WILLMS, S.C.

MEMORANDUM

TO: Clients and Friends of Willms, S.C.

FROM: Andrew J. Willms

DATE: October 11, 2016

RE: Basis Adjustment Planning

Under current law, property that is includable in a deceased person's estate for estate tax purposes receives a basis adjustment for federal income tax purposes even if the decedent's estate is not large enough to trigger an estate tax. This adjustment results in the recipient's basis for federal income tax purposes being either "stepped-up" or "stepped-down" to the property's fair market value at the date of the decedent's death. The one exception to this rule is "income in respect of a decedent" (or "IRD") which is earned income that has not yet been taxed (i.e., retirement accounts, IRAs, annuities, deferred compensation, etc.). The basis of IRD property is not adjusted.

For example, if a person's estate includes property that at the time of death had an income tax basis of $100,000 and a fair market value of $500,000, the person who inherits that property would receive a "stepped-up" basis of $500,000. As a result, if the recipient sells the property for $500,000, capital gain taxes are not triggered by the sale, because the $500,000 sales price and the $500,000 tax basis are the same.

By comparison, property received by gift has a "carry-over" basis in the hands of the recipient. This means the basis of property received by gift is equal to the income tax basis that the donor had in the property at the time of the gift. In other words, if the same property mentioned in the earlier example were given away during lifetime, the donor's tax basis of $100,000 is carried over to the donee. Accordingly, if the recipient of the gift sells the property for $500,000, then $400,000 (the difference between the $500,000 sales price and $100,000 basis) is taxable to the donee as capital gain.

The possibility of receiving a step-up in basis is an important issue that needs to be carefully considered before making lifetime gifts and also, for married couples, when deciding how and to what extent the estate tax exemption of the first spouse to die should be used. That's because while property sheltered from estate taxes by this exemption will receive a basis adjustment when the first spouse dies, the tax basis of that property might not be adjusted when the survivor of you dies.

Property held in trust will receive a step-up in basis when the beneficiary dies if the assets of the trust are considered part of the beneficiary's taxable estate. We can include provisions in your trust agreement that will cause the assets held in trust for a child of yours to be included in the child's taxable estate and therefore eligible for a basis step-up when the child dies. This could result in your grandchildren paying less or no capital gain taxes on the assets they inherit from you when your children die. However, because this results in the trust assets being included in a child's estate, it is important to consider if a child of yours has personal assets that, when combined with the assets they will inherit in trust from you, will add up to an amount that will potentially trigger an estate tax when the child dies.

Do not be concerned if the foregoing discussion is somewhat confusing. We can help you navigate these rules. Please contact us if you would like to schedule a meeting to discuss basis adjustment planning in connection with your estate plan.

End of Memo

Information contained in this memorandum is not a substitute for professional estate planning advice nor should any information provided in this memorandum be construed as legal advice. Therefore, none of the information being provided should be relied on without seeking the advice of legal counsel or other professionals regarding the tax and non-tax consequences associated with the same.