will, however, establish a lower basis for capital gains tax later. In generation-skipping situations, direct skips and taxable distributions generally follow the gift rules (cost basis carries over), whereas when a taxable termination occurs and a GST tax is imposed, the basis is adjusted as it would be under the estate rules.

Income in respect of a decedent (IRD) may be an issue as well, most often because of qualified retirement plans and traditional IRAs being included in the estate. IRD receives

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no basis step-up because, at the date of death, it has not yet been taxed ordinary income. Even when IRD is basis related (e.g. the net unrealized appreciation from employer securities withdrawn from a plan), there is still no step-up in basis at death.

An area where there is not clear guidance is in the reacquisition of property from a spouse within a year of death. This basic rule is clear: A donor may transfer any amount to their spouse without gift tax, or even a responsibility to report the transfer on a gift tax return because of the unlimited marital deduction. The reacquisition of that same property within one year of the donor's death should not receive a step-up in basis. This is a measure to avoid contemplation of death transfers solely for the purpose of obtaining a step-up in cost basis. This becomes more complicated when the "reacquisition" is not direct, such as when the assets are left to a trust for the benefit of the original donor's spouse. It seems a marital trust for the exclusive benefit of the spouse would fall under the same rules, but what about a family trust in which the spouse is only one of multiple permissible discretionary beneficiaries? To play it safe in such an instance, it may be wise to use a trust protector who later adds the spouse as a beneficiary, but with no preconceived plan to do so. In these cases it would seem the property does not fall under the "reacquired" criteria, but guidance is scant. In this case, pre-death planning should be considered where low-basis assets pass into trusts without spousal interests.

One more unintentional basis error that may be made is when beneficiaries sell their interest in a trust, such as the income interest in a Charitable Remainder trust, and trigger gain on 100 percent of the sale price. An interest in a trust has no basis unless all of the interests are subject to the sale. Under a deemed sale scenario, cost basis will need to be determined and will trigger the application of cost basis rules.

Proving Basis

On a positive note, contrary to popular belief, the basis of property is not zero if the taxpayer cannot prove the actual cost basis. While the duty does fall on the taxpayer, and the taxpayer should provide proof of due diligence, Internal Revenue Code section 7491 then shifts the burden to the IRS. A sophisticated guess may be as close as anyone comes, but that does not make the basis zero.

Summary

With all the recent discussions of portability of the estate tax exemption to surviving spouses, manufacturing basis in long-term trusts, and getting a second step-up in basis, an understanding of how basis is established is important. Hopefully this leaves you better prepared both to maintain accurate records as well as engage regularly with a team of professionals who can help you take advantage of the rules and avoid the traps along the way.

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A LOCAL TRUST SOLUTION

Call us today at (800) 786-1598 to learn more about working with Halliday Private Trust.

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