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.

Basics of Cost Basis

Any time an asset is sold, whether it be stock, real estate, or another investment asset, the gain or loss on the sale will be determined by calculating the difference between the cost basis and the amount for which the asset is sold. Generally, the cost basis is the purchase price, leaving out exceptions for adjustments.

If the asset was purchased for less than the selling price, there will be a gain. In a very simple example, if a client purchases an investment for $10,000, the cost basis will be $10,000. If the asset is then sold for $12,000, the gain is $2,000 ($12,000 sale price minus the $10,000 purchase price). The new purchaser of the asset would have a cost basis of $12,000. If the new purchaser then sold the asset, their gain or loss would be calculated based on the value of the asset sold minus $12,000.

But what happens with inherited assets? Or assets transferred to a trust? Or assets owned by a trust at the death of the grantor? Below is a brief overview of the basic cost basis rules in different scenarios involving trusts and estates.

Outright Ownership by the Decedent
Non-retirement assets such as a brokerage account, a home, antiques, art, collectibles, or other real estate will generally be eligible to receive a step-up in cost basis at the death of the owner. The inheritor of the asset will then own it with a basis equal to the value of the asset at the date of the owner's death. Assuming the value of the asset is greater than the cost basis, any gain or loss on later disposition of the asset will be calculated based on the stepped-up basis.

Retirement accounts and IRAs do not receive a stepped-up basis. This is why it is sometimes more advantageous to leave a brokerage account to heirs instead of a retirement account.

Assets Owned in a Trust
Determining the basis of assets held in trust depends on three factors: whether the trust is revocable or irrevocable, the trust's tax identification number, and whether or not the assets are included in the grantor's estate. At a high level, if the asset is part of the decedent's estate, it is typically eligible for a step-up. Assets that bypass the estate through a trust or another mechanism are usually not eligible for a step-up in basis.

If the asset was held in a revocable (or living) trust before the owner died, it will likely be eligible for a step-up in cost basis. With respect to a revocable trust, because the grantor retains full control of the assets in the trust, the cost basis calculation is the same as if the grantor owned the assets outright.

When a revocable trust is funded by a grantor, the assets continue to be treated as the grantor's own for tax purposes. Upon the grantor's death, the trust assets are included in the grantor's estate and

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receive a new basis equal to the fair market value (FMV) on the date of the grantor's death or an alternate valuation date. The trust then becomes irrevocable, and when the assets are distributed to the beneficiaries, the basis is carried over—meaning the beneficiaries' basis is the trust's adjusted basis.

For assets held in irrevocable trusts, the basis depends on whether the trust is deemed a grantor trust. An irrevocable trust is a grantor trust when the trust continues to use the grantor's tax identification number. While the assets are removed from the estate for estate tax purposes, the grantor continues to be liable for the trust's income taxes. The trust assets will carry over the grantor's adjusted basis, rather than get a step-up at death.

Assets held in an irrevocable trust that has its own tax identification number (such as nongrantor trust status) do not receive a new basis when the grantor dies.

Assets in a QTIP (Qualified Terminable Interest Property) marital trust also get a new basis upon the death of the surviving spouse because the assets are included in the surviving spouse's estate upon death.

The Impact of Transfer Taxes
There are two types of transfer taxes that can be relevant to trusts: the gift tax and the estate tax.

Gift tax, which is applied at the time of a gift transfer, and estate tax, which is applied at death, are different sides of the same coin. They operate together. They apply at the same rate, and the lifetime exclusion amount applies to both taxes.

Gift Tax
The cost basis of a gifted asset is generally the same as the cost basis in the hands of the donor. If, however, gift taxes are paid on the asset gifted, the basis is generally calculated based on the value of the gift and the gift tax paid. There are a number of factors that go into making this calculation, and a tax advisor should be consulted.

Not all gifts are taxable. Gifts to spouses who are United States citizens are not taxable at all. Gifts to charity, assuming they are given to tax-exempt charitable organizations, are not taxable. Moreover, the first $15,000 in gifts per year per recipient are not subject to gift tax. This is known as the "annual exclusion" amount.

Gifts not subject to any exclusion or exemption are deducted from the giver's lifetime transfer tax exclusion amount ($11.7 million in 2021). It is only once this amount has been exhausted that gifts or inheritances are subject to transfer tax.

Estate Tax and the Gross Taxable Estate
If the grantor of a trust retains certain rights over trust assets, they are considered part of his or her taxable estate, meaning that the trust assets would be subject to estate tax.

Under section 2036 of the Internal Revenue Code, if the grantor retains the use or enjoyment of property for the rest of his or her life, that property is part of his or her taxable estate. If the trust allows the grantor the right to income from the trust, that is considered use or enjoyment of the trust. Similarly, if the trust contains a house and the grantor lives there, that is considered use or enjoyment of the property, whether or not the trust specifically gives the grantor the right to live there.

Section 2038 also brings back into the grantor's taxable estate any property over which he or she retained the power to "alter, amend, revoke, or terminate." So, an estate tax planning trust must not give the grantor the power to do any of those things to the trust assets. In effect, the grantor must completely give up control over the trust assets.

If the asset is included in the decedent's taxable estate, the asset will receive a cost basis equal to the value of the asset at death or at the "alternate valuation" date. Any gain or loss on the

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subsequent disposition of that asset will be determined by the sale price minus the stepped-up cost basis.

Summary
If property is gifted, the recipient takes the cost basis of the donor.

When assets in a taxable brokerage account or a revocable living trust are inherited, the beneficiary generally receives a "step-up" in cost basis. A stepped-up basis increases the value of the asset for tax purposes to the market value at the time of death.

When the recipient sells the asset, he or she may pay capital gains taxes on the difference between the cost basis and the sale price. If the recipient sells at a loss, he or she can use the loss to offset other gains. If the loss is greater than this amount, the loss can be carried forward to use in future tax years.

What happens if the asset declined in value? Sometimes an inherited asset is worth less at death than the decedent paid for it. In that case, there will be a step-down in tax basis to the current value.

A step-up in basis is a tax advantage for individuals who inherit stocks or other assets, like a home. A step-up in basis could apply to stocks owned individually, jointly, or in certain types of trusts, like a revocable trust.

Cost basis and any advantageous step-up opportunities should be carefully considered when setting up a plan for asset transfer upon death. The rules can be quite complicated for certain types of transactions, and clients should consult a tax advisor in any case.

A LOCAL TRUST SOLUTION

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

For information and assistance, please feel free to contact one of our Trust Advisors:

- Michael F. Fleming, Esq.
- Sean S. Mohammadi

725 Glen Cove Avenue
Glen Head, NY 11545

4 Executive Park Drive
Clifton Park, NY 12065

1577 Fruitville Road
Sarasota, FL 34236

www.hallidayprivatetrust.com
(800) 786-1598