

Income Tax Basis Planning Using Your  
Estate Planning Family Limited Partnership

by

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He has presented papers for the University of Miami Heckerling Institute on Estate Planning, the University of Southern California Tax Institute, the Southern Federal Tax Conference, and the New York University Institute on Federal Taxation, among others. He participated in several bar association projects, including the Drafting Committee for the Revised Uniform Partnership Act and preparing the ABA's comments on the IRS's proposed private annuity regulations.

He received his BA and MBA from the University of Michigan and a JD from the University of Buffalo Law School. He was with the Office of Chief Counsel, Internal Revenue Service, Washington, D.C. from 1970 to 1975, and was a full-time law professor from 1975 to 1994, teaching at the University of Miami School of Law and the Albany Law School, Union University. He is currently an adjunct professor of law, teaching courses at the Florida International University Law School, the Graduate Program in Estate Planning at the University of Miami, the On-Line LL.M. Program at the Boston University Law School and the Vanderbilt Law School.

## Abstract

*With the reduction of the top estate tax rate to 40%, and the highest marginal income tax rates approaching the estate tax rate, or even exceeding the estate tax rate, especially when state income taxes are considered, the concern has now shifted to whether an individual should retain ownership of appreciated assets at death to obtain the income tax-free step-up in basis at death.*

*The first part of this presentation will evaluate the factors to examine in deciding whether to shift assets with built-in gain, and assets with the potential for appreciation in value, out of the estate.*

*The second part of this presentation will examine the available techniques that can be used to bring appreciated assets in grantor trusts that are not exposed to the estate tax back into the decedent's gross estate without increasing the value of the taxable estate.*

*The third part of this presentation will examine how to use the existing family limited partnership to borrow basis from partnership assets the partnership does not intend to sell and transfer that income tax basis to an appreciated asset one intends to sell before death to reduce and possibly eliminate the built-in gain. As part of this analysis, we will examine the impact that borrowed basis has on the partnership's remaining assets.*

### **I. Introduction**

#### *A. Before 2013 and After 2012.*

In the past, the successful estate plan transferred assets out of the decedent's taxable estate to avoid an estate tax that was as high as 55%. The ability to avoid the estate tax came at an income tax cost because only assets included in a decedent's gross estate received the income tax-free set-up in basis at death. When the highest Federal capital gain rate was only 20% and state income taxes ranged from 0% to 13.3%, the costs of paying Federal and state income taxes was far less than the estate tax cost under a 55% estate tax rate so that shifting appreciated assets out of the taxable estate was preferred.

Example: The family owned a long-term investment asset valued at \$1,000,000 with an income tax basis of zero.

If the asset is not included in a decedent's gross estate, the only tax cost is the income tax on a \$1,000,000 long-term capital gain. If the combined Federal and state income tax rate is 25%, the income tax would be \$250,000.

If the asset is included in a decedent's gross estate, the estate tax cost would be \$550,000 and there would not be any income taxes if the asset is sold for its \$1,000,000 value.

As the above example illustrates, under the old paradigm, the overall tax savings by shifting the asset outside of the decedent's gross estate is \$300,000 (\$250,000 of income taxes instead of \$550,000 of estate tax). If there is no intention to sell the appreciated asset after the decedent dies, the income tax cost is not a factor, although future depreciation is lost, so that saving estate taxes is preferred.

Today, with the 3.8% tax surcharge and the reduction of the estate tax rate to 40%, the spread between the estate tax and the income tax has narrowed considerably. In states like California, with a 13.3% income tax rate, and other high income tax jurisdictions like New York City, the difference has been narrowed to a point where paying the estate taxes may be preferred. And, with the indexed \$5,000,000 exemptions, a family can have over \$10,000,000 in assets without any estate tax and still obtain the income tax-free step-up in basis at death.

**Example:** D owns a long-term capital asset as a passive investment. It is valued at \$1,000,000 with a zero income tax basis. D lives in California. The combined income tax rate is 37.1%, computed as follows:

20%	Regular Tax
3.8%	Surcharge
<u>13.3%</u>	State Tax <sup>1</sup>
<u>37.1%</u>	

If the asset owned by the decedent was intellectual property (the "IP") in the hands of the creator,<sup>2</sup> then the gain in the sale of the IP would not be eligible for the capital gain preference, and the combined income tax rate would far exceed the estate tax rate.

**Example:** D created a valuable process that is not a capital asset as to D. The value is \$1,000,000, and, as a self-created intangible, its tax basis is zero. D is a resident of California. Since D created the IP, the gain is not exposed to the 3.8% Medicare surcharge. The combined effective income tax rate is 52.9% computed as follows:

39.6%	Regular Tax
<u>13.3%</u>	State Tax
<u>52.9%</u>	

In this situation, there is an overall 12.9% tax savings if the IP is included in the decedent's gross estate and its value is taxed at 40%.

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<sup>1</sup> D probably cannot use the itemized deduction for state income taxes because D is subject to the alternative minimum tax.

<sup>2</sup> § 1221(a)(3) commonly referred to as intellectual property.

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