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Planning for New Basis at Death

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EDUCATION:

- University of Texas School of Law, J.D. with High Honors, 1982. Chancellors; Order of the Coif; Associate Editor, Texas Law Review; Member, Board of Advocates
- University of Arizona, B.B.A. with High Distinction, 1979. Beta Alpha Psi; Beta Gamma Sigma

OTHER QUALIFICATIONS:

- Fellow, The American College of Trust and Estate Counsel (ACTEC), (Chairman: Estate & Gift Tax Committee; Member: Business Planning, Fiduciary Income Tax, and Program Committees)
- Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization
- Adjunct Professor, University of Houston School of Law, 1988–2015, teaching Income Taxation of Trusts and Estates and Postmortem Estate Planning
- Best Lawyers in America, Trusts and Estates
- Named Best Lawyers' 2013 Houston Trusts and Estates "Lawyer of the Year"
- Named by Texas Lawyer as a 2013 "Top Notch Lawyer" for Trusts and Estates
- Admitted to Practice: State Bar of Texas; Federal District Court for the Southern District of Texas; United States Tax Court
- Certified Public Accountant, Texas, Certified 1983

PROFESSIONAL ACTIVITIES:

- Editor, ACTEC Law Journal (2012-2013)
- Member of the Board of Directors, ACTEC Foundation (Chairman: Grant-making Committee)
- Member, State Bar of Texas (Sections of Real Estate, Probate and Trust Law; Tax); Houston Bar Association (Probate, Trusts and Estates Section); The College of the State Bar of Texas; Houston Estate and Financial Forum
- Member, Texas Society of Certified Public Accountants, Houston Chapter
- Estate Planning and Probate Law Exam Commission, Texas Board of Legal Specialization (Member 1993-2003, Chair 2000-2003)

RECENT SPEECHES AND PUBLICATIONS:

- Co-Author: Streng & Davis, Retirement Planning–Tax and Financial Strategies (2nd ed., Warren, Gorham & Lamont (2001, updated annually)
- Co-Author/Panelist: Directed Trusts and the Slicing and Dicing of the Trustee's Duties, ACTEC 2014 Fall Meeting
- Co-Author/Panelist: Evaluating Portability, Potential Problems and the Post-ATRA Planning Paradigm, 40th Annual Notre Dame Tax and Estate Planning Institute
- Speaker: Basis Adjustment Planning, State Bar of Texas 38th Annual Advanced Estate Planning and Probate Course, 2014
- Co-Author/Panelist: Recipes for Income and Estate Planning in 2014, State Bar of Texas 20th Annual Advanced Estate Planning Strategies Course, 2014
- Co-Author/Speaker: Income Taxation of Trusts and Estates—Ten Things Estate Planners Need to Know, Southern Arizona Estate Planning Council, 2014
- Co-Author/Panelist: The American Taxpayer Relief Act of 2012 One Year Later, Houston Estate and Financial Forum, 2014
- Author/Speaker: Funding Unfunded Testamentary Trusts, University of Miami 48th Annual Heckerling Institute on Estate Planning, 2014; Texas Society of CPAs Advanced Estate Planning Conference, 2014
- Co-Author/Panelist: Trust and Estate Planning in a High-Exemption World and the 3.8% "Medicare" Tax: What Estate and Trust Professionals Need to Know, The University of Texas School of Law 61st Annual Tax Conference – Estate Planning Workshop, 2013; Amarillo Estate Planning Council 23rd Annual Institute on Estate Planning, 2014
- Author/Speaker: Who Is Your Spouse? The Demise of DOMA and Its Impact on Estate Planning in Texas, Attorneys in Tax and Probate (Houston), 2013
- Author/Speaker: Tax Considerations in Lawsuits and Settlements, Texas Society of CPAs Advanced Estate Planning Conference, 2013
- Co-Author/Speaker: Taxes for Trusts and Estates–New Taxes, New Rates, New Challenges, State Bar of Texas 37th Annual Advanced Estate Planning and Probate Course, 2013
- Co-Author/Speaker: Estate and Trust Planning: Why You Can't Ignore Tax Issues Despite Portability and High Exemptions, Hidalgo County Bar Association, 2013 Probate, Trust & Guardianship Law Course, 2013
- Co-Author/Speaker: Living With the "New" Estate Tax–New Taxes, New Rates, New Challenges, 18th Annual Texas Society of CPAs CPE by the Sea, 2013

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I. INTRODUCTION

Historically large federal gift and estate tax exemptions plus the availability of portability mean that for many taxpayers, estate and gift taxes are simply no longer a primary concern. At the same time, increased applicable income tax rates have brought a new focus on the importance of income tax planning. The combined effect of these changes has given rise to a new emphasis on maximizing a taxpayer's basis in property acquired from a decedent.

II. THE NEW TAX ENVIRONMENT

A. ATRA Changes to Rates and Exemptions

The American Taxpayer Relief Act of 2012 ("ATRA") was passed by Congress on January 2, 2013 and signed into law on January 4, 2013. As a result, we now have "permanent," unified estate, gift, and generation-skipping transfer tax legislation with some little twists. ATRA adjusted tax rates and made the changes to the gift, estate and GST tax exemptions first enacted in 2010 "permanent," while increasing the effective federal estate tax rate on the excess from 35% to 40%. As a result, we now have permanent unified estate, gift and GST tax laws with an exemption of $5,000,000, adjusted annually for inflation after 2010, and a top estate, gift and GST tax bracket of 40%. For 2014, after applying the inflation adjustment, the exemption is $5,340,000. Easy to remember for the dyslexic among us, the 2015 exemption is projected to be $5,430,00. At the same time, federal income tax rates were increased, for individuals, trusts and estates to 39.6% for ordinary income and 20% for qualified dividends and capital gain tax.

