Incorporating Income Tax and Basis Planning Into an Estate Plan

By William E. Sigler

For many years, one of the primary goals of estate planning has been the minimization of federal estate tax. However, this has been slowly changing in recent years. Between 1997 and 2017, the federal estate tax exemption increased from $600,000 to $5,490,000. Under the Tax Cuts and Jobs Act, the exemption has now doubled to almost $11.2 million per person ($22.4 million for married couples). It will remain at that level until January 1, 2026, when the provision doubling the exemption sunsets.

The cumulative effect of these changes is that fewer people than ever before will be subject to federal estate tax. As a consequence, personal and family concerns and other tax issues are increasingly driving the estate planning process.

INCOME SHIFTING

For example, a client who is funding tuition costs for a college aged child, or support costs for a parent in an assisted living facility or nursing home, might consider approaches to shift the client's ordinary income and capital gains to the child's or parent's lower rate. This can be accomplished through a "sprinkling" or "spray" trust that gives the trustee discretion to distribute income and principal in different amounts among the various beneficiaries.

Another possibility would be to use a family limited partnership. The IRS' attacks on family limited partnerships have focused primarily on their use as a means of reducing federal estate tax. For most clients, the federal estate tax issues surrounding family limited partnerships have become moot. However, family limited partnerships remain a viable tool for shifting income to lower-bracket family members without giving up control over the underlying assets or family business. For instance, a client with rental properties might place them in a family limited partnership and use the annual gift tax exclusion, combined with Crummey withdrawal rights, to gradually transfer the limited partnership interests into a spray trust for the client's descendants.

BASIS PLANNING

The cost basis of assets is generally adjusted up to their fair market value at the time of death. In the past, clients tried to reduce asset values to minimize federal estate tax. As a result of the higher federal estate tax exemption, clients may now want to increase the value of their assets to obtain a higher basis step up. For example, instead of a chronically ill parent transferring majority control of the family business to the spouse or children in order to get minority and lack of marketability discounts, additional basis may be obtained by transferring a controlling interest to a chronically ill family member.

Sales of business interests to employee stock ownership plans ("ESOPs") also fit neatly into basis planning. If the ESOP sponsor is a C corporation, then under Code § 1042 the shareholders selling their shares to the ESOP may elect to defer the recognition of gain on the sale if the following requirements are satisfied:

1. The ESOP owns at least 30% of the shares of the corporation following the sale;

2. The selling shareholder held the shares for at least three years prior to the sale; and

3. The selling shareholder uses the sale proceeds to purchase qualified replacement property ("QRP"), which generally means any security of a domestic operating corporation.

The gain is deferred as long as the selling shareholders continue to hold their QRP. If a shareholder dies while holding the QRP, then the QRP receives a stepped-up tax basis with the consequence that the gain realized on the sale of the shares to the ESOP is never recognized.

If the company is an S corporation, then §1042 does not apply. However, the company may revoke its S corporation election. The company may re-elect S corporation status after five years or request a waiver from the IRS to re-elect S corporation status before the five year waiting period expires.

ESTATE DEFECTIVE TRUSTS

An intentionally defective grantor trust is a trust designed to cause the trust's income to be taxed to the grantor while making the transfer of assets to the trust a completed gift for estate tax purposes. These kinds of trusts have been very popular, particularly in the family business context, as a means of getting appreciation in the business out of the parents' estate. Structuring the transactions as sales avoids gift tax problems, and because the trust is a grantor trust no gain is recognized.

With the increase in the federal estate tax exemption, instead of creating intentionally defective grantor trusts, which cause the trust's income to be taxable to the grantor while transferring the assets out of the grantor's estate, many clients may now be interested in the reverse, i.e., creating "estate defective trusts." This is a trust designed with the intent that the trust income will be taxable to the trust's beneficiaries, but the trust assets will remain in the grantor's estate. This type of trust serves the combined purpose of shifting income to lower bracket family members while preserving the parents' basis step-up.

FORMULA GIFTS AND REVOCABLE TRUSTS

Many clients should consider updating revocable trusts that create sub-trusts funded according to formula clauses tied to the federal estate tax exemption. With the increased federal estate tax exemption, these trusts may be funded with significantly larger amounts than anticipated or desired. For example, revocable trusts commonly provide for a bequest to a "credit shelter trust" that includes children as beneficiaries, with the balance of the estate passing to or in trust for a surviving spouse. Those credit shelter dispositions are often defined by a formula expressed in terms of the maximum amount that can pass at death from the decedent's estate free of federal estate tax.

Amounts passing to the credit shelter trust receive a step-up in basis at the time of the grantor's death, but not again when the surviving spouse passes away. Thus, this type of formula bequest may no longer be desirable in situations where federal estate tax is not a concern, and providing for a step-up in basis at the time the assets pass to the children is a higher priority.

QUESTIONS

If you have any questions regarding the income tax situation of an estate planning client, or if you need to have their estate planning documents reviewed from an income tax perspective, please do not hesitate to contact us.