B. The Net Investment Income Tax

Coincidentally, although not a part of ATRA, January 1, 2013 also ushered in an entirely new 3.8% income tax. The Health Care and Education Reconciliation Act of 2010 ("HCA 2010") imposes an additional 3.8% income tax on individuals, trusts, and estates. For individuals, the tax applies to the lesser of net investment income or the excess of a taxpayer's modified adjusted gross income over certain defined thresholds. For individuals who are married filing jointly, the threshold is $250,000; for married filing separately, $125,000 each; and for single individuals, $200,000. For estates and trusts, the 3.8% tax applies to the lesser of *undistributed* net investment income or the excess of adjusted gross income over a threshold determined based on the highest income tax bracket for estates and trusts, which was $11,950 for 2013, $12,150 for 2014 and will be $12,300 for 2015. When combined with the increase in income tax rates noted above, the additional 3.8% tax on net investment income yields a top tax rate of 43.4% on ordinary income and a top tax rate of 23.8% on capital gains and qualified dividends.

C. Portability

The Tax Reform Act of 2010 added, and ATRA made permanent, the notion of "portability" of a deceased spouse's unused exemption amount. In essence, portability provides that upon the death of one spouse, the executor of that spouse's estate may file an estate tax return and elect on that return to allow the surviving spouse to effectively inherit any unused federal estate tax exemption of the deceased spouse. In other words, the deceased spouse's unused exemption amount can be "ported" to the surviving spouse. IRC § 2010(c)(2)(B). The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount," otherwise known as the "DSUE Amount." Once a spouse inherits a DSUE Amount, the surviving spouse can use the DSUE Amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE Amount from his or her "last deceased spouse." A simple example illustrates this concept.

Example 1: H dies in 2011 with an estate of $3 million. He leaves $2 million outright to his wife W, and the balance to his children. As a result, his taxable estate is $1 million ($3 million, less a $2 million marital deduction). The executor of H's estate elects to file an estate tax return using $1 million of H's $5 million estate tax exemption[1] to shelter the gift to the children, and pass (or "port") the other $4 million of H's estate tax exemption to W. W would then have an estate and gift tax exemption of $9 million (her own $5 million exemption plus H's unused $4 million exemption).

As a result, married couples can effectively shelter up to $10.86 million (using 2015 figures) in wealth from

[1] Although the surviving spouse's exemption amount would be adjusted each year for inflation, the $4 million DSUE amount would not. Unless stated otherwise, this outline assumes a $5 million exemption without adjustment for illustration purposes, to make the math easier.

federal gift or estate tax without utilizing any sophisticated estate planning techniques.

III. WHAT IS BASIS?

Basis is a fundamental concept in income tax planning. A taxpayer may recognize taxable income whenever he or she sells assets at a gain. Gain is measured by the excess of the amount realized from a disposition of property over the taxpayer's adjusted basis in that property. IRC § 1001. In general, a taxpayer's basis in an asset is measured by its cost, with certain adjustments. IRC §§ 1012, 1016. However, a special rule applies if the property in question is acquired from a decedent. IRC § 1014(a).

A. Basis in Property Acquired from a Decedent

With a few exceptions, the basis of property in the hands of a person acquiring the property from a decedent, or to whom the property passed from a decedent, is equal to: (i) the fair market value of the property at the date of the decedent's death; (ii) if an "alternate valuation date" election is validly made by the executor of the decedent's estate, its value at the applicable valuation date prescribed by Section 2032 of the Internal Revenue Code (the "Code"); and (iii) if a "special use valuation" election is validly made by the executor of the decedent's estate, its value for special use valuation purposes prescribed by Section 2032A of the Code. IRC § 1041(a). In short, then, in most cases, the basis in property inherited from a decedent is the value of that property for federal estate tax purposes. Although often called a "step-up" in basis, various assets may be stepped up *or down* as of the date of death. Therefore, it is more accurate to call it a basis adjustment. Original basis is simply ignored and federal estate tax values are substituted. The adjustment to the basis of a decedent's assets occurs regardless of whether an estate tax return is filed, and regardless of whether the estate is even large enough to be subject to federal estate tax.

B. What Property is "Acquired from a Decedent"?

Most people think of property "acquired from a decedent" as simply property passing to them under the Will of a deceased person. For purposes of fixing basis, however, the Code lists ten separate methods by which property can be acquired from a decedent. Some of the listed methods contain effective dates that have since past, which make parsing the statute somewhat difficult. In summary, the current list includes the following seven items:

1. Inherited Property. Property acquired by bequest, devise, or inheritance. The statute makes clear that the basis adjustment applies not only to beneficiaries, but also to the decedent's property held by his or her estate. IRC § 1014(b)(1).

2. Revocable Trust Property. Property transferred by the decedent during his lifetime and placed in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust. IRC § 1014(b)(2).

3. Property with Retained Right to Control Beneficial Enjoyment. Property transferred by the decedent during his lifetime and placed in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust. IRC § 1014(b)(3).

4. Property Subject to a General Power of Appointment. Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by Will. IRC § 1014(b)(4).

5. Both Halves of Community Property. Property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate. Thus, unlike the surviving spouse's separate property, *both halves* of a couple's community property receive a new cost basis upon the death of either spouse. IRC § 1014(b)(6).

6. Other Property Includable in the Decedent's Gross Estate. Property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate for estate tax purposes. IRC § 1014(b)(9).

7. QTIP Property. Property includible in the gross estate of the decedent under Code Section 2044 (relating to property for which a "QTIP" marital deduction was previously allowed). IRC § 1014(b)(10).